

[6705-01-P]

FARM CREDIT ADMINISTRATION

12 CFR Parts 611 and 619

RIN 3052-AC97

**Organization; Definitions; Eligibility Criteria for Outside
Directors**

AGENCY: Farm Credit Administration.

ACTION: Final Rule.

SUMMARY: The Farm Credit Administration (FCA, we, or our) is amending its regulations to modify the existing outside director eligibility criteria of Farm Credit System (System) institutions by expanding the list of persons who are excluded from serving as an outside director to strengthen the independence of System institution boards.

DATES: This regulation will be effective 30 days after publication in the **Federal Register** during which either or both Houses of Congress are in session. We will publish a notice of the effective date in the **Federal Register**.

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SUPPLEMENTARY INFORMATION:

I. Objectives

The objectives of the final rule are to:

- Amend the eligibility criteria for outside director in § 611.220;
- Remove the definition of outside director in § 619.9235;
- Strengthen the safety and soundness of System institutions;
- Strengthen the independence of System institution boards; and
- Incorporate many of the best corporate governance practices for System institutions.

II. Background

The Farm Credit Act of 1971, as amended (Act),¹ establishes that System banks and associations must elect a board of directors with such qualifications as may be required by the institution's bylaws. Additionally, the Act specifies that at least one member must be appointed by the stockholder-elected directors and that such member must not be a director, officer, employee, agent, or stockholder of a System institution.²

¹ Pub. L. 92-181, 85 Stat. 583.

² Sections 1.4, 2.1, 2.11, 3.2, 3.21(b)(1)(C) and 7.12(c)(3)(A) of the Act.

Outside directors are appointed³ by stockholder-elected directors to provide independent perspective and expertise in appropriate areas. Outside directors achieve this by broadening the board's collective knowledge, enhancing the board's independence, and improving the board's ability to carry out its fiduciary duties to the System institution, stockholders and investors. Current FCA regulations, however, do not specify how far removed from the statutory prohibited relationships the outside director candidate must be to adequately fulfill the intended independent role of an outside director. The final rule clarifies the eligibility requirements of an outside director to achieve the independence intended by the statutory requirements.

In the proposed rule, published on August 24, 2018, FCA proposed changes to the eligibility criteria in § 611.220(a) and to remove the definition of outside directors in § 619.9235.⁴ These changes were proposed to ensure that the outside directors on a board did not have direct or indirect connections with the System. The purpose behind the changes was to help ensure that outside directors serve in an objective role on the board of directors as well as to strengthen the safety and soundness of System institutions, as intended by the Act. And while the

³ To avoid confusion with stockholder-elected directors, we will use the term appointed when referring to outside directors. The term appointed does not refer to stockholder appointed directors.

⁴ 83 FR 42807. The comment period for the proposed rule closed on October 23, 2018. However, we accepted an additional comment letter on July 25, 2019.

changes to the eligibility criteria for outside directors may be more restrictive than other Federal regulators' regulations, unlike other commercial lenders, stockholder-elected directors are required to be stockholder borrowers of institutions. Additionally, stockholder-elected directors often have family members who are borrowers of the System and may have ownership interests in other businesses that are borrowers, thereby making them much closer and connected to the System institution than a director of a commercial bank. The changes to the eligibility criteria help to ensure that those selected as outside directors are truly independent of the institution.

III. Comments and Our Responses

We received 81 comment letters on the outside director proposed rule. Sixteen of those letters came from the four Farm Credit banks (1 each from AgriBank, FCB; CoBank, ACB; and the Farm Credit Bank of Texas; 13 from AgFirst, FCB); 63 letters from System associations; one letter from the Farm Credit Council (Council), acting on behalf of its membership; and one letter from the Farm Credit Foundations. The letters contained constructive comments seeking changes to several provisions in the proposed rule. Overall, commenters requested that FCA either withdraw the rule or make changes to the proposed definitions and other eligibility criteria which seek to lessen the restrictions on who may serve as an outside director. Most of

the comments received in opposition to various components of the proposed rule arise from a concern that these new eligibility restrictions will have a negative impact on the institutions' ability to recruit prospective outside directors. We have thoughtfully considered each of the comments received and have made changes in response to the comments, as discussed below. No changes were made to the provisions contained in the proposed rule that either received supportive comments or none at all, unless otherwise discussed in this preamble.

