



June 20, 2014

Mr. Barry F. Mardock  
Deputy Director  
Office of Regulatory Policy  
Farm Credit Administration  
1501 Farm Credit Drive  
McLean, VA 22102-5090

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

Dear Mr. Mardock:

Texas Farm Credit Services understands and supports the need for Standards of Conduct within the Farm Credit System. Due to the substantial impact the current regulations and proposed rule may have on our System, we have evaluated the proposed rule that was published in the Federal Register on February 20, 2014 ("Proposed Rule"). We appreciate the Farm Credit Administration's ("FCA") efforts to clarify the existing rule and provide the following comments in an effort to assist in the implementation of an unambiguous rule that supports the goal of high standards of behavior throughout the Farm Credit Systems.

Texas Farm Credit Services ("Texas FCS") fully supports and incorporates herein the comments submitted by the Farm Credit Bank of Texas ("FCBT"). On behalf of Texas FCS, we respectfully submit the following:

**GENERAL COMMENTS:**

While we recognize the need for clarity within the rule, we agree with the Farm Credit Counsel ("Council") and FCBT that the proposed rule seems to create ambiguity in some aspects while adding an increased, unnecessary compliance burden on the Farm Credit System institutions ("Institutions"). If the Proposed Rule is adopted, we are concerned it will discourage qualified individuals from seeking election, or re-election, to our board of directors as well as engagement as agents of the Institutions.

We reiterate and strongly support the Council and FCBT's comments that the Proposed Rule creates the threat of "regulation by examination" that could detrimentally effect the Institutions by resulting in inconsistent policies and violations of the Administrative Procedures Act ("APA").

**SPECIFIC COMMENTS:**

**I. Responsibilities and conduct – §612.2135:**

Texas FCS supports the FCBT's contention that the addition of the word "guidance" to §612.2135(b) flies in the face of the APA and, not only should the word "guidance" be deleted, but the entire phrase "and policy statements, instructions, procedures, and guidance" should all be stricken. By allowing this phrase to remain as is, it would invite FCA regulators to improperly penalize Institutions for a failure to follow agency "guidance" or even an individual examiner's interpretive "guidance" of substantive requirements. The resulting inconsistencies thereby created would make compliance with the rule difficult to say the least. We understand and appreciate the need for agency guidance and even welcome published guidance in certain, limited forms such as model disclosure sheets; however, the guidance should not be given the full weight of a mandatory regulation.

Additionally, we are concerned that through examination, the FCA would be able to reverse board decisions, thereby reserving to itself the right to make management decisions on behalf of the Institutions. This is outside the scope of the FCA. Substantive rules should be established through regular rule-making procedures with opportunities given for public notice and comment.

**II. Agents and consultants – §§612.2130, 612.2136, 612.2160(f), 612.2165(a)(2), and 612.2180:**

One of the most perplexing new requirements is those applicable to agents. The Proposed Rule makes it difficult to determine which type of persons the regulation applies to and the substantive obligations that should be imposed on that individual, once identified. Currently, "agent" is defined as "any person, other than a director or employee, who currently represents System institutions in contacts with third parties or who currently provides professional services to a System institution such as legal, accounting, appraisal, and other similar services." This definition is arguably vague and confusing, specifically the term "professional services."

We concur with the FCBT's reading of the Proposed Rule that the additional language used, not just in the definition, but in several other provisions that pertain to agents, creates additional uncertainty with respect to the identification of those persons who are covered by the regulation. Specifically, the Proposed Rule imposes certain requirements on agents and "consultants who provide expert or professional services" under §612.2136. This new section requires agents, consultants, employees and directors to report conflicts of interest proactively and recuse themselves from a matter if one is found. The FCBT's commentary provides that the requirements of disclosure by "consultants, professionals, and experts who are hired to give advice on a matter, transaction or activity" is so overly broad that it could include a plumber who is asked to make the necessary repairs in an Institution building. We agree.

