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October 23, 2018

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

Re: Proposed Rule – 12 CFR Parts 611 and 619 – RIN 3052 – AC97; Definitions; Eligibility Criteria of Outside Directors; 83 Federal Register 42807-42810 (August 24, 2018)

Dear Mr. Mardock:

Southern AgCredit (SAC) appreciates the opportunity to provide comments to the Farm Credit Administration (FCA) regarding its proposed rule to modify existing outside director eligibility requirements as published in the Federal Register on August 24, 2018. We fully support the comments submitted by the Farm Credit Bank of Texas (FCBT) and the Farm Credit Council (FCC) on behalf of System institutions. Because of the importance of these proposed regulations, however, SAC also wishes to submit its own comments.

From a general perspective, we believe that the proposed expansion of the eligibility requirements for outside directors of all System banks and associations likely exceeds the FCA's statutory authority and in any event are unnecessarily burdensome. While the agency's stated objectives in amending the eligibility requirements for outside directors, namely, to strengthen the safety and soundness of System institutions, strengthen the independence of System institution boards, and incorporate corporate governance best practices for System institutions, are laudable and important goals, FCA has not provided any evidence that the additional requirements will in fact help to achieve these goals, nor has it explained how the benefits of the amendments justify the additional burdens they will place on System institutions. Indeed, the only justification that FCA has offered for the new requirements is simply that current regulations do not now specify how far removed from the statutory prohibited relationships an outside director must be to be independent. In other words, according to the preamble, a thirty-year old statute somehow created a vacuum that a new regulation must now fill.

The preamble states that the expansion of the list of persons excluded from outside director consideration will improve the ability of System boards to carry out their fiduciary responsibilities. This statement appears to be based on the assumption that if, some independence is good, more independence is undoubtedly better, but FCA should apply a cost-benefit analysis before imposing any additional eligibility

restrictions. FCA's expansion of the eligibility criteria would extend far beyond the statutory requirements to the point where the regulation does not clearly serve the statutory purpose, and the agency has failed to take fully into account the cost to the System of achieving the supposed benefit of greater purity in the independent perspective of outside directors. The preamble cites no examples of any obstacles to the performance of System boards' performance fiduciary obligations that have been created by the existing eligibility requirements nor any circumstances where the purposes of the statutory requirements have been thwarted. Since there has been no demonstration of any need to impose additional regulatory requirements to achieve the statutory objective of providing independent viewpoints on System boards, we believe that the addition of even an incremental regulatory burden would be arbitrary and unjustified.

1. Statutory Authorization

One reason FCA should be cautious in imposing additional eligibility requirements for outside directors is that it is not clear that it has the statutory authority to do so. Section 5.9(1) of the Farm Credit Act of 1971, as amended, generally authorizes FCA to approve rules and regulations for the implementation of the Act that are "not inconsistent with its provisions," and section 5.17(a)(9) grants FCA the authority to prescribe rules and regulations "necessary or appropriate to carrying out this Act," but neither provision permits FCA to create new requirements that are not contained in the Act itself, and the proposed new limitations on outside director liability are completely absent from the Act. Since there were no regulations on the eligibility of outside directors between the enactment of the outside director requirement in 1987 and the adoption of the current regulation in 2006, it is also difficult to argue that the eligibility of outside directors is related to the FCA's safety and soundness authorities.

The Act contains different requirements for outside directors for different types of institutions under different circumstances. Specifically, the plain language of sections 1.4, 3.2, and 7.1 of the Act provides respectively that the board of directors of a Farm Credit Bank, a bank for cooperatives that is not merged into the United or National Bank for Cooperatives, and a bank resulting from merger of banks within a district must include a member who is not "a director, officer, employee, or stockholder of a System institution," while sections 2.1 and 2.11 respectively provide that the board of a production credit association and a Federal land bank association must include a member who is not a "director, officer, employee, stockholder *or agent* of a System institution," (emphasis added) and section 3.21(b)(1)(C) requires the board of the consolidated bank for cooperatives to include a member who shall not be a "stockholder *or borrower* of a System institution or an officer or director of any such stockholder or borrower."(Emphasis added.) In addition, section 7.12(c)(3) provides that a bank resulting from the merger of banks operating under the same title in different districts must have an appointed outside director who has not within the two years prior to appointment been "a *borrower from*, shareholder in, or director, officer, employee, or *agent* of any institution of the Farm Credit System." (Emphasis added.).

