FARM CREDIT BANK OF TEXAS

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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:

The Farm Credit Bank of Texas (FCBT) 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 have participated in the development of, and fully support, the comments submitted by the Farm Credit Council (FCC) on behalf of System institutions. Because of the importance of these proposed regulations, however, FCBT also wishes to submit its own comments. Having discussed the proposed rule with representatives of FCBT's affiliated associations, we believe that they share similar concerns about the proposed rule, and we expect many of them will submit their own comments.

General 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, is unnecessarily burdensome. While the agency's stated objectives, 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. We believe that there is no need for a regulation to specify the degree of removal because the statute has already unambiguously done so.

The FCA does not appear to have conducted any meaningful cost-benefit analysis of the additional eligibility restrictions. 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,

but does not explain how it will do so. The preamble cites no examples of situations where the existing requirements have created any obstacles to the performance of System boards' fiduciary obligations or the fulfillment of the statutory purpose. In addition, the agency has failed to take fully into account the cost to the System of achieving greater purity in the independent perspective of outside directors. Without a demonstration of the need to impose additional regulatory requirements in order to achieve the statutory objective of providing independent viewpoints on System boards, the addition of even an incremental regulatory burden would seem to be arbitrary and unjustified. The preamble also states, without supporting analysis that the additional eligibility criteria would not adversely affect a System institution board's ability to select a qualified candidate for an outside director. 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 has appreciated.

1. Statutory Authorization

One reason FCA should be cautious in imposing additional eligibility requirements for outside directors is that its statutory authority to do so is far from clear. 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." 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 when it could easily have imposed the same requirement on all institutions if that had been its intent. Indeed, the fact the original Senate bill expressly

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. This is not a case where Congress left a gap for FCA to fill, but rather, a clear and unambiguous expression of Congressional intent.

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. Any requirement not already contemplated by the Act would neither carry out its provisions nor be consistent with it. While it is true that the current section 611.220(a)(1) and the outside director definition at section 619.9235 already apply to banks as well as to associations the requirement that an outside director cannot be an agent of a System institution, and are arguably inconsistent with the Act with respect to banks that have not merged under section 7.12, that fact 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 outside director requirement for System institutions 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 institutions 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 conditions and a more 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 ever 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 to impair the director's objectivity. Instead, the available evidence simply shows that Congress believed 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 (or borrowers) of a System institution) or who would not be connected to System institutions through their livelihoods (i.e., outside directors should not be a System institution officer or employee (or agent)). In

addition, the exclusion of directors of System institutions from outside director eligibility reflects an intent to prevent 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 would be 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 the pool of potential candidates in any material way, they would undermine the fundamental statutory purpose of the outside director requirement. 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 as nomination committee members and as stockholder-elected directors. There does not appear to be a clear policy justification for a restrictive approach to outside director eligibility, on the one hand, and an inclusive approach to stockholder-elected director eligibility, on the other.

3. Undue Regulatory Burdens

The proposed additional eligibility requirements would impose significant new regulatory burdens that FCA appears not to have recognized. First, the costs of compliance would include both the restriction of the pool of potential outside director candidates and the creation of new complexity in the process for identifying eligible candidates. The preamble states 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," but does not cite any supporting evidence for that statement. 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 as currently written, 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 institution's annual report under section 620.6(e), the consequences of including an outside director candidate's immediate family members in the exclusions under the proposed 611.220 for the director candidate and the institution would be much more severe than the disclosure requirements under section 620.6(e). 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.

Where section 620.6(e) merely requires disclosure of immediate family members' loans and other transactions with the director's institutions, section 611.220 would completely disqualify a candidate from serving as a director because of an immediate family member's affiliation with a System institution. Not only would such a rule disrupt existing relationships with outside directors, it would make the

identification of eligible candidates much more complicated 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. 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. Once potential candidates are made aware of the extent of disclosures they would be expected to make even to be considered, they may very well be unwilling to serve on a System institution board.

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 outside director become 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 that could be made by multiple individuals in multiple locations at any time that could disqualify an outside director candidate, even though they would not in any way relate to the candidate's own interests or activities in a way that actually impairs the director's disinterestedness.

On the benefit side of the cost-benefit analysis, FCA has not demonstrated the likelihood of any material benefit that would justify the potential costs of the proposed eligibility restrictions. The preamble merely states without providing any explanation or support 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 boards, and given that the adoption of the regulation as proposed appears likely to cause System institutions to be unable to retain the valuable expertise of existing outside directors as well as to reduce the number of potential candidates who are eligible to provide similar expertise to System boards 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, select and retain 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 would be more appropriately addressed in the standards of conduct regulations than in eligibility requirements. An absolute prohibition for a candidate's immediate family members to have affiliations with System institutions goes far beyond anything that the Act contemplates, and threatens 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, the standards of conduct regulations already provide an effective mechanism to identify and control those conflicts that is more sensitive to differences in 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 that guarantees repayment of a loan. If FCA adopts an amendment to the eligibility requirements of section 611.220 that excludes borrowers of System institutions, 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 secondary obligors, and the existence of a regulatory definition of a "borrower" that includes secondary obligors 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 5 percent of voting equities would mean that an outside director/candidate could 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's 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 disparity would create another way in which outside directors would be treated differently that stockholder-elected directors: i.e., outside directors would be completely disqualified by a 5 percent controlling interest, while stockholder-elected directors would only have to disclose if they have a material interest.

By way of comparison, the regulations of the Securities and Exchange Commission (SEC) which govern whether a person is 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 presumably is a question that is not 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. 17 CFR § 240.10A-3(e)(1)(ii) (2018). The Federal Reserve Board's (FRB's) Regulations O and W use a 25 percent threshold for purposes of determining control in the context of the rules governing loans to insiders and transactions with affiliates and, respectively. 12 CFR §§ 215.2(c) and 371c(3) (2018). A 25 percent standard is also used in the Bank Holding Company Act, 12 USC § 1841(a)(2), and the Change in Control Act, 12 USC § 1817(j)(8)(B), and the implementing regulations for all three of the banking regulators, 12 CFR §§ 5.50(d)(4) [Office of the Comptroller of the Currency], 225.2(e)(1) [FRB], and 303.81(c) [Federal Deposit Insurance Corporation]. It is difficult to understand why the test for control for System outside directors should be more restrictive than the tests used by other regulators for non-System institutions.

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 the definitions used in SEC regulations governing audit committee and compensation committee members of publicly-traded issuers, as well as the FRB's Regulation O governing insider loans. See, 17 CFR § 240.10A-3(e)(8) and 12 CFR § 215.2(g). That definition 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 expressly 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

Once again, while we agree that FCA's regulatory objectives in proposing the new eligibility requirements for outside directors, i.e., to strengthen safety and soundness, strengthen outside director independence, and incorporate best practices in System governance are worthy goals, we believe that the proposed changes are unnecessary. Furthermore, by limiting the pool of qualified candidates available for consideration as outside directors and making it more difficult for System institutions to attract and retain qualified outside directors, the new requirements would actually undermine the original purpose of the statutory requirement. Accordingly, we respectfully urge the agency to withdraw the proposed rule in its entirety.

Sincerely,

Carolyn Owen

Carolyn Owen
Senior Vice President and General Counsel