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Further, the use of the terms “professional” and “consultant” are inconsistent throughout the Proposed Rule. The proposed new substantive requirements for agents seem unnecessary and, at a minimum, we think that FCA should revise the proposed regulation to (1) eliminate the category of “consultants, professionals, and experts” from the regulation, and (2) clarify the definition of the term “agents.” The inclusion of any person who provides expert advice on any matter potentially extends the proposed regulation to virtually any third party provider of business services, which would present an overwhelming and disruptive compliance burden that is far out of proportion to the potential for any conflict of interest presented by these relationships. The imposition on large consulting firms to create a system to collect or track information on clients that may be Institution borrowers seems ludicrous. Additionally, if an agent or consultant has signed a non-disclosure agreement with a previous client, then that agent or consultant would be unable to disclose “all material non-privileged information”.

Secondly, the definition of “agent” needs to be more clearly defined to include only those persons whose activities on behalf of Institutions are of such a significant nature to warrant the additional burdens. As set forth by the FCBT’s comment letter, the FCA should consider including, either in the regulation or commentary, a list of the specific types of persons who are considered to be agents for the purposes of the regulation with a clear explanation of the policy reasons why such persons should be covered. Simply stating that standards of conduct for agents are important is not sufficient. In order to address potential conflicts of interest beyond those already covered by the agents’ existing professional standards, we must determine which agents the Proposed Rule is trying to address.

Texas FCS would further adopt and herein incorporate the FCBT’s proposals that Institutions should only be required to provide agents with the provisions of the Standards of Conduct that apply to them and that the regulation identify which provisions must apply to agents. It is too cumbersome to attach the regulations in their entirety and have a potential agent analyze and read through the entire regulation and then determine which sections apply to the agent.

Lastly, in regards to the Proposed Rule’s restrictions on the acquisition of Institution’s property by an agent, the Proposed Rule is more restrictive on agents than employees or directors. As stated in the correspondence by FCBT, the fact that an agent must wait one year before acquiring property that was acquired by an employing Institution as a result of foreclosure or other, similar action, seems overly burdensome in light of the fact that the restriction applies to all agents, regardless of whether the agent had any involvement in the Institution’s decision to foreclose or its acquisition or sale of the property. Especially problematic is that the restriction, as to agents only, can extend for up to one year after the agency relationship is terminated. This restriction ends immediately upon an employee or director’s severance.

Agents who are not involved in the loan making or collection process should be exempt from this portion of the regulation. Furthermore, the regulation should, at a minimum, be modified to limit the prohibition to property for which the agent actively participated in the foreclosure process or the transaction to acquire or sell the property, for a period of twelve months after the sell / foreclosure.

We suggest and reiterate that perhaps a better way to control conflicts that may arise with agents is through restrictions on the purchase of property that an Institution may have acquired during the term of the engagement. Additionally, the current approach that requires Institutions to control conflicts through due diligence in the vendor management process has generally been effective. The imposition of affirmative obligations that other financial institutions do not require will likely deter agents from doing business with Institutions. We concur with the FCBT that any burdens imposed by these new requirements far outweigh any marginal benefits they might conceivably add.

### **III. Conflict of Interest Disclosure – §612.2136**

While we have no objections to requiring disclosure of potential conflicts of interest for directors and employees, the Proposed Rule seems to create confusion while implementing unattainable standards.

One problem is the omission of the modifier “potential” before “conflicts of interest” in subsection (a)(2). As set forth by the FCBT, “potential” is an important modifier that is imperative to the disclosure of conflicts of interest. We recommend the term be added back in to the regulation.

Additionally, subsection (a)(2) requires directors and employees to disclose conflicts of interest in “any matters, activities, or transactions pending at the System institution” and requires consultants, experts or professionals to “disclose conflicts in the matter, activity, or transaction for which they provide services.” This provision does not cover agents at all. Further, it assumes that employees, directors, or agents are knowledgeable about all “matters, activities, or transactions.” This provision places an impossible burden on employees, directors and agents to make disclosures regarding conflicts they aren’t even aware of. While the commentary does provide that these individuals take affirmative action in reporting known conflicts of interest, the regulation does not do so. Therefore, we would request the Proposed Rule be modified to limit the conflict disclosure to apply to matters of which directors, employees, or agents have knowledge.

The FCA commentary also requires reporting of conflicts to be “immediate.” However, the regulation fails to set forth a time frame for when a conflict should be reported. We recommend the standard of “promptly” continue to be utilized. The FCBT has stated that “promptly” should be defined as soon as practicable after the individual becomes aware that he or she has a personal financial interest

that could present a potential conflict of interest with respect to a pending matter, activity or transaction at the Institution. We agree with this definition and standard.