Neither the Act, nor the legislative history indicates why Congress created different requirements for different types of institutions, but it clearly did so and could easily have imposed the same requirement if that was its intent. Indeed, the fact the original Senate bill prohibited both agents and borrowers as well as directors, officers, employees and stockholders of System institutions from serving as outside directors of all System banks and associations while the final statutory language omitted one or both from the requirements for some institutions suggests that Congress specifically intended to create different requirements for different institutions. There is no indication that the different treatment was unintended

and merely due to Congressional oversight or error. At the same time, the Act does not contain any language granting FCA the authority alter, let alone augment, the statutory eligibility requirements. In contrast to other provisions of the Act, such as sections 1.5, 2.2, 2.12, and 3.1, which expressly make the exercise of identified statutory authorities by System banks and associations subject to FCA regulation, or section 7.2, which expressly provides that FCA shall issue regulations governing how the authorities of unlike banks that merge are to be reconciled, the statutory provisions dealing with the eligibility requirements for outside directors do not provide any express authority to FCA to issue regulations to implement or modify these requirements.

The fact that the Act clearly prescribes different eligibility requirements for different types of institutions while failing to grant FCA any express authority to issue implementing regulations calls into question whether FCA actually has the statutory authority under section 5.9(1) or 5.17(a)(9) to impose eligibility requirements for outside directors that are not contained in the statute pertaining to a particular institution. The current section 611.220(a)(1) and the outside director definition at section 619.9235 purport to apply to banks as well as to associations the requirement that an outside director cannot be an agent of a System institution, but these regulations are arguably inconsistent with the Act with respect to banks that have not merged under section 7.12, and thus outside FCA's authority under section 5.9(1). The fact that FCA has already issued a regulation that appears to conflict with the Act does not create a justification to adopt additional restrictions not contained in the Act. Two wrongs do not make a right.

FCA should also take into consideration that there is another reason why Congress might not have intended for the eligibility criteria for outside directors to be a matter for FCA interpretation. In the general corporate powers provisions of the Act at sections 1.5, 2.2, 2.12, and 3.1, all System banks and associations are authorized to "prescribe, by its board of directors, it bylaws that shall be consistent with law." As the FCC's comments also argue, to the extent that director eligibility is not prescribed by statute, the eligibility of individuals to serve as board members would normally be governed by an institution's bylaws. Consequently, if Congress actually intended for FCA to have authority to adopt additional eligibility criteria for outside directors, it would have been inconsistent for it to have enacted amendments that prescribe director eligibility criteria that are normally addressed within institutions' bylaws and at the same time enact limitations on FCA's authority to approve changes to those bylaws.

2. Statutory Purpose

While there is little legislative history behind the statutory outside director requirements, the history that does exist suggests that Congress intended for the requirement for System institutions to have outside directors to serve two purposes: (1) to bring additional financial and business expertise to System institution boards not typically provided by the System's farmer-borrower directors, and (2) to include on System boards persons with a more disinterested perspective than that provided by farmer-borrowers who have an ownership interest in the System institution that they serve. For example, the Senate Committee on Agriculture, Nutrition, and Forestry report accompanying the original Senate bill, S. 1665, stated with respect to the outside director requirement that, "[t]he Committee believes that receiving this outside input will improve the operation of the System." S. Rep. 100-230, 100th Cong., 1st Sess. 57 (1987). In the proceedings and debates of the Senate concerning the Senate bill, it was also stated that the bill required outside directors for System associations and the District boards of directors "to provide needed financial expertise to the boards," and that the "outside director must be knowledgeable and

experienced in banking and finance" and that "it would be prudent for all boards to have a disinterested, objective member experienced in agricultural finance on the board . . . [who] will be able to lend his expertise to the farmer-borrower board members." 133 Cong. Rec. S16831-01 (December 1, 1987).

