



EM-31.1

Category: Board & Management Operations

Topic: Corporate Governance

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Overview

Corporate governance is the system of rules, practices, and processes by which an institution is directed and controlled. A well-defined and enforced corporate governance is a structure that works for the benefit of everyone concerned by ensuring the institution adheres to accepted ethical standards and best practices as well as formal laws and regulations. Specific corporate governance components addressed in this Examination Manual section include direction and control of operations, director elections and qualifications, and standards of conduct practices. There are other important components of corporate governance, as well (e.g., business planning processes and audit and review programs), which we address as stand-alone Examination Manual topics.

Direction and control of operations is a key component of corporate governance. Direction and control speaks to the guidance and practices for establishing the institution's risk management and internal control framework. A comprehensive evaluation of board and management direction and control activities should address both regulatory compliance and overall effectiveness. Primary examination areas addressed as part of direction and control include enterprise risk management, bylaws, policies, and reporting processes.

Corporate governance is heavily influenced by an institution's director election processes and the qualifications of board members. Farm Credit Administration (FCA) Regulations and other guidance establish specific requirements for director elections and qualifications. Because the board establishes the institution's culture and guides overall operations, the election or appointment of qualified directors is key to a healthy institution. While elected directors play a vital role on the board, appointed directors are also very important. Appointed directors can provide financial and technical expertise to the board that may otherwise be limited. Further, training and self-evaluation programs help ensure the continued growth and education of board members, thus enhancing their ability to skillfully guide the institution.

Standards of conduct (SOC) is another key component of corporate governance. A comprehensive evaluation of an institution's SOC program should address regulatory compliance and the program's effectiveness. FCA Regulations provide both specific guidance and general principles for evaluating SOC programs. However, SOC is a complex area where usually no two circumstances will be identical. As such, while regulatory compliance is important, an institution's SOC program can be fully compliant and ineffective at the same time. Such situations can result in significant reputation risk and potential legal and financial risk for an institution, which underscores the importance of this area. Institutions must ensure SOC programs are both compliant with regulations and effective in practice. Whistleblower and criminal referral programs are also examined in conjunction with SOC programs and are addressed in this Examination Manual section.

Note: Guidance is currently under development for several of the procedures below. In the interim, the following links provide related guidance that was contained in the old FCA Examination Manual:

- [EM- 510 Overall Assessment](#)
- [EM- 520 Policies and Procedures](#)
- [EM- 525 Internal Controls](#)

Examination Procedures and Guidance

Direction & Control of Operations

1. Enterprise Risk Management:

Evaluate the use of an enterprise risk management framework and related processes and models to identify and manage risks from an integrated, institution-wide perspective.

Guidance:

2. Cooperative Principles:

Evaluate efforts to uphold a cooperative business culture and involve customers in the corporate governance of the institution.

Guidance:

3. Bylaw Changes:

Determine if changes to the bylaws are appropriate and comply with regulatory guidance.

Guidance:

4. Policy Administration:

Determine if processes for developing, maintaining, and implementing board policies are adequate.

Guidance:

5. Required Policies:

Determine if the board has adopted adequate policies in all areas required by statutes, regulations, or other regulatory guidance.

Guidance:

6. Internal Control Policy:

Evaluate the internal control policy for compliance with regulations and to ensure the board provides sufficient direction over the internal control function.

Guidance:

7. Reporting:

Evaluate the adequacy of management reporting to the board.

Guidance:

8. Corrective Actions:

Evaluate corrective action processes and controls to ensure timely followup, reporting, and resolution of identified weaknesses.

Guidance:

9. Audit:

Determine if the institution conducts an effective audit (scope, reporting, and followup) of corporate governance issues.

Guidance:

The internal audit and review program is a key mechanism for ensuring corporate governance processes are functioning effectively and in compliance with regulatory requirements. The internal auditor or other qualified, independent party should review the adequacy of governance processes to ensure compliance with applicable criteria. The audit risk assessment and scope should address corporate governance topics, and audit frequency should be commensurate with the complexity of the institution's operations and risk profile. Corporate governance is a broad area that covers several aspects of an institution's operations. Typically, there will be many different areas and processes that will fall within an audit scope for corporate governance. A reliable audit program provides the board reasonable assurance that corporate governance is sound and that reporting is complete and accurate.

Evaluative questions and items to consider when examining the audit function regarding corporate governance include:

- **Audit Coverage: Is there periodic audit or review coverage of corporate governance?** Audit or review coverage and frequency should be appropriate relative to risks, changes in the operating environment, regulatory requirements, and periodic testing needs. Coverage should also be consistent with the institution's risk assessment results and annual audit plan.
- **Scope and Depth: Are audit or review scope and depth sufficient to conclude on the adequacy, completeness, and timeliness of corporate governance processes?** The scope

should cover key processes and controls within the area being audited or reviewed. The depth of work should be sufficient to determine if internal controls are functioning as intended and regulatory requirements are met. The scope and depth of coverage should be consistent with the approved audit or review plan and engagement contract (if applicable). If audit or review work deviated materially from the original planned scope, the board (or Audit Committee, if so delegated) should be notified of the reasons for the change. Specific items that should be considered in the audit or review scope include:

- Enterprise risk management processes.
 - Policy and bylaw administration.
 - Board reporting.
 - Corrective action processes and reporting.
 - Whistleblower programs.
 - Director election policies, procedures, and processes.
 - Standards of conduct policy, procedures, and processes.
 - Director training, qualifications, and self-evaluations.
 - Criminal referral policy, procedures, and processes.
 - Compliance with corporate governance-related regulations, bylaws, and policies.
 - Fraud-related threats and vulnerabilities, as well as anti-fraud controls.
- **Reliability of Results: Did FCA identify any concerns with audit and review reliability?** Evaluate the reliability of internal audit or review work by comparing the results to FCA's examination results in this area. This comparison often includes FCA testing of transactions that were covered in the internal audit or review (transactions are often loans or loan applications, but may include other types of transactional activity, as well). In addition to the audit or review report, examiners should request and review the workpapers and hold discussions with the auditor to obtain a more thorough understanding of work completed. Often, auditors and reviewers will complete line sheets, flowcharts, control matrices, standard work programs, workpaper forms, or other relevant documents when conducting work. Workpapers should adequately document the work performed and support the final report. In addition, any proforma work programs, workpapers, or other tools should be accurate and sufficiently thorough. If there are material weaknesses identified by examiners that are not identified by internal audits or reviews, examiners should assess the underlying reasons.
 - **Reports: Do internal audit reports sufficiently communicate corporate governance review results and recommendations, if applicable?** Examiners should consider the following when evaluating the audit or review report:
 - Is the report prepared in accordance with the institution's guidelines?
 - Is an executive summary or overview included to provide the board with a general conclusion on audit or review results?
 - Is the report accurate, concise, supported, and timely in communicating the audit or review objectives, scope, results, conclusions, and recommendations?
 - Are conclusions and recommendations realistic and reasonable given the institution's size and complexity, with material and higher risk issues clearly identified and prioritized?

- Are conclusions and recommendations supported by convincing evidence and persuasive arguments (condition, criteria, cause, and effect)?
- Does the report conclude whether the institution adheres to policies, procedures, and applicable laws or regulations, and whether operating processes and internal controls are effective?
- Does the report address potential vulnerabilities to fraud, if applicable?
- **Corrective Action: Are management responses to audit findings in this area reasonable, complete, and timely? Have corrective actions been effective?** Audits and reviews are only effective if corrective action is taken to remedy the weaknesses identified. As such, there should be a reasonable, complete, and timely management response to the audit or review report. In some cases, management commitments and agreements or any areas of disagreement are documented in the report or in a separate memo or tracking system. If corrective actions are not resolving the issues or concerns (based on repetitive audit findings, FCA findings, etc.), examiners should further investigate the reasons. For example, this could indicate the audit or review did not sufficiently identify the underlying causes or materiality of weaknesses, sufficient resources are not being directed toward corrective actions, or weaknesses exist in the institution's corrective action process, including board oversight of the process.

