THE FARM CREDIT COUNCIL

June 20, 2014

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RE: Standards of Conduct – RIN 3052-AC44 / Federal Register 79 (February 20, 2014) 9649-9661

The Farm Credit Council (Council), on behalf of its membership, appreciates the opportunity to comment on the Farm Credit Administration's (FCA) proposed rule published in the February 20, 2014 Federal Register addressing requirements for the banks and associations of the Farm Credit System (System) regarding standards of conduct and creating a new requirement that each institution adopt a code of ethics. We also appreciate the action taken by the FCA Board to extend the comment period until June 20, 2014.

The comments that follow were developed after soliciting input from all System institutions. Following receipt of comments, a conference call was held with a group of System representatives to discuss specific concerns. A draft comment letter was then circulated for further review and comment. Due to the significance of this proposed rulemaking to each bank and association, we anticipate that many System institutions will submit their own comments on various aspects of the proposed rule.

General Comments

The System is strongly committed to a culture of high ethical conduct and the avoidance of conflicts of interest, both real and in those situations which might create the appearance of impropriety. Several years ago all System banks voluntarily adopted codes of ethics for their institutions. We believe the current process, which focusses on "self-disclosure" has worked well. Directors and employees regard their responsibilities very seriously. The annual certification process serves to emphasize that ethical conduct is an on-going priority for all System institutions.

In a speech before a System Executive Leadership program on April 29, the FCA Board Chair described that the agency's objectives for this rulemaking is to "clarify prohibitions on lending transactions and purchase of System acquired property, and to require each System institution to adopt a code of ethics and to have an in-house standards of conduct official." As described below, we believe those objectives can be achieved, but without the uncertainty and burdensome requirements that will flow from implementation of the proposed rule.

Over the past few years there have been numerous conversations between System directors and employees and FCA regarding the importance of standards of conduct and how to ensure compliance with the existing comprehensive regulations. In August 2013

The FCA's Office of Examination issued its exam guidance for 2014. In that memorandum, the following was noted regarding System standards of conduct and compliance with the existing regulations:

- Standards of Conduct (Phase 2) – FCS directors and employees are expected to maintain high ethics and standards to comply fully with the standards of conduct (SOC) regulations (*FCA Regulation 612, Subpart A*). We examined SOC disclosures and programs in 2013. Examiners identified some SOC administration weaknesses and regulatory violations; however, very few examples of willful misconduct were identified. Where corrective actions were necessary, they were implemented through the appropriate follow-up examination and supervision programs. The identified weaknesses are largely attributed to a lack of training and understanding or ineffective SOC processes. Given these conditions, we plan to continue our SOC evaluations in 2014, update examination guidance, and provide examiners additional information to discuss SOC expectations with you. We are also contemplating additional communications to you to further define FCA expectations, best practices, and common weaknesses identified through examination activities. I encourage the board and SOC Officer to evaluate their SOC programs closely and identify and address opportunities for improvement.

We find this language from the Agency's memorandum to be inconsistent with the regulation that has been proposed. It is clear that Agency's examinations efforts have not surfaced wide spread or even a pattern of unethical behavior within the System. As exams have been completed, the System has continued to reinforce, and as appropriate, refine and improve existing disclosure and reporting processes. We believe that the process identified in the OE's examination guidance has, to the extent it may have been necessary, highlighted for System institutions those circumstances where additional training might improve technical compliance with existing regulations. .

The Agency has noted in its preamble to the rule that, "The FCA has not made significant changes to its standards of conduct regulations since 1994, and we have determined that it is appropriate to strengthen and modernize the rule." What we do not see in the regulation is recognition of just how much agriculture has changed in the last twenty years and how much System operations have changed in that time as well. Today's farm families have much broader networks of business relationships that allow them to be successful in their operations. Also, today, System institutions have substantially revised their operations so that directors are not involved directly in the approval of individual loans nor are they in a position to influence the terms set for individual loans. The regulation should consider permitting institutions to be able to opt out altogether from the type of detailed, intrusive business and family relationship reporting for directors when the institution has created a clear separation between loan making and director involvement. Such an approach would truly modernize the regulatory requirements to match with current operating realities. Instead the agency attempts to expand the reporting burden and to develop complicated definitions of modern family relationships to meet a new social reality and in doing so may do more to discourage individuals from serving in these important positions than increase protections against unethical behavior. The Agency has noted in the past that there is a need for the System's directorate to reflect today's agriculture and the marketplace. Unfortunately, the Agency then proposes regulations such as this one which tends to discourage individuals from seeking a board position due to the unreasonable and unnecessary burden of complying with these reporting requirements.