In general, all the commenters agreed on the importance of safety and soundness of the System as well as the use of governance best practices. Additionally, commenters generally agreed that efforts should be maintained to ensure impartiality and independence in the operations of boards of directors. However, commenters noted that they believed the proposed rule would have serious negative impacts on System institutions' ability to attract and retain eligible and well-qualified directors and could increase administrative costs. Many commenters remarked that we should not impose additional regulatory requirements for outside directors that are already clear under the Act. Commenters stated the rule was a regulatory burden. Notably, none of the commenters argued that they would be unable to fill the outside director board position under the new eligibility requirements.

In our response to comments on certain provisions of the proposed rule (see Specific Issues below), we have made some changes that will further clarify our position on the eligibility criteria for outside directors.

Below we address comments specific to our proposed changes to § 611.220. All provisions are finalized as proposed, unless changes are discussed in our response to comments below.

Specific Issues

A. Statutory Authority and Purpose

We received numerous comments concerning FCA's authority in imposing the proposed eligibility requirements for outside directors. Commenters asserted that the proposed rule goes beyond FCA's statutory authority regarding outside directors as found in the Act. Commenters questioned whether the proposed rule is consistent with the requirements of the Act. Commenters further expressed concern that the proposed eligibility requirements are not specifically contained in the Farm Credit Act.

FCA is authorized by statute to promulgate rules and regulations that carry out the intent and purpose of the Act.⁵ The Act clearly states that there must be at least one member on the board of directors of System banks and associations that is

⁵ Sec. 5.17(9) of the Act.

elected by the other directors and that is not a director, officer, employee, agent or stockholder of a System institution.⁶ In looking at the legislative history of the 1987 amendments to the Act, the Senate conference report states that each System board "have at least one member who is not a **borrower** of the Farm Credit System.... The subcommittee believed that it would be prudent for all boards to have a **disinterested, objective member**, experienced in agricultural finance on the board."⁷ The purpose behind the sections of the Act which list the types of individuals that may not serve as an outside director is meant to convey that the outside director should be independent of the System, as supported by this legislative history.⁸ The final rule provisions being adopted herein advance the purpose intended by the Act to provide for at least one independent, disinterested, objective voice on each System institution board of directors. It is therefore within FCA's authority to enact these regulatory provisions to carry out the purpose of the Act.

B. Definitions [§ 611.220(a)]

⁶See Footnote 2.

⁷ 133 Cong. Rec. S. 16831 (Dec. 1, 1987) (emphasis added).

⁸ The Joint Conference Committee adopted the Senate version of the 1987 amendments to the Act containing language that at least one director must not be a borrower. We found no evidence that the exclusion of the term borrower in certain sections of the Act was intentional. We believe it would render Congress' intent meaningless if borrowers could qualify as outside directors because of the clear legislative history language that all boards should have a disinterested, objective member.

We proposed to include a new definitions section in § 611.220 that would apply only to that section. The newly defined terms were meant to provide clarity on the meaning of the amended outside director eligibility criteria. We also proposed removing the definition of outside director as found in § 619.9235 as it is not consistent with the changes proposed, and it is unnecessary to duplicate the same language as is proposed in § 611.220. We received no comments on the organizational removal in § 619.9235. Commenters did question the lack of definition for the meaning of agent as used in the regulation. We note that the proposed rule did not add the term agent to this regulation; it was already in the Act and the existing regulation. Some commenters appear to have made an assumption that the definition of agent as used in Part 612 would apply to this regulation. This is not correct. When a term is undefined, its common law meaning shall apply. For the terms that we proposed, we did receive comments on each defined term, and discuss those comments below.

1. Term "affiliated organization".

Commenters stated that the defined term "affiliated organization" is unclear and ambiguous and warranted further clarification. Commenters noted their concern that the new defined term is overbroad and could limit participation in organizations such as 4-H and Future Farmers of America (FFA).