10. UBEs:

Evaluate the adequacy of guidance and controls for administering the use of unincorporated business entities (UBEs) and complying with FCA Regulations and guidance.

Guidance:

FCA Regulations in Part 611, Subpart J allow institutions to organize or invest in UBEs for certain designated purposes. Institutions must submit to FCA's Office of Regulatory Policy either a notice or a request for approval when organizing or investing in a UBE, as required by FCA Regulations [611.1154](#) and [611.1155](#), respectively. Guidance on submitting this information to FCA is outlined in an Informational Memorandum entitled [Guidelines on Submissions of Notices to FCA and Requests for FCA Approval of Unincorporated Business Entities](#) dated July 30, 2013. In addition, institutions that use UBEs should have sufficient guidance and controls for administering UBE activities. Evaluative questions and items to consider when examining UBE administration include:

- **Guidance and Controls: Are guidance and controls sufficient to ensure compliance with FCA requirements on the use of UBEs?** Guidance and controls should be commensurate with the extent of UBE use. Institutions that only use UBEs infrequently for acquired properties would not be expected to have the same level of guidance and controls as institutions that make more extensive use of UBEs. Guidance and controls should specifically address and ensure compliance with the following regulatory requirements:
 - Compliance with the general restrictions and prohibitions on the use of UBEs (FCA Regulation [611.1153](#)).
 - Submission of the required notice or request for approval before organizing or investing in a UBE (FCA Regulations [611.1154](#) and [611.1155](#)).
 - Adherence to all FCA conditions of approval on individual UBEs.
 - Maintenance of documents necessary to protect the institution's interest in each

- UBE (FCA Regulation [611.1156\(a\)](#)).
 - Divestiture as soon as practical of its interest in UBEs (FCA Regulation [611.1156\(b\)](#)).
 - Disclosure of UBE investments and business activity in the annual report (FCA Regulation [611.1157\(a\)](#)).
 - Timely reporting to FCA on dissolution of UBEs that it controlled (FCA Regulation [611.1157\(c\)](#)).
- **Grandfathered UBEs:** Has the institution complied with the requirements in FCA Regulation [611.1158\(b\) and \(c\)](#) for UBEs that existed prior to July 22, 2013? Grandfathered UBEs remain subject to their conditions of approval and the same ongoing requirements, disclosures, and reporting as other UBEs. In addition, changes to a grandfathered UBE or an institution investing for the first time into a grandfathered UBE are subject to the notice and approval requirements of the regulations.
- **Reporting: Does the board receive sufficient reporting on UBEs?** Similar to the extent of guidance and controls, the amount and frequency of board reporting should be commensurate with the extent of UBE use. Reporting should enable the board to monitor UBE activities and investments for compliance with regulations and the institution’s guidance and to ensure the objectives of each UBE are being achieved.

Examination Procedures and Guidance

Director Elections & Qualifications

1. Director Elections:

Evaluate processes and controls for nominating and electing board members.

Guidance:

An effective board of directors is a key ingredient for a healthy and successful cooperative. Director elections involve the membership in selecting qualified and diverse stockholders to serve as directors. Institutions use nominating committees and other election processes and controls, as outlined below, to carry out this important governance function.

Nominating Committees: One of the most important contributions a stockholder can make is to serve on the Nominating Committee. The committee’s job is to identify, evaluate, and nominate candidates to stand for election to the institution’s board. This helps ensure that director candidates have sufficient skills and experience to provide sound guidance and leadership to the institution.

An effective Nominating Committee is vital to ensuring sound governance. FCA Regulations identify specific Nominating Committee requirements as a framework for an effective committee; however, compliance with regulations means more than having policies, procedures, and processes that reflect the rules. Institutions need to also properly follow and implement those processes. Evaluative questions and items to consider when examining Nominating Committee compliance and effectiveness include:

- **Regulatory Compliance: Do Nominating Committee processes comply with regulatory requirements?** FCA Regulation [611.325](#) provides parameters for Nominating Committee powers, duties, and general operations. While the regulation sets forth general parameters, it requires each bank and association to have policies and procedures on its Nominating

Committee to address the finer details of the committee's formation, composition, operation, resources, and duties. To aid institutions in developing these policies and procedures, FCA has supplemented the regulations with the following additional guidance:

- FCA Bookletter [BL-043](#) – Guidance on Farm Credit Bank and Association Nominating Committees
 - [FAQs About Governance Changes in 2006](#) (see the *Nominating Committee* section)
 - [The Role of Farm Credit System Nominating Committees](#) (a brochure communicated to institutions in a November 9, 2010 [Informational Memorandum](#))
 - [The Director's Role](#) (see the *Nominating Committee* section)
- **Selection Process: Is the process for finding Nominating Committee candidates effective?**
In addition to meeting regulatory requirements, institution processes should be effective in identifying eligible, qualified candidates for stockholder election to the Nominating Committee. Sound business practices would include identifying alternative candidates (beyond the existing committee members) and identifying more candidates than there are positions, which gives stockholders a choice in the election process. Periodic turnover in the committee members is also beneficial, as it introduces fresh perspectives. Institutions that have a history of using the same individuals (or group of individuals) should be challenged to widen the search for committee candidates. Additionally, if director positions are based on regional, geographic, or commodity representation goals, having a similar representational structure for the Nominating Committee may be beneficial.
 - **Committee Responsibilities: Is the Nominating Committee effective in carrying out its responsibilities?** Ultimately, the Nominating Committee's effectiveness is demonstrated through its ability to ensure competitive elections by identifying, evaluating, and nominating at least two qualified candidates for each director position. Institutions should have processes that ensure the committee receives and reviews all materials required by regulations. This includes evaluating potential candidates against the desired director qualifications policy, and considering any needs identified in the board self-evaluation, which the committee may request. In addition, FCA Regulation [611.325\(d\)\(1\)](#) directs institution nominating committees to "...endeavor to ensure representation from all areas of [an institution's] territory and, as nearly as possible, all types of agriculture practiced within the territory." As an institution's borrower base becomes more diverse, we encourage the Nominating Committee to consider seeking out qualified candidates that are representative of diverse backgrounds and skills. Other considerations when evaluating Nominating Committee effectiveness include the following:
 - The identification and evaluation of director candidates is a difficult and time-consuming process that may take several months rather than one or two meetings. Among other duties, the Nominating Committee needs to orientate new members, review and discuss regulatory requirements, and review the large amount of information available to the committee. An institution must give the committee sufficient time and resources to complete its duties. *Note:* Management should ensure the committee has the information and resources it needs but should not be directly involved in committee activities. This is important to avoid potential conflicts of interest or interference with the process.
 - The Nominating Committee may see its job as finding someone to run against the incumbent director, rather than finding the best qualified candidates. All candidates should be selected through a comprehensive evaluation process. The committee

should not give special preference to incumbents, and there is no requirement that an incumbent be automatically nominated by the committee. Given this, look to the privacy of Nominating Committee meetings and if the committee has avoided even the appearance of influence over its activities by directors, officers, or employees.