The Congressional view of the purpose of outside directors on System boards is consistent with the views expressed by FCA Board members in hearings considering the House version of the legislation. The FCA Board Chairman statement before the House Subcommittee considering the House bill provided as follows: "Outside directors can be a positive influence in improving business operations. . . . The involvement of outside directors with strong business credentials may offer a significant change in perspective and operations;" Agricultural Credit Conditions, Problems, and Legislative Proposals, Relating to the Farmers Home Administrations, the Farm Credit System, and Commercial Farm Lenders: Hearings Before the Subcommittee on Conservation, Credit, and Rural Development of the House Committee on Agriculture, 100th Cong. 1634-1635 (Statement of Frank W. Naylor, Jr. Chairman, Farm Credit Administration Board). Similarly, another FCA Board member testified that, "I believe the expertise that outside directors could bring to system institutions would be considerable. Outside directors should be mandatory on the district level and encouraged among associations. They should be selected from among persons experienced in the financial market place and in financial management." Id., at 1648 (Statement of Marvin R. Duncan, Member, Farm Credit Administration Board).

Although this evidence of Congressional intent does reflect two distinct concepts, disinterestedness and expertise, the Congressional commentary clearly expresses the overall desire to strengthen and expand the overall financial and business understanding on System boards so that they are better prepared to respond to an ever more challenging agricultural economy and complex economic environment. From this point of view, it would be contrary to the Congressional purpose to require, as the proposed regulation would do, that outside directors be disinterested to such a degree that the objective of providing System institution boards with needed expertise and experience would be undermined.

There is no indication in the legislative text or record that Congress intended that outside directors should have absolutely no connection to the System through their extended families. The fact that an outside director may have knowledge of the System because a family member of that director has a current transaction or relationship with a System institution does not necessarily do anything to diminish the potential value of the director's experience or expertise to a System institution's board or the director's objectivity. The available evidence simply shows is that Congress believed that System boards should include persons with financial and business expertise who would not otherwise be eligible to serve as System institution directors (i.e., outside directors should not be voting stockholders of a System institution) or who would not be connected by their livelihood (i.e., outside directors should not be a System institution officer or employee). In addition, the exclusion of directors of System institutions from eligibility prevents a single individual from serving as an outside director for multiple institutions, thus ensuring that the number of outside viewpoints and the overall amount of outside financial and business expertise available to System boards is maximized.

In the final analysis, the purpose of the outside director requirement was and continues to be to expand the pool of potential candidates who may serve on a System institution's board. To the extent that new regulatory eligibility requirements would operate to restrict that pool of potential candidates in any material way, they would operate to undermine the fundamental statutory purpose of the outside

director requirement and therefore would be detrimental to System institutions and the borrowers they are chartered to serve. Indeed, it is difficult to understand why FCA would have sought to limit the pool of eligible candidates for outside directors in the proposed regulations, while at the same time, in the September 13, 2018 Bookletter on Guidance on Farm Credit Bank and Association Nominating Committees, BL-043, it has tried to maximize the potential pool of persons eligible to serve on the nomination committee and as stockholder-elected directors by expressly stating that all joint stockholders, not just the joint stockholder designated to vote, are eligible to be considered. There does not appear to be a clear policy justification for a restrictive approach to outside director eligibility and an inclusive approve to stockholder-elected director eligibility.