Some commenters suggested that the new term would include a prohibition of outside directors from service to Section 4.25 organizations or other affiliated organizations of the System. A few commenters suggested that the term affiliated organization could be construed to apply to Microsoft® and would also include entities such as the Funding Corporation, the Farm Credit Council, Farm Credit Leasing, Farm Credit Foundations, and the FCC Services Corporation.

It appears that some commenters are not applying the full definition of the term affiliated organization in reaching the conclusion that entities such as 4-H, FFA or Microsoft® could be captured by the term. Those examples are not entities that are "organized and operated for the benefit of, and in support of, an institution...." While it is true that those entities might conduct activities that advance the mission of System institutions, you cannot leave the other half of the definition out of the term. An entity is not an affiliated organization simply because it conducts activities that advance the mission of the System, such as 4-H or FFA. The entity must also have been organized and operate for the benefit of a System institution, which 4-H and FFA (as well as Microsoft®) clearly were not. The other examples as provided by commenters such as the FCC Services Corporation, Farm Credit Council [and the Funding Corporation] would fall within the definition of

affiliated organization and would therefore impact the eligibility of an outside director. Affiliated organizations are intended to include System-controlled unincorporated business entities (UBEs) such as AgDirect, LLP and ProPartners, LP. However, we clarify for commenters that the Funding Corporation and 4.25 Service Corporations, such as Farm Credit Leasing, AgVantis, Inc., and Farm Credit Foundations are System institutions and should not be construed to be affiliated organizations.

Some commenters stated that our application of the term affiliated organization was inconsistent with FCA Bookletter-009 (Revised December 15, 2016).⁹ Commenters note that our proposed regulation text prohibiting the ability of outside directors to serve on the board of only one System institution or affiliated organization conflicts with Bookletter-009. Bookletter-009 primarily sets forth FCA's position on the legal authority for the selection of stockholder-appointed directors. When necessary, Bookletter-009 distinguishes between outside directors and other appointed directors, such as the requirement that outside directors have no affiliation with the Farm Credit System. As noted within Bookletter-009, it was Congress' intent that directors appointed as outside directors are meant to

⁹ Farm Credit Bank and Association Appointed Directors (Revised), www.fca.gov, (December 15, 2016).

provide an independent perspective and some additional expertise in appropriate areas. Bookletter-009 states, "in 1987, Congress added to the Farm Credit Act of 1971, as amended (Act), the authority for Farm Credit banks and associations to appoint directors, *including at least one director who has no affiliation with the Farm Credit System (outside director).*"

(Emphasis added.) An outside director, therefore, is not meant to serve exactly the same role as stockholder-elected directors or other appointed directors. Rather, it is stated in both the Act and Bookletter-009 that the outside director is meant to serve an independent role. The current regulatory language already prohibits outside directors from serving on the boards of other System institutions, which includes Section 4.25 Service Corporations.¹⁰ The new language broadens this restriction to include all affiliated organizations, such as System-controlled UBEs. That is our intention and will help ensure that the outside director maintains an independent, objective voice on the board of directors.

2. Term "borrower".

Several commenters also expressed concern with the definition of "borrower." Some commenters acknowledged that there is a difference between the term stockholder and borrower

¹⁰ See 12 CFR 611.220(a) and 12 U.S.C. 2213.

but that the Standards of Conduct Official should determine whether a borrower can serve as an outside director. The current prohibition on stockholders serving as an outside director does not capture all borrowers because not all borrowers are stockholders. We believe that a fundamental purpose of the statutory provisions regarding outside directors was meant to ensure that no borrower of a System institution would serve as an outside director. This is supported by the legislative history of the 1987 Amendments to the Act when it was stated in the Senate Conference Report that "[t]he Farm Credit Act Amendments of 1987 includes a requirement that all production credit association, Federal land bank association, and district boards have a least one member who is not a borrower of the Farm Credit System."¹¹ We feel it is important to clarify that no borrower may serve as an outside director in order to fulfill the purpose of the Act.