Other Election Processes and Controls: FCA Regulations and other guidance identify several requirements related to director election processes and controls. The primary purpose of these requirements is to ensure elections are fair, impartial, and facilitate effective governance through implementation of cooperative principles. Evaluative questions and items to consider when examining these director election processes and controls include:

- **Impartiality in Elections: Does the institution remain impartial in director elections as required by FCA Regulation [611.320](#)?** Institutions must adopt policies and procedures that ensure director elections are conducted in an impartial manner. Director candidates cannot be endorsed by the institution or its employees or agents. This is particularly important for incumbent directors so they are not given any favoritism or special treatment. Also, directors are prohibited from using their official capacity to take a position or campaign on behalf of anyone but themselves. The regulation also addresses the use of institution property, facilities, resources, and records to ensure equitable treatment for all candidates, including floor nominees. While the regulation outlines specific requirements, the overriding principle is that institutions, including officers, directors, employees, and agents, must remain impartial in director elections.
- **Campaign Materials: Are campaign and educational materials for director candidates handled in accordance with regulatory requirements?** FCA Regulation [611.320\(e\)](#) prohibits institutions from distributing director candidate campaign materials. However, FCA Regulation [611.330\(c\)](#) requires that institutions provide stockholders with disclosure statements prepared by each candidate that serve as educational materials to ensure an informed electorate. FCA Bookletter [BL-056](#) clarifies the regulatory requirements by differentiating between campaign material and educational material. In general, campaign material is intended to influence stockholder voting decisions, while educational material is designed to inform voters of the candidate's background, experience, and qualifications. The Bookletter identifies specific expectations for addressing these materials as part of the impartiality in elections policy and procedures. The following provides additional guidance related to campaign and educational materials:
 - FCA Regulation [618.8310\(b\)](#) requires institutions to provide a candidate (upon request) with a list of stockholders that can be used for distributing campaign materials.
 - Candidates should not use the Farm Credit System's Bio-star, the institution's logo, or other similar proprietary information in campaign materials. Institutions should address this in guidance and communicate it to candidates to help avoid an appearance that the institution has endorsed the candidate, which could result in a violation of FCA Regulation [611.320](#) on impartiality in elections.
 - FCA's [FAQs About Governance Changes in 2006](#) (questions 33 and 34) discuss requesting and distributing educational and campaign materials.
- **Floor Nominations: Do floor nomination processes comply with regulatory requirements?** FCA Regulation [611.326](#) requires associations to allow floor nominations for every open

stockholder-elected director position, and to adopt policies and procedures for making and accepting floor nominations. Banks that allow floor nominations must also adopt policies and procedures, and follow other related requirements. FCA Bookletter [BL-055](#) provides additional guidance on floor nomination procedures. One important aspect discussed in both the Bookletter and the regulation is that institution policies and procedures do not have to require a second of a floor nomination; however, if any support for a floor nomination is required, it may not require more than a second. If this issue is not addressed in policies and procedures, then floor nominations do not need a second, although members may second a nomination to show support. After evaluating an institution's policies and procedures, examiners should review historical meeting records, disclosures, or other information to ensure compliance with policies, procedures, and regulatory requirements.

- **Director Nominee Disclosures: Do director nominee disclosure processes comply with regulatory requirements?** FCA Regulation [611.330](#) requires banks and associations to adopt policies and procedures that ensure a disclosure statement is prepared by each director nominee. These disclosure statements must be distributed to voting stockholders and include the information required by the regulation and referred to in FCA Regulation [620.6\(e\) and \(f\)](#). Any person, including a floor nominee, who does not make the required disclosures under this regulation may not continue as a nominee or be placed on the ballot. These disclosures are part of the Annual Meeting Information Statement (AMIS) and ballots issued for director elections, pursuant to FCA Regulation [611.330\(c\)](#).
- **Confidentiality and Security in Voting: Do election practices ensure confidentiality and security in voting?** FCA Regulation [611.340](#) requires banks and associations to have policies and procedures that ensure: 1) ballots will only be provided to the record date list of stockholders, 2) ballots and other election material will be adequately secured, and 3) certain information and materials regarding the election will remain confidential. Refer to the regulation for specific requirements. Institutions must either establish a tellers committee, consisting of voting stockholders, or hire an independent third party (e.g., an accounting or law firm) to validate and tabulate votes. Employees, directors, director nominees, and members of that election cycle's Nominating Committee are prohibited from serving on the tellers committee. A small number of institution administrative employees may assist the tellers committee in verifying a stockholder's eligibility to vote. The administrative employees may also be stockholders as long as there is no conflict of interest; however, they may not be members of the institution's management or leadership team. Verification of voter eligibility may be done in advance of the vote tabulation, but only after the record date list of voting stockholders has been provided to the tellers committee. The regulation also prohibits the use of signed ballots, and addresses proxy ballots and ballot security.
- **Cooperative Principles in the Election Process: Does the director election process promote the application of cooperative principles?** Following cooperative principles is key to System institution governance. FCA Regulations [611.350](#) and [615.5230](#) outline the requirements related to stockholder voting rights, including cumulative votes and holding regional voting in director elections, to ensure the proper application of cooperative principles. Internal controls should be sufficient to ensure processes for determining voting stockholders and conducting elections are sound, prevent manipulation, and comply with these regulatory requirements.

- **Midterm Vacancies: Have any midterm vacancies in stockholder-elected director positions been appropriately addressed?** Midterm director vacancies should be addressed in a reasonable and timely manner, consistent with the institution's bylaws. Institutions will typically have three options to fill midterm vacancies: have the board appoint a replacement to complete the term, hold a special election, or address the vacancy in the next regular election. However, institutions will need to accelerate the process if the board composition has fallen below the FCA Regulation [611.220\(a\)\(2\)](#) mandatory minimum requirement that 60 percent of the board be stockholder-elected. Refer to questions 7 and 8 in the *Board Composition* section of FCA's [FAQs About Governance Changes in 2006](#) for additional guidance.

Appointed Directors: Bank and association boards are allowed to appoint a limited number of directors. This includes both stockholders (appointed stockholder directors) and individuals with no System affiliation (outside directors). Each institution must always have at least one outside director, but may appoint more directors so long as stockholder-elected directors continue to constitute at least 60 percent of the members of each institution's board. The *Board Composition* section of FCA's [FAQs About Governance Changes in 2006](#) answers common questions related to using this authority. Refer to FCA Bookletter [BL-009](#) for specific guidance on board policy expectations and conflicts of interest for appointed directors. Also, refer to the examination guidance for the *Outside Director* procedure, as outside directors are the most common type of appointed director.

The following documents provide additional information and criteria related to election processes:

- FCA Regulation [611.110](#) on meetings of stockholders
- [FAQs About Governance Changes in 2006](#) (see the *Director Elections and the AMIS* section)

2. Director Eligibility, Qualifications, & Training:

Evaluate the adequacy of policies and processes for director eligibility, qualifications, and training.

Guidance:

Institutions are to comply with director eligibility requirements contained in FCA Regulations and institution bylaws. Institutions are also required to establish a policy identifying desirable director qualifications. The policy on qualifications must be provided to the Nominating Committee for use in identifying director candidates. Once elected, each director must comply with the institution's policy regarding director training. These regulatory requirements are intended to promote strong corporate governance.

Evaluative questions and items to consider when examining policies and processes for director eligibility, qualifications, and training include:

- **Eligibility for Board Membership and Subsequent Employment: Are processes and controls sufficient to ensure compliance with director eligibility and subsequent employment restrictions?** FCA Regulation [611.310](#) identifies eligibility and subsequent employment restrictions for bank and association board members. Institutions may have additional requirements in bylaws or policies. Processes and controls should be sufficient to ensure these eligibility and subsequent employment restrictions and requirements are followed. This should include making sure the Nominating Committee and board are aware of these

restrictions and requirements. *Note:* Eligibility requirements included in bylaws or policies cannot exceed the scope of the institution's authority or be discriminatory. Also, the eligibility requirements may not deny a stockholder his or her "membership and voting interest in the association" pursuant to section [4.14B\(c\)](#) of the Act.

