FARM CREDIT

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Mr. Barry F. Mardock,
Deputy Director, Office of Regulatory Policy
Farm Credit Administration
1501 Farm Credit Drive,
McLean, VA 22102-5090
(sent by email to: reg-comm@fca.gov)

Dear Mr. Mardock,

Thank you for the opportunity to comment on the proposed Standards of Conduct regulations on behalf of the board of directors and management of Colonial Farm Credit.

General Comments:

We are supportive of Farm Credit System (System) standards of conduct as a guide for employee, officer, director and agent behavior, in order to avoid real and perceived conflicts of interest and protect the System's reputation. However, we are under no illusion that the mere existence of standards, no matter how comprehensive, will totally prevent inappropriate behavior. Thus, there needs to be an appropriate balance among the burden of administering such standards, the privacy and disclosure of personal, financial and operational information, and the System's ability to attract and retain the most qualified directors and agents.

As proposed, these regulations are overly intrusive, administratively burdensome, unenforceable, virtually impossible to implement as FCA proposes, and too costly to System stockholders. Further, they are written without regard for the passage of time between certain transactions, do not reflect the current organizational structure of System institutions, are imprecise in many areas where they need to be more precise, and will interfere with customary business practices. The administration of these regulations will place the System on an unlevel playing field with competitors, drive away the most competent "agents", divert valuable time and resources away from serving farmers, ranchers and rural residents, including young, beginning and small farmers, and prevent normal and necessary business transactions between directors, other customers and agents. We predict that if there are not substantial changes to the proposed regulations there will be resignation of current directors and great difficulty in recruiting new, qualified board members. Those current directors and director candidates who will be most impacted are those owning large, diverse, and complex operations whose businesses touch large numbers of potential association customers (example: grain /feed dealers, farm supply companies, equipment dealers, nursery/greenhouse operations, livestock integrators and markets, and other farm-related businesses and marketing and processing operations) . Typically, owners of these types of operations are the most valuable board members a System institution can have by virtue of their business acumen, financial expertise, "street knowledge" and their ability to assist in new business development--- exactly the type of board members that System institutions cannot afford to lose and must have to be successful.

In System institutions the most likely occurrence of a conflict is when an employee or director is in a position to act on a matter involving his or her personal interest or that of a relative or business partner. Most Association boards of directors delegate much of the loan, agent contract and OPO decision-making authority to management, employee committees or to individual credit officers, thus avoiding potential conflicts by directors. The regulations should acknowledge this modern business practice and provide for less disclosure by (and control of) directors who do not have loan or OPO decisioning responsibilities. FCA should consider permitting institutions to opt out altogether from the proposed detailed, intrusive business and family relationship reporting for directors when the institution has created a clear separation between loan making and director involvement. Additionally, in institutions where most loan approval has been delegated to employees, directors are less likely to know who the institution's borrowers are for reporting purposes.

FCA certifies that under the Regulatory Flexibility Act these regulations would not have a significant impact on a substantial number of small entities. FCA's reasoning is based on the consolidation of the System assets and income taking them to a level in excess of a "small entity." We take strong exception to this conclusion, because the consolidated System does not have to implement these regulations--- each System institution must individually implement and administer them, and each will be individually examined and held accountable. We believe that if FCA accurately assessed the impact on each individual institution a vastly different conclusion would be drawn. Therefore, we request that FCA revisit this analysis under the Regulatory Flexibility Act before proceeding with these regulations.

While we appreciate the proposals to establish a materiality threshold under which no reporting would be necessary, and the prior approval of certain exceptions to reporting requirements and conflict of interest designations, there are more efficient ways to accomplish flexibility and operational efficiency, while maintaining appropriate control and oversight, as elaborated below.

Specific Comments:

FCA proposes a definition of "controlled entity" as one for which there is 5% or more ownership. However, FCA acknowledges that other definitions of "control" involve a greater ownership interest, but states that 5% is appropriate for this regulation in order to insure complete objectivity in decision-making. We disagree. The proposed 5% level is far too low and will result in the inclusion of a multitude of entities that are not material, including ones for which minority interests were obtained via inheritance and typical estate planning of which the director/employee/borrower has absolutely no true control by virtue of voting strength, management or influence. Five percent is not consistent with the concept of "materiality." Federal Reserve Reg. O utilizes a 25% threshold. The intended result can be accomplished at the 25% level and be much less burdensome on all parties.

FCA's explanatory comments with the proposed regulations give an example of a transaction requiring review and prior approval of the standards of conduct officer (SOCO): a director or employee purchasing a piece of farm equipment from a known borrower. Unless the director or employee (or a subordinate of the employee) is involved in approving a loan for the purchaser or is servicing the borrower's account, the likelihood of a conflict is extremely remote, and thus shouldn't warrant prior approval. The proposed regulations require the recusal of directors and employees from any loan transaction involving them, a relative or a business partner, thus eliminating the possibility of any conflict. Annual disclosures by directors and employees of borrowers with which they have had business transactions (exceeding the established materiality threshold) provide an avenue to insure that appropriate recusals have been made. In reality, all such transactions involving farm supplies, equipment, feed, grain, personal and household needs, etc., should be considered as occurring "in the normal course of business", and thus not require <u>any</u> reporting. To do otherwise is intrusive, administratively burdensome and interferes with the normal business operations of directors and other customers.