Subsection (b) states that persons subject to subparagraph (a) who have a conflict of interest should avoid participating in official actions, board discussions, or votes on particular matters, activities or transactions affecting their personal interests. It seems that requiring an employee, director, or agent to refrain from the aforementioned duties for any “potential” conflicts of interest would be more appropriate. Once the Standards of Conduct Official makes a determination that there is no conflict of interest or that there is no appearance of a conflict, then further recusal should not be required. In the event that the Standards of Conduct Official deems a conflict exists, then recusal should be required. Because of this, there is no need for a waiver as set forth in subparagraph (c) and therefore this provision should be deleted.

**IV. Director and Employee Reporting and Prior Approval Requirements – §§612.2130, 612-2140, 612.2145, 612.2150, 612.2155 and 612.21659(c)**

a. MATERIAL FINANCIAL INTERESTS AND ORDINARY COURSE OF BUSINESS TRANSACTIONS

Texas FCS concurs with FCBT that the Proposed Rule creates greater uncertainty about standards of conduct requirements and presents a new and overly complex approach to compliance which will prove unrealistic and unworkable, especially for Institution directors. We completely adopt FCBT’s analysis on how Institutions have historically attempted to comply with the existing regulation.

*1. Compliance under the Existing Regulation*

Under the current regulations, directors and employees are required to report periodically to the Standards of Conduct Official “the name and nature of the business of any entity in which the director/employee has a material financial interest or on whose board the director/employee sits if the director/employee knows or has reason to know the entity transacts business with: (i) the director’s/employee’s institution (or a supervised institution) or (ii) a borrower of that institution. Subparagraph (c) requires directors/employees who become or plan to become involved in any relationship, transaction, or activity that is required to be reported under subparagraph (b) or that “could constitute a conflict of interest” to promptly report such involvement in writing to the Standards of Conduct Official for a determination of whether there is, in fact, a conflict of interest.

The existing regulations do not require the director to obtain prior approval from the Standards of Conduct Official for each and every transaction with a borrower. However, it does require directors to identify affiliated entities that a director knows or has reason to know do business with borrowers. In practice, the understanding has been that directors provide a blanket disclosure of entities in which a

director has a material financial interest that might do business with an Institution's borrowers on occasion and describe the nature of the business. Once the initial disclosure is reviewed and approved by the Standards of Conduct Official, that type of business would thereafter be deemed in the ordinary course of business and therefore not a conflict of interest. This would require the director to make an annual disclosure, but would negate the need for directors to seek approval for each future transaction the entity might conduct with borrowers.

As provided by the FCBT, the same general approach has been taken under standards of conduct policies established under §612.2165(b)(3) for permitted business transactions between directors/employees and borrowers that do not involve a material financial interest in an entity. The regulation does require reporting of transactions that could constitute a conflict of interest; this has not been understood to extend to obtaining prior approval on a transaction specific basis. The general practice has required directors to make prior disclosure of material transactions where they have specific knowledge that their counter party is a borrower; however, activities disclosed and approved under §§612.2140(b)(2) and 612.2165(b)(3) are no longer deemed to involve a conflict of interest.

## 2. *Need to Accommodate Directors as Agricultural Producers*

The majority of our directors are primarily engaged in the business of agriculture in addition to serving as directors. The implementation of a regulatory scheme that requires our directors to report and seek approval for everyday transactions in the normal course of their business is impossible. Furthermore, our directors do not participate in the day to day credit decisions made by the Institutions. As a result, the directors do not normally have any influence, nor can they take actions, with respect to a particular borrower with whom they might happen to do business that could constitute a "conflict of interest."