- ***Desirable Director Qualifications: Are the institution's policy and practices on director qualifications sufficient and in compliance with regulatory requirements?***
 - FCA Regulation [611.210\(a\)\(1\)](#) requires banks and associations to have a policy that identifies desirable director qualifications. The policy must explain the type and level of knowledge and experience desired for board members. It must also be updated periodically and provided to the Nominating Committee. A sound business practice is to update it before providing it to the committee, using the results of the board's annual self-evaluation. This will help the committee to address any current board needs when identifying candidates. In addition, FCA Bookletter [BL-009](#) identifies expectations for related policy guidance on appointing directors.
 - FCA Regulation [611.210\(a\)\(2\)](#) requires all institution boards to have a financial expert and defines the qualifications for that position. FCA developed a [Financial Expert Determination](#) flowchart to assist in determining if an individual meets these qualifications. Refer to the *Financial Expert* section of FCA's [FAQs About Governance Changes in 2006](#) for additional guidance.
- ***Board Training Needs: Are the institution's policy and practices on director training sufficient and in compliance with regulatory requirements?*** FCA Regulation [611.210\(b\)](#) requires banks and associations to establish and maintain a policy and procedures on director training. The policy must identify training areas that support the institution's desired director qualifications. Newly elected or appointed directors must complete director orientation training within 1 year of their election or appointment. However, a sound business practice is to complete this training within 30 to 60 days of becoming a director. In addition to standard orientation information, the training should cover key issues such as fiduciary duties, standards of conduct, and committee functions. Also, the policy must require that incumbent directors attend training periodically to advance their skills. In implementing this requirement, boards should consider developing both group and individual annual training plans. Individual plans should be tailored to the director's position on the board, such as Audit Committee chair, and consider the results of any individual self-assessment or other feedback mechanism used to gauge board member performance. The training policy should specifically address ongoing training for directors related to the duties and functions of committees on which they serve. FCA Bookletter [BL-060](#) provides guidance on this as it relates to helping directors carry out their Compensation Committee duties. [The Directors Role](#) is also a valuable resource for identifying potential training topics.

For additional guidance and clarification of regulatory requirements on director qualifications and training, refer to the *Board Composition* and *Board Development* sections of FCA's [FAQs About Governance Changes in 2006](#).

3. Outside Directors:

Determine if the use of outside directors complies with regulations and provides expertise to the board.

Guidance:

FCA Regulation [611.220](#) requires banks and associations to have outside directors. These positions should bring an independent perspective to the board, and help the board acquire additional or specialized skills to supplement the skill set of stockholder-elected directors. For example, a board may find that none of the stockholder-elected directors have the necessary skills to be considered a financial expert. In general, as the scope and complexity of the institution's operations increase, the need for specialized skills on the board will also increase.

Evaluative questions and items to consider when examining the use of outside directors include:

- **Selection Process: Does the institution have adequate processes to identify outside director candidates?** The institution should conduct a formal search for candidates similar to what a nominating committee does for stockholder-elected directors. The search should center on candidates that can fill a specific board role or need. The board's desired director qualifications policy and its self-evaluation are vital tools in identifying those areas. Potential conflicts of interest are another important consideration. Recusals necessitated by the conflicts may reduce the person's value to the board. Sound business practices call for a process that provides the board at least two qualified candidates to choose from for each vacancy. The process should also include a formal performance assessment of any incumbent seeking reappointment. Processes that allow incumbents to go unchallenged or be reappointed for multiple successive terms should be questioned and discussed with the board.
- **Regulatory Compliance: Is the institution complying with FCA Regulation [611.220](#) on outside directors?** This regulation addresses specific requirements for eligibility, number, terms of office, and removal of outside directors. Institution bylaws, policies, or procedures should address these requirements and the institution's processes for ensuring compliance. In addition, institutions should maintain documentation supporting compliance with these requirements and the assessment of how each outside director helps the institution achieve the desired director qualifications pursuant to FCA Regulation [611.210\(a\)](#).

The following documents provide additional information and criteria related to outside directors:

- FCA Regulation [619.9235](#) – Definition of Outside Director
- FCA Bookletter [BL-009](#) – Farm Credit Bank and Association Appointed Directors
- [FAQs About Governance Changes in 2006](#) (see the *Outside Director* section)

4. Board Self-Evaluations:

Evaluate the board's annual self-evaluation process, and determine if it is used to enhance the quality of board direction and oversight.

Guidance:

Self-evaluations provide the board a valuable tool to assess its strengths, weaknesses, and needs. This is particularly important to the strategic planning process as the board evaluates opportunities to improve its performance, especially in light of current and anticipated economic conditions. The following FCA Regulations refer to the need for board self-evaluations:

- FCA Regulation [618.8440\(b\)\(2\)](#) requires the board to consider its annual self-evaluation as part of business planning. This includes reviewing internal and external factors to assess the

board's needs, including skills and diversity, and developing strategies to address any identified weaknesses. The board should consider appointing qualified directors if the elected directors do not possess the desired skills or diversity.

- FCA Regulation [611.325\(e\)](#) requires the board to provide the self-evaluation to the Nominating Committee upon their request.

The regulations do not require a specific method for completing the self-evaluation. Boards may complete it themselves or use outside facilitators, often in conjunction with their planning activities. Using outside facilitators often results in more effective evaluations as they can provide expertise, an objective opinion, and knowledge of best practices used by other boards. Refer to the *Board Development* section of FCA's [FAQs About Governance Changes in 2006](#) for additional guidance. Importantly, the self-evaluation process should be a substantive, beneficial activity and not merely a routine exercise to satisfy regulatory requirements.

Evaluative questions and items to consider when examining the adequacy of board self-evaluations include:

- **Self-Evaluation Process: Does the board have a sufficient process to complete its self-evaluation?** The board should have a defined process for completing the annual self-evaluation. For example, the process should identify information such as applicable regulatory criteria, how all directors will be engaged in the process, who will compile results, and how the results will be communicated to the board. It should also address how audit and examination results will be considered, especially any concerns identified that involve board governance. If the institution does not have the expertise to design and implement a self-evaluation process, it should obtain some form of outside help, such as from the funding bank or an outside consultant. The board should also have a process to address issues raised in the self-evaluation. Recurring issues or weaknesses should receive increased scrutiny. The quality of the input received from directors, either in written form or as part of a group discussion, will dictate how useful the self-evaluation process will be. The board should ensure the self-evaluation process does not become a rubber stamp of the previous year's results. Continued use of the same input forms or facilitators can lead to stale results, so changes to the process may be needed to ensure the results remain fresh. Also, if all board members do not participate in the self-evaluation process, the results may be less useful because they may fail to capture key issues. This may be a basis for additional examination analysis.
- **Self-Evaluation Results: Are the self-evaluation results reasonable and incorporated into board operations?** The self-evaluation results should reflect a thoughtful and candid assessment of the board's performance. The results must be used when assessing the board's needs, including skills and diversity, as part of business planning pursuant to FCA Regulation [618.8440\(b\)\(2\)](#). However, other opportunities exist for using the self-evaluation process to improve operations. For example, the board should consider the results when creating training plans or updating its policy regarding the desirable characteristics of director candidates. The results may also provide insight into the capability of the board, which must be considered when developing the capital adequacy plan pursuant to FCA Regulation [615.5200\(c\)\(1\)](#).
- **Nominating Committee Access: Does the Nominating Committee have access to a summary of the board self-evaluation?** FCA Regulation [611.325\(e\)](#) requires institutions to provide a summary of the current board self-evaluation to the Nominating Committee upon

request. Policies and procedures adopted pursuant to FCA Regulation 611.325 should address this requirement, and the institution should have controls in place to ensure the committee is informed of its right to ask for this summary. Institution's should consider providing this material to the committee even without a request as it provides beneficial information for carrying out the committee's responsibilities. Institutions may require a pledge of confidentiality by committee members before releasing this information.