While the proposed regulations include comprehensive disclosure and control requirements for employees, directors and agents, they fail to provide System institutions with any authority to take action against directors who violate standards of conduct regulations or the institution's policies. Employees and agents can be terminated for violations, but what are the consequences for directors? Requirements without consequences have no teeth.

In the promulgation of these regulations has FCA researched standards of conduct regulations for commercial banks and other similar financial institutions to insure that what is being proposed is consistent with that of other regulators, and thus not placing the System in a competitive disadvantage? An independent analysis recently commissioned by the Farm Credit Council appears to indicate that FCA's proposed regulations are inconsistent with those of the regulators of other financial institutions.

While FCA hasn't changed the definition of "material" from the current regulations, the commentary states that System institutions will have to establish "...specific parameters on what constitutes a material financial interest or transaction." The commentary also states that our policies may "...include de minimis values below which a financial interest is determined by the board not to be material... A de minimis amount is an amount or value representing an interest that is so insignificant that no reasonable person could conclude that it would influence a director or employee's ability to act impartially and in the best interests of the System institution." FCA's comments imply that "material" equals "di minimis", although accepted definitions of both terms would support a significant range between what is considered a "di minimis" amount and a "material" amount. If this is truly FCA's intention, then these regulations not only don't provide any flexibility, they in effect substantially change (reduce) the stated definition of "material." We suggest that the following examples illustrate a more appropriate and reasonable definition of these two terms:

- Lending relationships between directors and customers below $10,000 constitute a di minimis, for which no reporting is necessary.
- Lending relationships between directors and customers in amounts above 10% of the director's gross annual income are considered material, requiring prior approval.

The proposed regulations address OPO sales to directors and employees, but they do not address acceptable and unacceptable practices for initial foreclosure sales (before the property becomes an OPO.) Is it FCA's intention that the same rules of conduct apply to both, or is it up to individual institutions to develop policies regarding director and employee involvement in foreclosure sales?

Section 612.2140, (a), (1), requires directors to report the names of immediate family members or affiliated organizations, "...who had transactions with the institution at any time during the year." FCA's commentary notes that the, "...rule does not require a director to solicit information from these persons or entities whether they had or have transactions with the institution." It goes on to say that, "...FCA presumes that a director would know whether or not a relative or other persons residing in the director's household had or has transactions with the institution." This presumption is inaccurate and unfounded, and thus this section should be amended to include language similar to section 612.2140, (b), (2):"...knows or has reason to know..."

612.2145, (a), (7) prohibits a director from borrowing from, lending to or becoming financially obligated with a director, employee, agent, borrower or loan applicant of the institution. Similar to the issue raised regarding 612.2140, a director may not know whether someone is a borrower, applicant or agent, and language such as, "...knows or has reason to know..." should be added to this section. Additionally, what happens if the director does not know that the person or entity he or she enters into a lending relationship with is an association borrower, but the SOCO recognizes he or she is a borrower when reviewing the director's disclosure? What would FCA propose be done, if anything?

612.2150, (a), (1), --- same issue as above

The commentary accompanying these regulations gives an example of a director purchasing grain "on credit" from a borrower needing SOCO review annually to determine whether there's a conflict. Surely FCA does not intend to interpret "on credit" to include the sale of agricultural products on a 30/60/90 day account (with terms), as "on credit."? This is such a common practice that virtually every transaction of every director would need SOCO review and approval. This could amount to hundreds of transactions annually per director. As stated above, as long as the director is not acting on loan requests for the borrower, the likelihood of a conflict of interest is remote, and the proposed regulatory requirements should acknowledge and reflect that reality.

The commentary states that transactions involving the sale of farm products or services "...in the ordinary course of business..." which fall below the materiality and de minimus limits, and for which the price is fixed (i.e. not negotiated), do not need to be reported. However, it goes on to say that transactions involving price negotiations, such as for "...a tractor or heavy farm equipment, could raise issues of impartiality or favoritism and should be subject to more scrutiny." FCA should understand that virtually every transaction is open for negotiation in terms and price. Trying to define those transactions for which there is/is not price negotiation would be an administrative nightmare and impossible to administer. Again we reiterate, if the director is not involved in the approval of loans for the borrower, the potential for conflict is remote and thus should not be regulated.

The manner in which 612.2155, (a), (7) and (b), (4) are written they: 1) Would prohibit an employee from EVER owning a former OPO if that employee participated in the deliberations or decision to foreclose or dispose of the property, and 2) An employee could have participated in the deliberations or decision to foreclose or dispose of the property, but would be prohibited from inheriting it. We don't believe this is what FCA intended, and thus we ask that this section be rewritten.

Section 612.2160, (h), (2) requires an independent audit of our standards of conduct program (the commentary states every 3-4 years, but that is not in the regulations). This seems like an excessive and redundant cost for our stockholders to bear, considering that we are also paying FCA to exam our compliance with the regulations.