Some commenters suggested that FCA add co-applicant and co-borrower to the definition of "borrower", for clarity. Such additional language is unnecessary as individuals who cosign a loan application are already included within the meaning of the definition of borrower because a co-borrower/co-applicant is an individual to whom an institution has made a loan. Additional

¹¹ 133 Cong. Rec. S. 16831 (Dec. 1, 1987).

comments were received seeking the removal of partnership, joint venture, trust and corporation from the definition of "borrower" due to cross-over in the definition for "entity." We feel deleting these terms could inadvertently lessen the scope of the term borrower which is not our intention.

Commenters stated the new term borrower would include guarantors or secondary obligors as persons ineligible to serve as an outside director. Commenters also requested that FCA consider removing the language 'guarantees repayment of a loan' from the definition of "borrower" due to potential unintended application in collection and lender liability litigation and in state agency enforcement of state law. The definition of "borrower" is meant to include guarantors of a loan for purposes of this particular regulation. The introductory sentence to the new definitions section of § 611.320(a) clearly states that these definitions apply only to this section of the regulations. We recognize that guarantors and borrowers may be treated differently for other regulatory purposes, however, we are intentionally including guarantors as part of the group of people that should not be eligible to serve as an outside director due to the guarantor's financial connection to the System. We believe that a person that has a financial interest in the System is not the disinterested, objective individual that was intended to serve as an outside director. The argument

regarding unintended consequences of this language is not persuasive because the definition is clearly limited in application to this regulation regarding outside directors.

We received comments that the language as currently written to define "borrower" could include any person that had a borrowing relationship in the past. Upon further review of the comments, we are changing the definition of "borrower" by inserting the word "current" in the definition to clarify that the eligibility criteria do not include past borrowing relationships.

3. Term "controlling interest".

We received comments on the proposed term "controlling interest." Some objections to the new term stem from proposed changes in FCA's proposed Standards of Conduct rule. Some commenters suggested FCA not adopt the term "controlling interest" as proposed but suggested FCA adopt the term "reportable business entity" as proposed in the Standards of Conduct rule. We disagree with the commenters assertion that our proposed term is inconsistent with the definitions in Part 612 for Standards of Conduct. For purposes of our proposed rule, the term "controlling interest" is consistent with the current Part 612 definition of "controlled entity". We also do not agree with the commenter's notion that, for consistency with other parts of our regulations, this proposed rule should adopt the Standards

of Conduct proposed term for "reportable business entity." While we appreciate the convenience of having consistent definitions, we do not believe that is a determinative consideration. We have decided that the "controlling interest" definition is better at meeting the needs of this regulation.

Other commenters suggested FCA adopt the Securities Exchange Commission's (SEC) interpretation of control¹². Under the SEC's terminology, a person is not deemed to be in control unless the specified person is the beneficial owner, directly or indirectly, 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. We feel the definition of controlling interest we proposed is more appropriate for the outside director rule, however, we will finalize the term with a change to increase the percentage amount from 5 percent to 10 percent.

4. Term "entity".

We received a few comments on our proposed term "entity" in conjunction with our "controlling interest" definition. Commenters acknowledged the proposed term was consistent with the current definition found in Part 612 relating to Standards of Conduct. However, commenters noted that the Standards of

¹² See 17 CFR 240.10A-3(e)(1)(ii).

Conduct regulations are currently under regulatory review and that our proposed definition for "entity" differs from the proposed definition in Standards of Conduct. For purposes of this rule, the term "entity" is to be defined as currently proposed, regardless of the change to the term "entity" in the Standards of Conduct proposed rule. We determined that that definition of "entity" as currently contained in Part 612 meets the needs of this regulation.

5. Term "immediate family member".

Commenters articulated multiple concerns with FCA's proposed term "immediate family member." First, commenters suggested FCA should remove the term "immediate family member" from this rulemaking. Secondly, commenters suggested that institutions be allowed to set parameters in consultation with the institution's Standard of Conduct officer. Other commenters recommended FCA remove the reference to in-laws within the definition and modify the definition to limit to those persons residing in the same household. Commenters also expressed concern with the impact the rule would have on the disclosure of familial relationships. Commenters stated that outside director candidates should not be required to inquire from family members whether they have a financial, or other relationship with a System institution that would disqualify an individual from serving as an outside director.