Examination Procedures and Guidance

Standards of Conduct (SOC) & Criminal Referral

1. SOC Policy & Procedures:

Determine if SOC policies and procedures are appropriate and comply with FCA Regulations.

Guidance:

Effective SOC programs begin with the board based on the culture and tone at the top that it sets. SOC policies and procedures should be an outgrowth from this culture and tone, and should reflect the importance of appropriate and ethical conduct. FCA Regulations require boards to issue policies and procedures governing standards of conduct for directors and employees. Importantly, these policies and procedures must address requirements and prohibitions sufficient to promote public confidence, preserve the integrity and independence of the supervisory process, and prevent improper use of official property, position, or information. Refer to the regulations for details on items that must be addressed.

Evaluative questions and items to consider when examining SOC policies and procedures include:

- **Required Content: Do policies and procedures support a culture of high ethical standards and comply with regulatory requirements?** As outlined in FCA Regulation [612.2135](#), directors and employees must maintain high standards of conduct in carrying out their duties, obligations, and responsibilities. The board plays a key role in this by setting a strong and effective culture regarding appropriate and ethical conduct. This culture should be the driving force behind the institution's policies and procedures. FCA Regulations [612.2160\(c\)](#) and [612.2165](#) identify specific items that policies and procedures must address. It is especially important that they establish appropriate criteria and conditions for allowable relationships, transactions, and other activities addressed in FCA Regulation [612.2165\(b\)\(3\) through \(7\)](#) that are not prohibited, but could present a conflict of interest or appearance thereof. Policies and procedures should be reviewed and updated periodically to ensure they remain pertinent and appropriate as conditions change.
- **Prohibited Activities: Do the policies and procedures clearly communicate prohibited activities and other requirements as described in FCA Regulations [612.2140](#), [612.2150](#), [612.2157](#), and [612.2270](#)? Are recusal processes appropriately addressed?** While these regulations address several areas, they focus on prohibited activities designed to limit conflicts of interest or the appearance thereof. The board may decide to further limit activities based on their desired culture, risk tolerance, or other concerns. Directors and employees are expected to conduct official duties in a prudent and professional manner, and to avoid conflicts of interest with other directors, employees, borrowers, or persons who do business with the institution. In addition, directors and employees must not engage in activities that might impair their judgment or objectivity, discredit themselves, or discredit

the System. Policies and procedures should specifically address recusal expectations, processes, and controls to ensure directors and employees do not influence or have involvement in the decision-making process when a conflict situation exists (see FCA Regulation [612.2165\(b\)\(10\)](#)). A common example would be decisions impacting a director's or employee's loans or loans to their relatives, business partners, or other close acquaintances.

- ***SOC Official Consultation on Insider Transactions: Do the policies and procedures address expectations for consulting with the SOC Official on insider transactions?*** Policies and procedures should define situations that require the credit department to coordinate with the SOC Official when evaluating credit requests involving a director or employee, or where a director or employee has a relationship to the applicant. Policies and procedures should also allow the SOC Official access to director and employee loan files. While these are not regulatory requirements, they are sound business practices and serve as important controls to ensure proactive identification and resolution of potential conflict situations.
- ***Agents: Do policies and procedures address expectations for agents?*** Agents may include contract auditors and reviewers, information technology service providers, outside counsel, or others (see FCA Regulation [612.2130](#)). FCA Regulation [612.2260](#) requires System institution agents to maintain essentially the same high standards as directors and employees. As such, SOC policies and procedures should address the engagement, use, and retention of agents. In addition, FCA Regulation [621.30](#) specifically requires institutions to have policies and procedures governing the engagement of external auditors that must incorporate the provisions of FCA Regulation [612.2260](#). Institutions should identify and maintain a list of all agents, ensure directors and employees are aware of the rules regarding agents, and ensure agents that represent the institution in contacts with third parties or provide professional services are subject to enforceable conduct standards. Institutions must have sufficient processes to demonstrate an agent's acknowledgment of receiving and understanding applicable SOC policies and requirements. For example, this could be accomplished through an acknowledgment form or appropriate verbiage in contracts or agreements with the agent.
- ***Unincorporated Business Entities (UBEs): For institutions that use UBEs, do policies, procedures, or other control processes sufficiently address expectations on compliance with SOC regulations?*** FCA Regulation [611.1153\(c\)\(3\)](#) requires institutions to ensure that transactions between a UBE and System institution directors, officers, employees, and agents are conducted at arm's length, in the interest of the System institution, and in compliance with SOC rules. Institution controls used to ensure compliance should be commensurate with the extent and type of its UBE activities. For example, if the institution is involved in a UBE that conducts business operations and has officers, employees, or agents, then policies and procedures should typically address compliance with the SOC requirements.
- ***SOC-Related Policies for Banks: Do bank policies sufficiently address the following SOC-related issues as required by FCA Regulations?***
 - ***FCA Regulation [614.4460](#)*** – Each bank board that delegates loan approval of official loans and loans with potential conflicts to bank management must have an established policy.

- **FCA Regulation [614.4900\(g\)](#)** – Personnel policies for each Agricultural Credit Bank (ACB) must include written standards of conduct for those involved with foreign exchange activities.

Note: As defined in FCA Regulation [612.2130\(b\)](#), a conflict of interest or appearance thereof exists when a person has a financial interest in a transaction, relationship, or activity that affects or has the appearance of affecting the person's ability to perform official duties and responsibilities in a totally impartial manner and in the best interest of the employing institution when viewed from the perspective of a reasonable person with knowledge of the relevant facts. Refer to FCA Regulation [612.2130](#) for additional definitions related to the SOC regulations.

2. SOC Internal Controls:

Evaluate the adequacy of internal controls, with a focus on the SOC Official role, training programs, and board reporting and oversight.

Guidance:

The board and management are responsible for maintaining a sound SOC internal control environment. FCA Regulation [612.2160](#) identifies the institution's responsibilities, which include ensuring compliance with FCA Regulations and acting promptly to preserve the integrity of and public confidence in the institution in any matter involving a conflict of interest. Conflicts of interest or the appearance thereof can adversely affect an institution's profitability and reputation for fiduciary integrity, and can undermine public confidence in the System. In addition, a conflict may result in financial loss to an institution if the individual involved considers self-interest and personal gain above the institution's interests. As such, internal controls are critical to ensure an effective SOC culture and practices.

An institution may use many internal controls to ensure SOC compliance, all of which begin with the culture the board establishes. Policies and procedures are critical controls as discussed in the preceding examination procedure, and internal audits and reviews serve as an important detective control. Examiners should consider the sufficiency of policies and procedures and the adequacy and results of internal audits and reviews when concluding on SOC internal controls. Refer to the *Audit and Transaction Testing* procedures under the Corporate Governance topic for information on examining audit coverage and conducting transaction testing to validate that controls are functioning as intended. The guidance below focuses on three other key controls: the role of the SOC Official, the effectiveness of SOC training, and the adequacy of board reporting and oversight on compliance with SOC regulations and board policies. Importantly, controls that can prevent SOC problems are critical in helping institutions avoid the negative impacts that SOC issues can create.

SOC Official Role: The board must designate an SOC Official who is responsible for advising directors and employees on requirements of the regulations. FCA Regulation [612.2170](#) outlines the specific duties and responsibilities of the SOC Official. To accurately assess SOC program effectiveness, examiners must understand and evaluate the SOC Official's role within the program. Evaluative questions and items to consider to accomplish this include:

- **Is the SOC Official aware of and performing all duties and responsibilities outlined in FCA Regulation [612.2170](#)?** If the SOC Official is contracted from the district bank, the institution must ensure the person has access to the information needed to perform the duties of the position.