Based on our research, we have been unable to identify any other Federal financial regulatory agency that promulgated similar disclosure based standards of conduct regulations for their regulated entities. Is it reasonable to conclude from this that FCA believes that the ethical standards of farmers and ranchers and cooperative directors are somehow in need of greater scrutiny than those of commercial bank directors? Our research has also found that even with respect to standards of conduct regulations concerning third party vendors, even as it applies to the agencies themselves, in contracting with third party vendors, regulations relating to conflicts of interest are transaction specific, requiring disclosure when there is the potential for a conflict in a specific circumstance rather than a dragnet approach. . Attached is a memorandum prepared by outside counsel regarding the disclosure standards of other Federal financial regulators.

This proposed regulation fails to comply with the spirit and the provisions of Section 212 of the Farm Credit System Reform Act of 1996. Congress directed the Agency then that it was to continually review its regulations "…and eliminate, consistent with law, safety, and soundness, all regulations that are unnecessary, unduly burdensome or costly, or not based on law." The proposal increases rather than decreases the burdens and costs on System institutions, the changes are largely unnecessary and inconsistent with current operations, and the proposal has no direct basis in law since, unlike other regulated financial institutions, the Congress has not included in the Farm Credit Act specific statutory requirements that underpin these regulations.

While some general updating of the existing regulations to have them reflect changes in System operations may be appropriate, we are particularly concerned that certain aspects of the specific director reporting requirements in the proposed rule will be unduly burdensome, costly, without significant corresponding benefit and are confusing. Most System bank and association directors consider farming to be their primary occupation, and most are significantly involved in the day to day management of their farming operations. We have found that the individuals that serve on System institution boards do so primarily out of a desire to protect the System's mission as a dependable source of credit for producers, their cooperatives and rural America, not for financial gain. We urge the Agency to pay particular attention to the comments it receives from directors so as to gauge the potential that the reporting and disclosure process being proposed may discourage prospective director candidates from seeking election to their board, and existing directors from continuing to serve. Even the potential for this outcome runs directly counter to the purpose for the Act found in Sec. 1.1 (b), to continue to encourage farmer- and rancher-borrowers participation in the control of the System.

Regulatory Flexibility Act

In the Proposed Rule, FCA notes that "Each of the banks in the Farm Credit System, considered together with its affiliated associations, have assets and annual income in excess of the amounts that would qualify them as small entities." We question the appropriateness of this determination. While there may be some regulatory subjects where such a view may be appropriate, we do not consider it applicable here. Indeed, the Proposed Rule emphasizes the need for each institution to operate its own program independent of either its funding bank or other associations. Each institution will be responsible for the costs it incurs in administering the program.

"Other Guidance"

In the preamble to the Proposed Rule, FCA states that Section 612.2135 will "not be substantively changed," but goes on to note that the words "and guidance" will be added to "make clear that in addition to regulations, policy statements, instructions and procedures, directors and employees must observe…." We object strenuously to the implication that directors and employees are legally obligated to follow "guidance" and similar non-binding statements by the Agency. The role of the Agency is not to directly manage System institution operations through guidance and other policy declarations.

Moreover, Standards of Conduct regulations may not be used to thwart the requirements of the Administrative Procedure Act. In order to adopt general requirements with the force of law, the Agency must follow the notice and comment requirements of the APA. *See Appalachian Power Co. v. EPA*, 208 F.3d 1015, 1019 (D.C. Cir. 2000). For this reason, agency guidance should "not [be] improperly treated as legally binding requirements." 72 Fed. Reg. at 3433. Office of Management and Budget, *Final Bulletin for Agency Good Guidance Practices*, 72 Fed. Reg. 3432, 3433 (Jan. 25, 2007). A requirement that directors and employees "must observe . . . the letter and intent of all applicable . . . guidance" would depart from these established principles, by elevating agency "guidance" to the status of a binding legal requirement. [It could also have unintended consequences. For example, institutions may be less willing to seek the Agency's guidance if doing so is likely to subject them to additional binding requirements for which penalties can be assessed.]