After reviewing the comments and considering the many hypothetical examples that would make someone ineligible to serve as an outside director with the language as proposed, we found commenters believed the most significant barrier to meeting the eligibility criteria was the System-wide application of the term "immediate family member." For example, it was noted that an outside director, under the proposed rule, could become ineligible if his/her brother-in-law is an attorney at a law firm that provides services to a System institution in a different part of the country. While we are not changing the definition of "immediate family member" because the changes proposed would not capture the independence necessary to serve as outside director, we are limiting the applicability of the term. We agree that the System-wide application of the term "immediate family member", as written, provides a more restrictive limitation on those persons eligible to serve as an outside director than intended. However, we still believe an outside director must be an independent and objective member of the board and should not be influenced by immediate family members who are connected to entities that are closely related to the outside director's own institution. After considering the comments received on this issue and due to the far-reaching consequences of making this prohibition System-wide, we will amend the final rule language to lessen the eligibility

restriction by limiting the immediate family member application to the outside director's own institution, that institution's funding bank and to any affiliated organization in which that institution has an ownership interest. Thus, we will finalize the rule with modified language that limits the effect of immediate family member on eligibility.

With the changes being made to the final rule, outside directors would not be required to inquire from his/her family members whether they have a connection to any System institution or affiliated organization. Instead, the outside director can simply provide the names of immediate family members to the specific institution who can then verify eligibility with the institution, the institution's Funding Bank, and the affiliated organizations in which the institution has an ownership interest. The change in the eligibility criteria therefore eases the burden on outside directors.

C. Eligibility [§ 611.220(b)(1)]

We received several comments on the proposed eligibility criteria set forth for outside director candidates. Commenters expressed confusion as to whether the eligibility criteria extends to current outside directors as well as candidates/nominees. Commenters noted that the proposed rule preamble language suggests that under proposed § 611.220(a), the eligibility requirements apply only to outside director

candidates. The rule is meant to apply the eligibility requirements to all outside directors. Therefore, for clarification purposes, we are deleting references to candidates so that it is clear that the regulation is not limited solely to candidates and nominees. However, the eligibility requirements in the final rule should be taken into consideration when seeking qualified outside director candidates.

In our proposed rule, we modified the eligibility criteria for outside directors by expanding the list of persons who would be excluded from serving as an outside director. Additionally, the proposed rule provided that the expansion of ineligible persons would have included immediate family members of directors, officers, employees, agents, stockholders, or borrowers of any System institution. We received several comments concerned with the expansion of the eligibility criteria and how the new criteria would severely limit the pool of eligible candidates. As mentioned above, we clarify that due to the far-reaching consequences of making this prohibition System-wide, we will lessen the eligibility restriction by limiting the immediate family member consideration to the outside director's own institution, that institution's funding bank and to any affiliated organization in which that institution has an ownership interest. Commenters suggested that the proposed rule would cause excessive administrative expenses

and possible regulatory violations should an outside director need to be removed if they become ineligible while serving as an outside director. For clarification, any outside director who becomes ineligible during their term would not have to be removed immediately. However, he/she would be ineligible to be reappointed as an outside director at the conclusion of his/her current term unless the ineligibility is cured prior to reappointment. In addition, the outside director would need to recuse him or herself from any matters that compromise the director's independence. The institutions' bylaws could also determine whether immediate removal of the outside director is warranted and by what means.

IV. Compliance Date

System institutions are required to comply with the changes in the eligibility criteria of outside directors at the next appointment of an outside director following the effective date of the final rule.

V. Regulatory Flexibility Act and Major Rule Conclusion

Pursuant to section 605(b) of the Regulatory Flexibility Act (5 U.S.C. 601 et seq.), FCA hereby certifies that the proposed rule will not have a significant impact on a substantial number of small entities. Each of the banks in the Farm Credit System, considered together with its affiliated associations, has assets and annual income in excess of the amounts that would qualify

them as small entities. Therefore, System institutions are not "small entities" as defined in the Regulatory Flexibility Act.