- **Does the SOC Official have the qualifications, training, and independence to conduct his or her duties in an appropriate and impartial manner?** The SOC Official should possess an in-depth knowledge of FCA SOC regulations and the institution's SOC-related policies and procedures. This person should have the qualifications needed to make SOC determinations, document actions taken, and explain the basis for such actions. The SOC Official's qualifications are a strong indicator of an institution's SOC culture, as an unqualified person in this role would suggest that SOC is unimportant to the board and management. The SOC Official should participate in regular training to maintain the needed skills as a subject matter expert. This person should also have direct access to the board to ensure there is no undue influence from management in this important area.
- **Does the SOC Official complete a thorough, timely, and documented review of annual and ongoing director and employee disclosures?** The SOC Official's role should involve more than just distributing and collecting disclosure forms. It should include active involvement in the process to help directors and employees understand the disclosure requirements so they comply with regulations, policies, and procedures. After receiving the completed disclosure forms, the SOC Official should follow a structured process to ensure any issues or relationships are properly evaluated and communicated. The review should be thorough, sufficiently documented (including the resolution), and discussed with the director or employee, as needed. Other responsibilities and considerations include:
 - The SOC Official should formally notify individuals, in writing, that they should refrain from any official duty related to an identified conflict of interest situation. Followup should occur to ensure these individuals are recusing themselves, when necessary.
 - The SOC Official should have access to director and employee loan files. This access enables the SOC Official to more thoroughly assess, as needed, the accuracy and completeness of disclosures. Additionally, the SOC Official should be consulted on potential conflict situations involving loan transactions with directors or employees, or where a director or employee may have a relationship to the applicant. This will help the institution to proactively identify, evaluate, and prevent conflicts of interest and ensure preferential treatment is not occurring.
 - The SOC Official should not consider transaction size when determining if a real or apparent conflict exists.
 - The board (or a designated, qualified individual) should review the SOC Official's disclosures, if applicable, and follow up as needed.
- **Does the SOC Official maintain a list of all current agents and have processes in place to ensure compliance with FCA Regulation [612.2260](#) on standards of conduct for agents?**
- **Does the SOC Official effectively carry out board reporting responsibilities?** The SOC Official should formally report to the board (or designated board committee) on all conflicts of interest, current investigations or complaints, and any other issues required by regulations and the institution's policies and procedures. This helps to ensure the board engages in the SOC process and provides the SOC Official with the necessary resources. In addition, a direct reporting line to the board reduces the potential for undue management influence on the SOC process or SOC Official conclusions.

- **Does the SOC Official ensure the institution adequately maintains SOC-related documentation?** FCA Regulation [612.2160\(e\)](#) outlines specific document maintenance requirements and time frames.

Training: FCA Regulation [612.2160\(b\)](#) requires the institution to take appropriate measures to ensure that all directors and employees are informed of the SOC regulatory requirements and related policies and procedures. While not a regulatory requirement, training can be an effective tool to communicate expectations and facilitate a proper ethical culture. Evaluative questions and items to consider when examining SOC training practices include:

- **Has the institution provided formal SOC training to all directors and employees?** Annual training (or more often if warranted) is a sound business practice to ensure directors and employees are well informed of SOC expectations. SOC is also an important topic to address in new director orientation and training.
- **Does the training help establish the appropriate *tone at the top* and communicate the appropriate culture and expectations for SOC compliance?** This includes informing staff of the potential penalties and remedies for noncompliance.
- **Does the training cover what should be reported on the disclosure statements and provide clear examples of items to be reported?**
- **Do directors and employees certify that they have successfully completed SOC training and understand their responsibilities for regulatory and policy compliance?** While not a regulatory requirement, periodic certifications can be an effective business process to highlight the importance of SOC compliance within the organization.

If the institution doesn't provide SOC training, it should implement other appropriate measures to comply with FCA Regulation [612.2160\(b\)](#) and facilitate an ethical culture. Failure to do so would be an unsafe and unsound condition.

Board Reporting and Oversight: Timely and complete reporting on SOC issues and compliance is a key control for enabling the board to effectively carry out its oversight responsibilities. FCA Regulation [612.2165\(b\)\(12\)](#) outlines general expectations for SOC-related reporting, and requires that policies and procedures establish the institution's reporting requirements. Evaluative questions and items to consider when examining SOC-related reporting to the board include:

- **Does the board receive timely and complete information on SOC issues and compliance to ensure directors, employees, and agents are refraining from any duties or actions where conflicts of interest exist?** The SOC Official should periodically meet with the board (or designated board committee) to discuss SOC activities. The SOC Official must work closely with the board to ensure the proper culture is established, and the board should ensure the SOC Official has appropriate access to the board or a board committee without undue management influence.
- **Do board reports include sufficient detail about director, employee, and agent transactions to ensure the board is informed on any potential issues?** The board should receive sufficient information to carry out its oversight responsibilities.
- **When a conflict of interest or a violation of FCA Regulations or institution policy exists, did the board receive sufficient reporting on the status and resolution of the issue?** Note that

FCA Regulation [612.2170\(a\)\(6\)](#) requires reporting to the board and FCA in some situations.

- **Have reporting expectations outlined in the institution's policies and procedures been followed?**

3. SOC Disclosure Statements:

Review the director and employee SOC disclosure statements for compliance with regulations and institution guidance, and ensure potential issues were appropriately addressed.

Guidance:

As outlined in FCA Regulation [612.2135](#), directors and employees have a responsibility to achieve high standards of conduct in carrying out their duties, obligations, and responsibilities and must avoid conflicts of interest (as defined in FCA Regulation [612.2130\(b\)](#)). Disclosure statements are a key part of the process to help identify and prevent conflicts of interest.

Evaluative questions and items to consider when examining disclosures include:

- **Disclosure Form Templates: Do the disclosure form templates clearly and effectively address items required by FCA Regulations [612.2145](#) (directors) and [612.2155](#) (employees) and the institution's policies and procedures?** The forms should include appropriately worded questions that enable the individual completing the disclosure to understand what must be reported. The institution should also have a process for periodically reviewing the forms to determine if changes to the questions could help individuals better understand conflict of interest situations and prohibitions.
- **Accuracy and Completeness: Were director and employee disclosures accurate and completed in accordance with the institution's policies and procedures?** When completing the disclosures, directors and employees must report all applicable activities. They should not make materiality determinations as that is part of the SOC Official's role. Examiners should consider the results of any transaction testing (completed by FCA during the examination activity or by the institution's audit and review program) when concluding on disclosure accuracy and completeness.
- **Filing and Updating: Were disclosures filed timely with the SOC Official, and is there evidence that disclosures were updated outside the normal, annual reporting process when needed?** FCA Regulations [612.2145](#) and [612.2155](#) address time frame requirements for annual and periodic disclosures, including specific requirements related to senior officers, newly elected or appointed directors, and newly hired employees. Note that an existing employee who is promoted to a senior officer position must complete the disclosures required by FCA Regulation [612.2155\(a\)](#). Since the employee would not have made these disclosures previously, an initial disclosure of this information should be completed within a reasonable time frame after the promotion (similar to the requirement in FCA Regulation [612.2155\(d\)](#) for new employees to report this information within 5 days after starting employment). The regulations also address prompt reporting on an ongoing basis when a director or employee becomes, or plans to become, involved in any relationship, transaction, or activity that is required to be reported or could constitute a conflict of interest.
- **Addressing Conflicts: When a conflict of interest or appearance thereof is disclosed, does the SOC Official appropriately address it?** If the information in the disclosure does not

provide sufficient information to determine the nature of the conflict, the SOC Official should obtain clarification of the information. As a sound business practice, the SOC Official should meet individually with the person to discuss the SOC disclosure and maintain adequate documentation of the outcome.