Comments regarding agents:

System institutions strive to select the very best quality service providers in order to deliver timely and effective service to our membership, comply with laws and regulations, and insure a sound, collectable loan portfolio. The best service providers have choices for whom they work, and the additional burdens proposed in these regulations are going to make it difficult to continue "employing" the best, as this will be costly, restrictive and time- consuming for them. If the best service providers no longer want to work with us, we will be forced to use a sub-par group of agents, adversely affecting customer service, portfolio credit quality and overall institution performance. We do not believe this is what FCA intended.

As proposed, the regulations regarding agents are administratively burdensome, contradictory, overly cautious, impossible to implement and enforce, and will be viewed as insulting to many of our best vendors. We respectively request that FCA rethink and revise these requirements. Specifically:

> FCA's definition of "agent" (and more importantly examiners' interpretations of this definition) is overly broad and captures what would typically be considered vendors or service providers. (loan closing attorneys, fee appraisers, real estate agents selling OPO's, internal auditors, corporate legal counsel). Many vendors identified by examiners as agents perform work on a sporadic basis for institutions over many years, some with large gaps between assignments, such as appraisers, real estate agents and loan closing attorneys. We ask FCA to clarify the definition of "agent" to include only those who provide ongoing services or representation over clearly definable periods.
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> Section 612.2160, (f) requires that we provide agents with a copy of our standards of conduct policy and Code of Ethics. Section 612.2165, (a), (2) requires that the code of ethics be "presented" to agents, and that those not subject to "industry or professional ethics standards" sign the code of ethics. Section 612.2180, (b) requires agents to "acknowledge receipt" of our code of ethics, and certify that they will adhere to either our code of ethics or their industry

ethical standards. First, section 612.2160 only requires that we provide a copy of our code of ethics and standards of conduct policy to agents, not that they acknowledge receipt, which contradicts section 612.2180. Second, 612.2160 requires agents to certify to compliance with our code of ethics only if they are not subject to industry ethical standards. If we determine that an agent is covered by their own industry ethical standards, why should we have to "present" them with a copy of our code of ethics at all? Third, if agents are only required to sign our code of ethics policy (but not our standards of conduct policy), why should we be required to provide them with a copy of our standards of conduct policy? Fourth, asking an agent to certify that he or she will comply with either our code of ethics or their profession's ethical standards will be highly insulting to these professionals.

Section 612.2180, (d), restricts agents from acquiring (except through inheritance) any OPO that was acquired "...during the agent's employment." Further, this prohibition applies for one year after transfer of the OPO out of the institution's ownership, or after the termination of the agent relationship, whichever occurs first. These requirements will be an administrative and public relations nightmare to communicate and impossible to enforce for the following reasons: First, for agents such as lawyers and appraisers, who do sporadic work for the association over a multitude of years, sometimes with months or years in between each specific assignment, what is the period of "employment"?; Second, typical engagement letters with law firms, auditors and accountants (and real estate firms who may be employed to market OPO's) are with the firm (sometimes containing hundreds of individual lawyers, auditors or accountants), not with specific individuals. Many times, multiple firm members perform the actual work on an assignment. Does this mean that all members of each firm are subject to this prohibition? If not, how do we differentiate?; Third, how do we "police" this provision, and what action would FCA suggest we take if we find that an agent has indeed acquired an OPO after it has been sold by the institution to a third party, but within the one year time frame?; Fourth, since agents perform a variety of different types of work for the institution (audit, legal, sales, etc.), much of it unrelated to the acquisition and sale of OPO's, is it really equitable and reasonable to prohibit an agent from purchasing an OPO if the agent's work for the institution didn't involve the OPO?; Fifth, is it realistic to expect that every institution agent contemplating the purchase of real estate (including a home) perform a title search before they sign a purchase contract to insure that the System institution hasn't been in the chain of title in the past year? The following is an example of how burdensome and unrealistic this requirement could be: System institution sells a house and lot previously acquired through foreclosure to an unrelated third party; within 12 months of that sale, the purchaser puts the property on the market and an attorney (who provides human resource counsel to the institution—i.e. an "agent" by FCA definition) and spouse decide to make an offer on the house. If their offer is successful, this attorney is in violation of these proposed regulations. It makes no sense that an agent who had nothing to do with the acquisition, management or disposal of the OPO, and who had no inside knowledge of the OPO, should be subject to such onerous restrictions.

If FCA feels that there needs to be some control of OPO sales to agents (presumably due to some isolated misconduct of an agent, probably in concert with an employee or director somewhere in the System), it should be limited to those specific agents (not firms) who actually have some inside knowledge of the OPO that would put them in a competitive advantage vis-à-vis other potential buyers, and it should be limited to direct sales to them from the Association, not later in the chain of title.

We appreciate the opportunity to comment on these proposed regulations. As written they will result in a multitude of unintended, adverse consequences to our stockholders and service providers, tarnish the System's public reputation and add unnecessary administrative burdens. We respectfully request that significant changes be made to the regulations to address our concerns before being finalized.

Sincerely,

*Hugh S. Jones*

Hugh S. Jones
Chairman

*Greg B. Farmer*

Greg B. Farmer
President