As noted in out specific comments, FCA is significantly modifying many provisions relating to institution policies. In turn, it is stating that determinations made in those policies are "subject to FCA examination." If the FCA seeks to establish rules, it cannot be through informational memorandums or the examination process. Instead, it must be through rulemaking, with an opportunity for notice and comment.

Applicability of Rules Regarding Agents

The System supports maintaining the existing regulations for agents. In our review of other financial regulators' rules, we find nothing similar to what is being proposed by FCA for agents of System institutions. Indeed, we find nothing similar with respect to rules of the other financial regulators for hiring their own agents. The Proposed Rule creates a distinction between agents who are subject to their own professional standards, and those who have no set industry standards. Asking an institution's outside counsel to acknowledge receipt and review of the Code of Ethics and to certify that they will (nevertheless) adhere to their state's code of professional responsibility, which they are in any event required to abide by, creates no benefit for the organization, and is costly and burdensome. As the existing rule already provides, it is the institution's responsibility to use safe and sound business practices in retaining agents.

In those instances where institutions engage agents who are not otherwise subject to professional standards, it is appropriate to require that they maintain confidentiality of information received, and to not breach their fiduciary duties. We note the OCC in 2013 emphasized that the bank's auditor is supposed to monitor the bank's risk-management process by ensuring that conflicts of interest don't exist in selecting or overseeing third parties. (OCC 2013-29).

In the particular instance of property that has been acquired through the foreclosure process, prohibitions should only apply to those agents who have been specifically involved in the instant matter, and have knowledge thereof. It is unlikely a member of a professional accounting firm employed by the institution would have knowledge of a particular foreclosure action unless it was part of his engagement with the institution. It is even more unlikely that another partner in that firm, not engaged in representing the institution would have such knowledge.

Moreover, provided that the institution takes precautions to ensure that the property is disposed of in a manner that allows open, competitive bidding, there is no real opportunity for a conflict of interest, and no legitimate concern regarding the appearance of impropriety.

Regulatory Burden

As noted throughout this letter, the System supports a strong Standards of Conduct Program and corresponding Code of Ethics. We support clarifying the circumstances by which directors may purchase

property previously acquired through the foreclosure process. We are concerned that the proposed rule creates a "one size fits all" labyrinth for all institutions that result in an inefficient allocation of resources for many System institutions and for FCA. Requirements for prior approval of various transactions will result in the need for institutions to dedicate more personnel to the SOC function, without any commensurate benefit. Directors, virtually all of whom have other primary occupations, must be able to conduct those businesses without undue concern that they are somehow "tripping" over a rule in conducting the normal course of buying and selling that is typical of farming operations.

As noted above, FCA has made this subject area a focus area in 2014 examinations. If and when FCA observes weaknesses in this area, it can address those through its existing authority.

Specific Comments

1. Code of Ethics". As noted above, System banks, as well as some associations have already voluntarily adopted a Code of Ethics. While we do not object to this requirement, we suggest that to minimize unnecessary duplication and reporting requirements, that directors and employees acknowledge receipt as part of their annual report.

2. We believe the definition of "controlled entity" is too broad. We suggest the definition utilized by the Federal Reserve in Reg. O be adopted. (See attached outline Sec. 1.D.) We see little reason for the agency to impose a narrower definition for the purpose of this regulation.

3. We are concerned that the definition of a "family" member may be too broad. Given the additional reporting requirements placed on directors and employees, we suggest using the definition in Sec. 620.1(e) of "immediate" family members and those living within the same household as the director or employee. The new language regarding "equivalent" relationships is so ambiguous that it is not helpful and in any case should be limited to relationships of only those individuals living in the same household as the director or employee.