4. Whistleblower Program:

Determine if the institution has an effective whistleblower program that allows an individual to confidentially report complaints or tips about a violation of law, regulation, or policy, as well as fraud, corruption, or operational weaknesses, for investigation and resolution.

Guidance:

Every institution must have an effective internal control process as required by FCA Regulation [618.8430](#), and a whistleblower (WB) program can be a key component of the process. A WB program, or a similar program by another name (e.g. Ethics, Standards of Conduct, Anonymous Reporting), provides ways to anonymously and confidentially report complaints or tips about a violation of law, regulation, or policy, as well as fraud, corruption, or operational weaknesses. Examples include lending fraud, ethical concerns, and financial reporting irregularities. FCA issued an Informational Memorandum on [Whistleblower Programs](#) dated July 9, 2015, to provide additional guidance and criteria in this area.

Evaluative questions and items to consider when examining WB programs include:

- **Program Structure and Confidentiality: Does the institution have a formalized WB program that provides for confidential and anonymous reporting from both inside and outside the institution?** A WB program should provide anonymous and confidential methods for internal and external sources to provide complaints or tips on suspicious activity. This is typically, and most effectively, accomplished with a telephone hotline or other electronic means for directly communicating a complaint or tip to a third party.
 - WB programs should not be limited to employees. Industry best practices expand WB programs to include external parties, such as customers, loan applicants, appraisers, vendors, and others.
 - Using a third-party WB hotline provider is a key way to ensure confidentiality and anonymity, which should reduce the fear of retribution for making a report. The WB service provider should have experience in handling WB issues and provide a reasonable process for reporting complaints and tips to ensure anonymity.
 - If the institution does not have an externally administered WB program, an alternative process should be in place to ensure confidential and effective WB reporting. While alternative solutions may prove to be effective, institutions should be strongly encouraged to contract this service with a third party. Examiners should discuss with the institution potential drawbacks related to confidentiality and effectiveness with an internally-administered process. Example drawbacks may include potential conflicts of interest and reduced reporting due to confidentiality concerns, fear of retribution, and an intimidation factor. Cost should not be a primary deterrent as third-party services are generally inexpensive.
- **Policy Guidance: Does the institution have adequate written WB policy guidance, including an anti-retaliation policy?** Institutions should have written WB policy guidance

that clearly communicates board expectations to management and staff. The policy should address key items such as internal and external access, investigation processes, reporting expectations, and documentation expectations for WB complaints and investigations (including retention requirements). Policy guidance should also address anti-retaliation expectations to provide appropriate assurance that any person who submits a WB complaint or tip will not be subject to retaliation or retribution from the board of directors, institution management, or its employees. An effective policy will help the board hold management accountable for installing and properly administering the WB program.

- **Reporting, Investigating, and Resolving: Are processes sufficient to ensure complaints and tips are reported to the appropriate parties, investigated, and resolved?** Institutions should assign specific board, committee, and managerial positions with responsibility for following up on WB complaints and tips. Institutions should also consider the SOC Official's role as outlined in FCA Regulation [612.2170\(b\)](#) for investigating complaints received against directors and employees of the institution. Well-defined processes should exist for screening, routing, and tracking complaints and tips, including an escalation structure that ensures a party named in the complaint is not sent a notification. This is important for managing potential conflicts of interest. Automatic notices should be provided to the Audit Committee or board chairman, with alternate routing processes if the complaint or tip involves Audit Committee members or the board chairman. Effective programs include a thorough screening process, secure tracking system, timely followup, proper investigation, adequate resolution, and final closure of the issue. The board or Audit Committee should receive regular status updates on complaints and tips, and be notified if there were no items to report. Institutions should also have protocols to keep FCA informed of complaints and tips received and investigative efforts, and to file criminal referrals when necessary. Depending on the complaint or tip, institutions may need outside expertise such as qualified advisors to promptly and fully investigate the issue and ensure independence.
- **Education and Awareness: Is WB program information effectively disseminated to staff, the board, and outside parties through training programs and other communications?** The board and management should promote the WB program and provide the necessary training and other communications to support it.
 - A formal training program should be in place for all employees and board members. As a sound business practice, training should be provided annually, and also as part of new employee and director orientation. Training should promote awareness of the WB program, provide information on reporting processes, and address what should be reported. Furthermore, training should emphasize confidentiality to ensure staff understands how the process works and protects anonymity. Board training should also ensure that directors fully understand their crucial role in establishing a healthy, ethical culture that supports the WB program. If the WB program is informal or not highly visible (e.g., through annual staff training, posters in the break room, or other means), the culture may discourage staff from using the program.
 - In addition to internal WB program awareness, institutions should take adequate actions to ensure external parties are aware of how to report complaints or tips. Information and links on the institution's website could be used in addition to including information in quarterly financial reports, newsletters, or other documents mailed to customers or vendors.

- **Testing and Audit Coverage: Are WB programs tested periodically and included in audit plans?** WB programs should be tested periodically to ensure the reporting and routing mechanisms are functioning as intended and are easy to use. For example, testing should ensure a party named in the complaint is not sent a notification. Furthermore, a busy phone line, a complicated set of menus, a break of confidentiality, or an unanswered email may cause the WB process to fail or be less effective. Additionally, WB programs should be included in the internal audit program's risk assessment process and audit plans. Audit coverage should address all aspects of the program to ensure controls are sufficient and processes are working as intended. This would include the reliability and responsiveness of a third-party hotline provider. If audit personnel are involved in administering the WB program, an independent evaluation should be completed. Refer to the *Audit* procedure under the Corporate Governance topic for more information on examining audit coverage.

5. Criminal Referral:

Evaluate the adequacy of policies, procedures, and controls to ensure compliance with criminal referral regulations.

Guidance:

System institutions have the responsibility to detect, investigate, and report criminal activity involving their assets, operations, or affairs. FCA Regulations in 12 CFR Part 612, Subpart B, promote consistency, efficiency, and timeliness in addressing known or suspected criminal activities. This helps to reduce potential losses, ensure the institution's safety and soundness, and ensure the public's confidence in the System. The regulations require an institution to notify law enforcement agencies of known or suspected criminal violations that meet certain criteria. For state and local crimes, the institution must notify the applicable state or local law enforcement authorities. When the crime relates to United States Code, reporting to the applicable law enforcement agencies and FCA must be completed using the FCA Criminal Referral Form. This must be completed within 30 days of determining that a known or suspected violation has occurred (even in certain situations where the suspect(s) is not known). Generally, institutions must report if there appears to be a reasonable basis to conclude that a criminal violation has been committed that meets the criteria outlined in the regulation. Examples include (but are not limited to) diversion of proceeds, filing of false financial statements, collateral conversions, money laundering, check fraud and kiting, computer intrusion, wire transfer fraud, mortgage and consumer loan fraud, embezzlement, misuse of position or self-dealing, and identity theft. An institution may not consider whether the activity is worthy of prosecution when determining the need to file. Once it is determined that a known or suspected criminal act has occurred, a criminal referral must be filed. Refer to section [EM-1.5](#) in the FCA Examination Manual for the FCA Criminal Referral Form filing instructions and a link to the form.