3. Undue Regulatory Burdens

The proposed additional eligibility requirements would impose significant new regulatory burdens, both in restricting the pool of potential outside director candidates and in creating new complexity in the process for identifying eligible candidates that FCA appears not to have recognized. This lack of recognition affects both sides of the cost-benefit equation with respect to the new requirements. First, the costs of compliance with the new requirements will undoubtedly be greater than FCA has realized. As noted earlier, the preamble states, without citing any supporting evidence, that the agency does not believe "that including additional eligibility criteria would adversely affect the board's ability to select a qualified candidate for an outside director seat." In fact, primarily because FCA proposes to attribute to outside directors the System affiliations of the director's immediate family members, at least three of the fourteen associations in the Texas district alone will find that their current outside directors have been disqualified if the proposed regulation goes into effect, and we understand that System institutions in other districts will likewise be affected.

The proposed definition of "immediate family member" is indeed quite broad, encompassing three generations, siblings and in-laws. While this is the same definition that applies to directors' disclosures in an institutions annual report under section 620.6(e), the consequences to the director candidate and the institution of including an outside director candidate's immediate family members in the exclusions under the proposed 611.220 would be more severe. A rule that would prevent not only an outside director candidate, but also any member of that candidate's immediate family members as so defined from being a director, officer, employee, agent, borrower or stockholder of any System institution or holding a controlling interest in an entity that borrows from any System or that is an affiliated organization of any System institution has the very real potential to reduce the number of eligible outside director candidates in a material way.

While section 620.6(e) merely requires disclosure of immediate family members' loans and other transactions with the director's institutions where it applies, an immediate family member's affiliation with a System institution under section 611.220 would completely disqualify a candidate from serving as a director. Not only would such a rule disrupt existing relationships with outside directors, it would make the identification of eligible candidates much more complicated and difficult and impair the ability of System institutions to attract suitable candidates with desirable expertise and experience. More extensive disclosures would be required of potential candidates, which many individuals would be likely to find unreasonably intrusive and arbitrary, since they may involve individuals with whom the candidate is not in regular communication, especially about business matters. As a result, these individuals may very likely

be less willing to consider serving on System institution boards. Many System institutions already face difficulty in finding individuals with the desired expertise and experience in the rural areas where they operate. Qualified individuals who are already active and working in such rural communities are likely to have some immediate family member who has some affiliation to some System institution somewhere.

System institutions would also have to take additional steps to validate candidate disclosures before a candidate is selected in order to avoid the problem of having an appointed director be unable to serve because of a System affiliation of an immediate family member that comes to light only after the director is seated. This due diligence may require disclosure of confidential borrower information by other System institutions in other districts, which is currently not addressed in FCA's borrower privacy regulations. In any event, the additional disclosures and due diligence may nevertheless prove to be unavailing since neither the candidate nor the institution would necessarily be in control of potentially multiple business decisions made by multiple individuals in multiple locations that would disqualify an outside director candidate, but would in fact not in any way relate to the candidate's own interests or activities so as to impair the director's disinterestedness.

On the benefit side of the cost-benefit analysis, FCA has not demonstrated the likelihood of a material benefit that would justify the potential costs of the proposed eligibility restrictions. The preamble states without providing any explanation or support that the agency believes that expanding the list of those to be excluded from outside director consideration will further improve the board's ability to carry out its fiduciary responsibilities. Assuming that the purpose of the outside director requirement was to make additional business and financial expertise available to System institution board, and since the adoption of the regulation as proposed appears likely to result in the inability of System institutions to have access to the valuable expertise of existing outside directors, and to reduce the number of potential candidates who are eligible to provide similar expertise to System going forward, it is hard to see how expansion of the list of those excluded from outside director consideration could possibly improve a board's ability to carry out its fiduciary duties.

4. Alternatives

The existing eligibility requirements for System outside directors have been in place in the FCA regulations for more than a decade and in the Act for more than three decades, and as far as we are aware, they have achieved their original purpose. If the agency is aware of situations where the existing eligibility requirements have not achieved their statutory purpose, FCA should bring them to light. In the absence of such information, we do not believe that there is any demonstrated need to amend the eligibility requirements for outside directors in the current section 611.220 at this time. Indeed, we believe that if the proposed regulation is adopted as currently written, it will have a material negative impact on the safety and soundness of the System by making it more difficult for System boards to identify, attract, and select qualified outside directors. Consequently, we strongly urge the agency to withdraw the proposed rule in its entirety. In any event, since a number of the terms and definitions used in the proposed regulation, including "agent," "controlling interest," "entity," and "immediate family member," are also used in or could be affected by pending changes in the standards of conduct regulations currently being considered by the agency, the proposed outside director regulations should be withdrawn until such time as the standards of conduct regulations have been finalized so that the potential for confusion resulting

from the current inconsistencies in the use of these terms and definitions in the different regulations can be minimized.