Most problematic for our directors involves the substantial interference in day to day agricultural operations. Directors must have flexibility to conduct an agricultural operation and meet the demands of the marketplace. In most cases, directors do not have, nor can they reasonably be presumed to have, advanced knowledge that the persons with whom they conduct business transactions are borrowers of Texas FCS or other Institutions. This is especially problematic for directors who own or have a material financial interest in business endeavors such as feed and supply stores, seed dealers, feed yards, and beef processing operations. It would be likely that, given the Institutions market penetration, there is a high probability that some of the directors' business transactions would involve borrowers. Further, transactions may be conducted through informal means, through brokers, or an auction where the identities of sellers are not necessarily known in advance. It would be extremely cumbersome and time consuming to compare a customer list to an Institution list on a regular basis, and then, prior to completing the transaction, seek pre-approval from the Standards of Conduct

Official. In certain transactions such as livestock auctions, time is of the essence and this process is impossible to comply with and would serve no true purpose. These types of transactions, performed in the ordinary course of business, are not likely to create conflicts of interest.

We fully agree with the FCBT's sentiment that directors can be expected to transact business with borrowers in the ordinary course of their business and on a regular basis simply based due to the Institution's market penetration. Regulatory schemes governing standards of conduct must find practical ways to allow directors to conduct transactions with borrowers in the ordinary course of business efficiently and without fear of violating regulations or forcing directors into the dilemma of refraining from transactions necessary to conduct agricultural operations or resign from their respective board. The currently regulation strikes the proper balance while the Proposed Rule makes this difficult to say the least.

### 3. *Compliance with Proposed Regulation*

The Proposed Rule adds a new requirement to report "all material financial interests with directors, employees, agents or borrowers of the employing, supervised, and supervising institution." The current regulation requires a director/employee to report material financial interests in entities known to be doing business with borrowers. The Proposed Rule requires reporting for all material transactions a director/employee has with borrowers that involve a "financial interest," which is defined as "receiving or providing something of monetary value or other present or deferred compensation."

While it may not appear to be a substantial difference on the surface, requiring disclosure of all material financial interests involving borrowers may actually be extremely burdensome. This modification would require a transaction by transaction disclosure, which is nearly impossible for an agricultural operation. Additionally, subparagraph (1) does not include the "know or reason to know" qualification, unlike the reporting requirements in the other subparagraphs of this subsection (b). Our directors, as full time agricultural producers and businessmen, are not likely to be in a position to know whether their counter-party or customer is a borrower of Texas FCS.

Subparagraph (b)(1) of §§612.2145/612.2155 requires directors to report material financial interests. Material is defined as "the interest or transaction or series of transactions is of such magnitude that a reasonable person with knowledge of the relevant facts would question the ability of the person who has the interest or is party to such transaction(s) to perform the person's official duties objectively and impartially and in the best interest of the institution and its statutory purpose." This definition allows for flexibility in interpretation. However, the FCA commentary attempts to limit this exercise of judgment by requiring Institutions' boards to set specific parameters for materiality. While

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the commentary allows for flexibility based on circumstances and geographic location, it also subjects the boards' decisions to reversal by FCA examination.

The fact that the commentary is addressing this issue is problematic by itself, but even more concerning is that, while §612.2165(c)(2) allows a board to adopt policies that establish exceptions to reporting requirements for certain categories of transactions, the regulation and commentary expressly state that an institution is not obligated to provide for any exceptions to these reporting requirements. We concur with the FCBT's suggestion to revise the Proposed Rule to specifically require boards to establish materiality parameters to determine when disclosure under §§612.2140(b) or 612.2150(b) is required. Further clarification of the terms "material", "de minimus", and "insignificant" in the Proposed Rules or commentary or creating a means for Institutions to submit their proposed policies and procedures for prior approval by the FCA would eliminate this need for regulation by examination. We agree wholeheartedly with the FCBT in their conclusion that the FCA could use agency "guidance" to help clarify the regulation and correct perceived problems on a go-forward basis and not hold Institutions to a substantive standard that it is unwilling to articulate in advance.

The policy exceptions found in §612.2165(c) are unclear and ambiguous. Specifically, 612.2165(c)(2) allows for a policy exception from reporting requirements for types of interests of transactions that are either "immaterial in amount or value" or "in the ordinary course of business." Subparagraph (iii) requires the board to consider the Standards of Conduct Official's recommendation to apply the policy exception when supported by a written determination of, "the amount of value in the transaction or the particular type of interest or transaction, does not require the application or the reporting requirement or prohibition subject to the exception and is not necessary to avoid a conflict of interest, the appearance of a conflict of interest, or to ensure confidence in the impartiality and objectivity of the director, employee, or Institution." This would seem to support a requirement for directors to track the aggregate amount of purchases, made in the ordinary course of business, throughout the year in order to make a disclosure once the "de minimus" level is reached.