Generally, an institution must file a criminal referral within 30 days of determining there is a reasonable basis to conclude that a known or suspected criminal violation has been committed that meets the criteria outlined in the regulations. A key component of this is determining whether there was an intent to defraud the institution through violation of a Federal criminal statute. For example, if a borrower misrepresented financial statements (e.g., overstated the value of assets or excluded a loan) or converted collateral, the institution would make a determination of whether it was done inadvertently or with the intent to defraud the institution. The institution should consider all facts and circumstances, including evidence of intent and the degree of the error, to determine whether there is a known or suspected criminal violation. For instance, omitting a small liability or inverting

numbers may indicate no intent to defraud. On the other hand, omitting a large liability or double counting collateral may indicate an intent to defraud. Institutions are vested with considerable discretion when making these determinations, but independence is important in this process; therefore, it is important that persons making these determinations are independent of the lending relationship or situation under question. If the institution is persuaded there is no evidence of intent and, hence, no criminal violation, a criminal referral is not needed. The institution is responsible for thoroughly documenting these determinations as evidence of completing its due diligence and making a good faith effort to comply with the regulatory requirements. It would be beneficial for an institution making such a determination to consult with either its examiners or the FCA Office of General Counsel, as needed.

Evaluative questions and items to consider when examining criminal referral policies, procedures, and controls include:

- **Policy and Procedures: Does the institution have effective criminal referral policies and procedures as required by FCA Regulation [612.2303](#)?** Each institution must establish effective policies and procedures to ensure compliance with FCA Regulations on referral of known or suspected criminal violations, including, but not limited to, adequate internal controls. Clear lines of authorities and responsibilities should be established for appropriate discovery, investigation, and reporting of any known or suspected criminal activities in accordance with FCA Regulations. This includes guidance on preparation, review, and approval of the FCA Criminal Referral Form and the related documentation that must be collected, organized, and retained in accordance with the FCA Criminal Referral Form instructions outlined in Examination Manual section [EM-1.5](#). Institutions must file the FCA Criminal Referral Form as outlined in the instructions and retain one copy of the form, along with supporting document(s), for 10 years. Guidance must also address the requirements for notifying the board and bonding company. The notification requirement is usually among the terms of the bonding or insurance contract, and is not dependent on the filing of a claim against the bonding or insurance coverage. A System institution may not provide a copy of the FCA Criminal Referral Form to the insurer. In addition, guidance should address the SOC Official's role as outlined in FCA Regulation [612.2170\(b\)](#) for investigating possible violations of criminal statutes by insiders. Guidance could also address the process for obtaining legal resources that may be needed to help determine if a potential criminal violation occurred. An effective policy will help the board hold management accountable for installing and properly administering the criminal referral reporting process and related controls. Policies and procedures must address adequate internal controls and be designed to ensure compliance with the following regulations:
 - FCA Regulation [612.2300](#) – Purpose and scope.
 - FCA Regulation [612.2301](#) – Referrals.
 - FCA Regulation [612.2302](#) – Notification of board of directors and bonding company.
- **Training, Testing, and Audit: Has the institution conducted appropriate training, testing, and audits of criminal referral processes?** The board and management should promote a culture that supports the criminal referral reporting processes, which includes providing the necessary training and other communications to staff. Training should be conducted annually for staff and the board. It should cover activities that require criminal referrals to be made, and the processes for preparing criminal referrals. Criminal referral processes should also be tested periodically to ensure the discovery and reporting mechanisms are functioning as intended. Testing could include management specifically watching for

indicators of suspect activities that may warrant a criminal referral filing when reviewing ICR reports, loan committee minutes, high risk asset reports, chargeoff lists, wire transfer activity, or other information. If an institution has not filed a criminal referral over an extended period of time, examiners should ensure these processes are occurring and working as intended. Additionally, criminal referral policies, procedures, and processes should be included in the internal audit program's risk assessment and audit plans. Audit coverage should assess all key aspects of the area to validate controls are sufficient and processes are working as intended. Refer to the *Audit* and *Transaction Testing* procedures under the Corporate Governance topic for more information on examining audit coverage and conducting transaction testing.

- **Other Internal Controls: Are other internal controls established by the board and management effective?** The board and management are responsible for sound controls to discover, investigate, and report criminal activity. In addition to the controls already discussed in the evaluative questions above, other controls that can help to accomplish this effectively include strong management information systems, which can help to identify potential criminal activity, and having a designated person responsible for overseeing criminal referral processes. On a macro level, it is important for institutions to establish strong overall risk management practices, ensure appropriate staffing, and provide sufficient management oversight with respect to suspicious activity monitoring and reporting.

6. Transaction Testing:

Examine individual loans and other transactions to verify effectiveness of institution control processes, accuracy of disclosure statements, and compliance with SOC and criminal referral regulations.

Guidance:

Examiners should always be attentive to any transaction or activity that may represent an SOC concern or potential criminal activity. Besides conflict of interest situations, SOC concerns would include ensuring insiders (directors, employees, and agents) are not using their position, or information acquired in their position, to obtain favorable treatment or derive personal benefit. For example, when reviewing board minutes, examiners should ensure directors are following board policies and procedures for recusing themselves from decisions impacting their personal interests or the interests of parties related to them. Examiners should watch for indications of SOC concerns or criminal activity by any party involved in a transaction. While loan actions are the most common transaction to examine, other types of transactions to consider testing include, but are not limited to, financially related services, property sales, and institution personnel actions.

When identifying potential transactions specifically for criminal referral process testing, examiners should ask management about any potential criminal activity (by borrowers, insiders, or unknown parties) that has not been reported. This may reveal situations where the institution decided not to file a criminal referral. Whether the activity is worthy of prosecution is not a consideration when determining the need to file. Once it is determined that a known or suspected criminal act has occurred, a criminal referral must be filed. As such, examiners should validate management's responses and follow up, as needed, through the transaction testing process. To assist in validating management's responses and identifying potential transactions to test, examiners should review chargeoff lists, high-risk asset reports, internal audit or review reports, loan committee minutes, board materials, or other information for indicators of potential criminal activities.

When examining individual transactions to test SOC and criminal referral processes, consider the following:

- **Loans** – Watch for evidence of potential criminal activities on any loan examined to ensure compliance with criminal referral processes and requirements. Specifically, examiners should be alert for common types of potential criminal situations (e.g., collateral diversion that surfaces when loans are in collection, or intentional misstatements that become evident on a borrower’s or applicant’s financial statements).
- **Insider Loans** – Cross-check loan file information against the director and employee disclosures to confirm that all relevant information was accurately disclosed. Look at names on file documents (lease agreements, private promissory notes, receivables, payables, sales contracts, bill of sales, financial statements, etc.) to identify relationships or transactions that were not disclosed. In addition, look for signs of preferential treatment, such as in loan pricing or conditions, and ensure that loan approval requirements in FCA Regulations [614.4460](#) and [614.4470](#) are met. This should also include determining that recusals due to potential conflicts of interest are being carried out effectively. Insiders should not inappropriately influence or have involvement in loans to themselves or their affiliated organizations and family members (e.g., involvement in the loan analysis, collateral evaluation, approval, or disbursement). Ensure appropriate SOC Official involvement, as needed.
- **Personnel Actions** – Review personnel actions (resignations, terminations, reprimands, etc.) for employees and directors to identify issues related to suspicion of wrong doing, SOC violations, or criminal activity. Ensure appropriate SOC Official involvement and institution filing of criminal referrals, if warranted.
- **Criminal Referrals** – Review criminal referrals the institution has reported to test compliance with regulations and the institution’s criminal referral processes.
- **Sales of Acquired Properties** – Determine who purchased the property to ensure there are no director, employee, or agent conflicts of interest. Cross-check against director and employee disclosures and ensure appropriate SOC Official involvement, as needed. If it was an entity (limited liability company, corporation, partnership, etc.), look for entity or other documents that identify the individuals involved (officers, shareholders, partners, etc.).
- **Financially Related Services** – Ensure that directors, employees, and agents are not receiving preferential treatment and there are no conflicts of interest. Cross-check against director and employee disclosures and ensure appropriate SOC Official involvement, as needed.