We also urge FCA to consider that its concerns about the objectivity and independence of outside directors that are reflected in its proposal to expand prohibited affiliations with System institutions to a candidate's immediate family members would be more appropriately addressed in the standards of conduct regulations than in eligibility requirements. An absolute prohibition for candidate's immediate family members to have affiliations with System institutions goes far beyond what the Act contemplates, and threatens a serious disruption to the governance of System institutions. To the extent that the System affiliations of a family member might constitute a conflict of interest for an outside director/candidate, more specifically, that the affiliation represents a financial or personal interest on the part of the outside director/candidate that affects or has the appearance of affecting that person's ability to perform official duties and responsibilities in a totally impartial manner and in the best interests of the institution when viewed from the perspective of a reasonable person with knowledge of the relevant facts, the standards of conduct regulations already provide an effective mechanism to identify and control those conflicts that is more sensitive to actual risks than an eligibility requirement.

Specific Comments

1. § 611.220(a) Definitions

    a. § 611.220(a)(1) Affiliated organization.

    The proposed definition of "affiliated organization" is so broad and vague that it arguably could be construed to apply to Microsoft and certainly would easily include the Funding Corporation, the Farm Credit Council, the FCCServices Corporation, and Farmer Mac all of which historically would have been thought to benefit from the additional business and financial expertise provided by outside directors of their System institution members. The prohibition for outside directors, in their capacity as System directors, to serve as directors of these types of organizations, which would not apply to their stockholder-elected counterparts, appears to conflict with the policy articulated in FCA's Bookletter on Farm Credit Bank and Association Appointed Directors, BL-009 Revised, which states:

    > All directors have the same fiduciary responsibilities to each institution's stockholders, regardless of how they are selected. All directors must also have the same voting rights, and related responsibilities and duties and be subject to the same rules and requirements, including requirements on pledges of confidentiality, disclosures, and conflicts of interest.

    Prohibiting outside directors from participating in these types of organizations while allowing stockholder-elected directors to do so would amount to arbitrary and unjustified discrimination. Because we believe, as noted below, that section 611.220(b)(1)(i), which prohibits outside directors and their immediate family members from having a controlling interest in an affiliated organization, and section 611.220(b)(1)(ii) which prohibits an outside director from serving on the board of an affiliated organization both should be removed in their entirety, the definition of "affiliated organization" should also be entirely removed. If

FCA does not remove subsection (b)(ii), then the definition of "affiliated organization" should be substantially revised to limit its scope.

b. § 611.220(a)(2) Borrower.

The proposed definition of a "borrower" would include a person or entity guarantees repayment of a loan. If FCA adopts an amendment to the eligibility requirements of section 611.220 that excludes borrowers, FCA should remove guarantors from the definition of a "borrower." The term "borrower" as it is commonly understood does not include persons who are only secondarily liable, and the existence of a regulatory definition of a "borrower" that includes secondarily liable persons could have unintended application in collection and lender liability litigation and in state agency enforcement of state law.

c. §611.220(a)(3) Controlling interest.

The proposed definition of a "controlling interest" which applies to any ownership interest or power to control that an outside director or immediate family member has either in an entity that borrows from any System institution or in an affiliated organization of any System institution, is based on the definition of a "controlled entity" in the current standards of conduct regulations, which includes a 5 percent ownership interest, the power to vote 5 percent of voting stock, or the power to exercising a controlling interest over management policies. We think that this definition is overly restrictive to the extent it applies to entities that borrow from a System institution, and should not apply at all to an affiliated organization.