4. The commentary for the term "material" suggests that the "value" of a transaction may vary depending on circumstance, but then cautions that such determination would be subject to FCA examination. As noted above, most System directors conduct farming operations. FCA should recognize that what is considered "material" or "de minimus" in the context of a director's farming operation may well be different for farming operations as compared to other business activities and investments. As noted above, we have significant concern regarding the regulatory force of "other guidance". While we appreciate the Agency's attempt to provide flexibility to institutions through enabling them to establish exceptions for ongoing and normal business transactions, materiality and de minimus transactions, doing so while also establishing a process for that reasoned decision by the board to be arbitrarily overturned by examiners is questionable. Institutions need certainty that they have the ability to establish reasonable standards and if questions are raised that there is a specific process in place for them to make their case to maintain that standard before the FCA board. Examiners should not be in a position to make arbitrary decisions that lead to a patchwork of inconsistent policies across the System and this should be clear in the regulation But in any event, FCA should recognize that any revision to institution policies establishing those values following examination will, in the context of reviewing individual directors' and employees' disclosure forms, only be applied on a prospective basis.

5. The reporting requirements in Sec 612.2140 require disclosure of the name of any entity in which the director has a material financial interest or on which the director serves as a board

member, if the director has reason to know the entity transacts business with certain parties. However, the commentary to the proposed rule suggests that after a determination by the SOC, a director need not disclose certain service, such as on a chamber of commerce or a place of worship. If the board member serves on his church board (or similar governing body), unless that church transacts business with the FCS institution, we do not believe that any disclosure, or SOC determination of "insignificance" is required.

6. In Sec. 612.2145 directors are prohibited from participating in deliberations or determinations wherein they, or certain others, have a financial interest. In turn, there is an exception if the SOC makes a determination, before the conduct takes place that the action is of "general applicability to all shareholder/borrowers in a nondiscriminatory way." There is a similar prohibition for employees. We believe this standard is too narrow. Board members regularly engage in deliberations regarding loan programs, interest rate programs, disaster assistance programs, YBS programs, etc that effect classes of borrowers, but not "all" borrowers. Boards and SOC officials need to be able to use sound business judgment in such cases and recuse themselves as appropriate in each particular situation.

7. Section 612.2145 also prohibits directors from acquiring property that has been the subject of foreclosure (or similar proceedings), except in certain enumerated exceptions. One of those exceptions relates to acquisition through open, competitive bidding. Technically, if the property were acquired by the institution on January 1 of a year, subsequently sold on February 1 by the institution to a third party through open, competitive bidding, the director could not buy that property before Jan 1 of the following year, unless he subsequently purchased through another "open, competitive bidding". The obligation to sell the property through "open competitive bidding" is on the institution. Once a bona fide sale to a third party has occurred, there should not be a similar restriction on the manner of sale for subsequent sales. We are also concerned that the Proposed Regulation uses the phrase "through public auction with open competitive bidding". The commentary to the Proposed Rule adds the term "unsealed". We are unclear as to what the term "unsealed" means in this context. Moreover, we believe that institutions should be able to sell the property in a manner that satisfies the requirements of 617.7620, and having used one of those methods, not preclude a director from purchase.

8. Section 612.2170(b)(7)(i) should be clarified to read, "A preliminary investigation indicates a reasonable basis to conclude a Federal criminal statute…"

9. We request clarification that an employee of the institution, such as the internal auditor, and not otherwise part of the SOC process, could satisfy the independence requirement for the audit described in 612.2160(h).

Conclusion

Again, we support institutions having in place and abiding by appropriate standards of conduct and codes of ethics. Regulations that require institutions to have these have largely been in place for two decades. It is inappropriate for the Agency to pursue proposals that are so prescriptive and that create significant, unnecessary reporting burdens for directors that they discourage qualified, ethical individuals from seeking positions as System directors. Today's agriculture is highly complex with enormous interconnections that should not be viewed as a barrier to service on a System board. We ask that FCA take into consideration and address our comments prior to the issuance of a final rule.

We appreciate this opportunity to comment on the Proposed Rule and trust that our comments and those of other System institutions will assist the Agency. If you have any questions, please do not hesitate to contact me.

Respectfully submitted,

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Enclosure