The FCA commentary further states that ordinary course of business includes fixed price items and services (under a certain threshold amount), but that transactions involving price negotiation would be subject to a higher level of scrutiny. This seems to support an analysis that transactions involving price negotiations cannot be considered within the ordinary course of business. By excluding transactions that either exceed an aggregate amount or that involve price negotiations from the ordinary course of business exception, the Proposed Rule would cripple directors who engage in daily agricultural operations.

Furthermore, the requirement that an exception be approved by the board would stifle a director or individual's business efforts as most boards meet on a monthly basis. Our recommendations

are predicated on finding a balance between directors serving on the board and their ability to conduct ordinary course of business transactions necessary to the success of their agricultural operations. Requiring a director to choose between these two functions is detrimental to the success of Institutions. We agree with the FCBT in that discouraging qualified individuals from serving as directors without any real corresponding improvement in ethical standards would not be in the System's long-range interests. Because of this, we recommend that the FCA remove the Proposed Rule requiring disclosure of all material financial interests and allow Institutions to continue by adopting policies and procedures to address business transactions with directors, employees and borrowers. To do otherwise without proper analysis as to the impact on directors' ability to conduct their agricultural operations would be irresponsible.

b. DEFINITION OF "FAMILY"

The definition of family has an impact on the periodic reporting obligations under 612.2140(b) and 612.2150(b) as well as the prohibitions found in 612.2145 and 612.2155. Again, we concur with the FCBT's concerns with the proposed expansion of the definition of "family" which now includes "anyone whose association or relationship with the director or employee is the equivalent" of a traditional family relationship should be removed. Inclusion of those persons living within the same household is sufficient to take into account individuals who might be "equivalent" to a defined family member. Also, if adopted children are to be included, then the language should be clear and not possibly offensive. Further, we agree that it is a reasonable presumption that a director may know or have reason to know whether or not a relative or other person residing in the director's household had or has transactions with the Institution, but this presumption should not be imputed as to all relatives as it is defined by the Proposed Rules.

c. CONTROLLED ENTITY

We would recommend that instead of the stringent 5% equity interest threshold, perhaps substituting a voting control interest to constitute controlling interest would be more appropriate and in line with the purpose of the regulations. Many directors and employees utilize entities for the purposes of estate planning or for tax purposes, yet they retain no active control or involvement in the entities. These entities and individuals' interests therein, could easily be overlooked and, in good faith, be unintentionally left off of disclosures. A more substantial percentage that reflects actual control, such as 25% or more, should be substituted for the current and proposed 5%.

**V. Prohibited Conduct - §§612.2145 and 612.2155**

Texas FCS fully incorporates the FCBT's analysis of the Proposed Rule regarding prohibited conduct. The FCA commentary requiring disclosure and a waiver prior to a director entering into

particular transactions, including ordinary course of business lending transactions, makes it almost impossible for our directors to transact business. The requirement that merchants selling on credit must disclose and obtain a waiver prior to the transaction as stated in the FCA commentary will cause our directors substantial hardship and will likely result in inadvertent and innocent violations of this provision. The FCBT states that a ratification process be allowed in the event that a director becomes aware of a prohibited lending relationship with another party; we strongly support this recommendation.

Furthermore, it seems unlikely that a director would have any more accurate or timely information about an Institution owned property that has changed hands within the 12 month look back period and is being auctioned off by a subsequent owner. There is no need in these situations for directors to be forced to submit an unsealed bid. Also, the removal of the language allowing for exceptions to a separate subparagraph does not, in itself, rectify the ambiguously written prohibitions. In fact, we concur with the FCBT that this only makes it more confusing and complex and perhaps rearranging the text to have exceptions follow each prohibition might make the regulation easier to navigate.

**VI. Joint Employee Relationships - §612.2157**

The FCBT states that the expansion of the joint employee prohibition is disturbing from the perspective of a full service bank; again, we agree. The term “employee” should not be interpreted in any manner other than that given by the common law meaning of the word. If a bank employee, merely by virtue of performing a duty that an Institution could perform for itself, can be considered to be an employee of the Institution for the purpose of §612.2157, then the regulation would unduly interfere with a bank’s ability to provide services to their affiliated associations and would undermine the business model of those banks that wish to be a full service bank.