Setting the standard for control at a 5 percent ownership interest or power to vote voting equities would mean that an outside director/candidate would be disqualified by a immaterial passive ownership interest in an entity that decides to borrow from any System institution, even when the outside director/candidate does not have any liability on the entity' loan, does not have actual power to control the entity's borrowing decisions, or does not even have information about those decisions.

We note that FCA has proposed to replace the definition of a controlled entity in the standards of conduct regulations with the definition of a "reportable business entity" which would require a disclosure if there is ownership of a material percentage of an entity's equity, a power to vote a material percentage of its voting equities, or exert a material influence over the entity's management policies. If FCA adopts the standards of conduct regulations as proposed, the result would be that the test for control for eligibility purposes would be inconsistent with the test for the standard for disclosure and conflict of interest purposes. By way of comparison, the regulations of the Securities and Exchange Commission (SEC) which establish the rules for determining whether a person in an affiliate who controls, is controlled by, or is under common control with another person for the purposes of determining the independence of audit committees and compensation committees for publicly traded issuers,

which should not be any less important than the independence of System outside directors, states that a person is deemed not to be in control of a specified person if the person is not the beneficial owner of more than 10 percent of any class of voting equity securities of the specified person and is not an executive officer of the specified person, whereas an executive officer. 17 CFR § 240.10A-3(e)(1)(ii) (2018).

In addition, it is not clear how an outside director/candidate would ever have a controlling interest in any affiliated organization of a System institution, and therefore, it would seem to be unnecessary to prohibit an outside director/candidate from having such a controlling interest under subparagraph (B). We recommend that subparagraph (b) be deleted.

d. § 611.220(a)(5) Immediate family member. Because we believe that the list of excluded affiliations in the regulation should not be extended to include immediate family members, we believe that the definition of immediate family member is unnecessary and should be deleted from the proposed regulation. If FCA retains the exclusion of affiliations involving immediate family members, then FCA should consider revising the definition of immediate family member to only a spouse, a minor child or stepchild, or a child or stepchild sharing a home with the outside director/candidate. Such a definition would be similar to SEC regulations governing audit committee and compensation committee members of publicly-traded issuers. 17 CFR § 240.10A-3(e)(8). It would also limit the exclusion to situations in which an outside director/candidate is likely to have a personal interest and would lessen the potential to impair the ability of a System institution to attract qualified outside directors.

2. § 611.220(b)(1)(i) Eligibility.

For the reasons stated in our general comments above, we recommend that any limitations on the eligibility of outside director candidates be limited to those provided in the Act. Accordingly, we recommend that the phrase, "or be an immediate family member of any of the above," be deleted from first sentence of the proposed section 611.220.(b)(1)(i), and the phrase "or an immediate family member of such candidate" be deleted from the second sentence of the same provision. Also as noted in our comments regarding the definition of a controlling interest, we also recommend that subparagraph (B) of section 611.220(b)(1)(i) be deleted. Finally, for the reasons stated above related to the definition of affiliated organization, we recommend that section 611.220.(b)(1)(ii) be deleted.

Conclusion

The FCA also asserts in the preamble that the additional eligibility criteria would not adversely affect a System institution board's ability to select a qualified candidate for an outside director but does not provide any evidence or analysis to support that assertion. It is our view that, due to the increased complexity of the vetting process and the potential disqualification of previously eligible candidates, the potential burdens imposed on System institutions by the additional eligibility requirements will be far greater than FCA appreciates. SAC firmly believes that the proposed rule would severely hamper the Association's ability to attract, select and retain qualified directors, likely creating a human capital void at the board level.

We request the FCA to withdraw the proposed rule in its entirety so that the Southern AgCredit Board be an attractive service opportunity for talented individuals to contribute to its governance and success.

Sincerely,

Jeff Williams, General Counsel
Southern AgCredit, ACA

Cc: Board of Directors, Southern AgCredit
Joe H. Hayman, CEO