**VII. Institution Responsibilities - §612.2160**

The requirement of “immediately” notifying the FCA of any “known or suspected material standards of conduct violations as described in §612.2170(b)(7)” is premature. At a minimum, the Standards of Conduct Official should be allowed a reasonable time to investigate any suspected matters before being required to report to the FCA. Additionally, it is unclear who should determine whether the standards of conduct violation is “material.”

Even more concerning is §612.2170(b)(7)(i), which requires the Standard of Conduct Official to report to our board and to the FCA’s Office of General Counsel all cases where a preliminary investigation indicates that a Federal criminal statute, pursuant to subpart B of 12 CFR part 612, may have been violated. As set forth by the FCBT, this creates a duty for the Standards of Conduct Official to

report suspected violations by third parties, either unknown persons or borrowers who have converted loan collateral. These types of violations have nothing to do with standards of conduct and, typically, should be addressed by other officers, not a regulatory duty of the Standards of Conduct Official.

We respectfully request that if the regulation requires Texas FCS and other Institutions to remain informed of applicable industry approved best practices for standards of conduct, that these best practices be identified.

#### **VIII. Policy Requirements - §612.2165**

FCA has set forth a requirement that each Institution have, in addition to the Standards of Conduct, a Code of Ethics. We concur with the FCBT when they state that the requirement for an additional Code of Ethics seems duplicative. In the event that this requirement remains, FCA should set forth the distinction between the two. We further incorporate the FCBT's suggested revisions to §612.2160(a)(2)(iv) (removal of the term "competency") and instead add in a knowledge requirement on the part of any person required to report violations or activity requiring investigation by the Standards of Conduct Official under §612.2165(a)(2)(vi).

Additionally, we do not see the necessity of having the Standards of Conduct Official review "excess" loans not involving insiders for standards of conduct violations. The review of "excess" loans is a credit review, not a standards of conduct issue. Proposed Rule §612.2165(b)(2) should be revised to remove the requirement for Standards of Conduct Officials to review all loans before the supervisory bank's approval under §614.4470.

Further, the FCA commentary states that Institutions should ensure credit decisions on a loan made to an Institution's directors should be made without favoritism or special terms. Our Standards of Conduct Official, as are most, is not a credit officer, and therefore not in the best position to determine whether terms of a loan are in fact comparable to those a similarly situated non-insider would receive. Guidance on how a Standards of Conduct Official should analyze and document loan terms and pricing and show that they are not preferential would be beneficial.

Another example of regulation by examination is set forth in §612.2165(f) which allows FCA examiners to determine that a particular transaction creates a conflict of interest notwithstanding a board's good faith determination to the contrary. This subparagraph should be deleted.

As stated by the FCBT, the best course of action in regards to exceptions and waivers may be to identify those circumstances that may never be subject to waiver. This would allow for broad based exceptions to be applied to all other scenarios. Also of note is to replace the term "criteria" as used in §612.2165(c)(1) with "exception," defining the terms "requiring written disqualification" and "additional

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public disclosure”, and removing all language following “appropriate conditions.” By revising the Proposed Rule accordingly, the purposes of this section would be made less vague.

Finally, allowing for broad based exceptions for directors who sit on boards of non-profit entities should be expressly granted. The language in the commentary regarding subparagraph (c)(2) discussing exceptions for directors who sit on non-profit boards should be stricken.

In conclusion, we strongly urge the FCA to withdraw or substantially revise the Proposed Rule. As written, it will likely result in a mass exodus of directors or an increase in inadvertent violations. As an Institution, we are dedicated to training our directors and employees on standards of conduct and ethics and are hopeful that an annual training on these issues will help avoid inadvertent violations of the existing standards.

Thank you for the opportunity to submit our comments regarding the Proposed Rule. These rules are imperative to our success as an organization and we recognize the importance for unambiguous regulations. Please feel free to contact us to discuss our comments should you need further clarification.

Respectfully submitted,

A handwritten signature in black ink, appearing to read 'M. J. Miller', written in a cursive style.

Mark Miller

CEO, Texas Farm Credit Services