Under the provisions of the Congressional Review Act (5 U.S.C. 801 et seq.), the Office of Management and Budget's Office of Information and Regulatory Affairs has determined that this final rule is not a "major rule," as the term is defined at 5 U.S.C. 804(2).

List of Subjects in 12 CFR Part 611

Agriculture, Banks, banking, Conflict of interests, Crime, Investigations, Rural areas.

For the reasons stated in the preamble, parts 611 and 619 of chapter VI, title 12 of the Code of Federal Regulations are proposed to be amended as follows:

PART 611--ORGANIZATION

1. The authority citation for part 611 continues to read as follows:

Authority: Secs. 1.2, 1.3, 1.4, 1.5, 1.12, 1.13, 2.0, 2.1, 2.2, 2.10, 2.11, 2.12, 3.0, 3.1, 3.2, 3.3, 3.7, 3.8, 3.9, 3.21, 4.3A, 4.12, 4.12A, 4.15, 4.20, 4.21, 4.25, 4.26, 4.27, 4.28A, 5.9, 5.17, 5.25, 7.0-7.13, 8.5(e) of the Farm Credit Act (12 U.S.C. 2002, 2011, 2012, 2013, 2020, 2021, 2071, 2072, 2073, 2091, 2092, 2093, 2121, 2122, 2123, 2124, 2128, 2129, 2130, 2142, 2154a, 2183, 2184, 2203, 2208, 2209, 2211, 2212, 2213, 2214, 2243, 2252, 2261, 2279a-2279f-1, 2279aa-5(e)); secs. 411

and 412 of Pub. L. 100-233, 101 Stat. 1568, 1638; sec. 414 of Pub. L. 100-399, 102 Stat. 989, 1004.

§ 611.220 [Amended]

2. Section 611.220 is amended to read as follows:

(a) Definitions. For the purposes of this section, the following definitions apply:

(1) *Affiliated organization* means an entity that is legally distinct from any Farm Credit System institution, but is organized and operated for the benefit of, and in support of, an institution and conducts activities that advance the mission of an institution.

(2) *Borrower* means an individual, sole proprietorship, partnership, joint venture, trust, corporation, or other business entity to which an institution has a current loan or a commitment to make a loan or holds a participation interest in a loan. The term *borrower* also includes any person or entity to whom an institution has a current lease or a commitment to make a lease, or who guarantees repayment of a loan.

(3) *Controlling interest* means an individual that, directly or indirectly, or acting through or in concert with one or more persons:

(i) Owns 10 percent or more of the equity in an entity;

(ii) Owns, controls, or has the power to vote 10 percent or more of any class of voting securities of an entity; or

(iii) Has the power to exercise a controlling influence over the management of policies of such entity.

(4) *Entity* means a corporation, company, association, firm, joint venture, partnership (general or limited), society, joint stock company, trust (business or otherwise), fund, or other organization or institution.

(5) *Immediate family member* means spouse, parent(s), sibling(s), children, mother(s)- and father(s)-in-law, brother(s)- and sister(s)-in-law, and son(s)- and daughter(s)-in-law.

(b) *Eligibility, number and term.*

(1) *Eligibility.* Eligibility to serve, and continue serving, as an outside director requires independence from affiliations with the Farm Credit System. Farm Credit banks and associations must make a reasonable effort to select outside directors possessing some or all of the desired director qualifications identified pursuant to § 611.210(a) of this part.

(i) An outside director must not be a director, officer, employee, agent, stockholder, or borrower of an institution in the Farm Credit System.

(ii) An outside director must not have an immediate family member who is a director, officer, employee, agent, stockholder, or borrower of the institution in which the person serves as outside director or that institution's Funding Bank or any

affiliated organization in which that institution has an ownership interest.

(iii) An outside director must not have a controlling interest in an entity that borrows from a System institution or an affiliated organization of a System institution.

(iv) An outside director must not have an immediate family member with a controlling interest in an entity that borrows from the institution in which the person serves as outside director.

(v) At any given time, an outside director is eligible to serve on the board of directors of only one Farm Credit System institution or affiliated organization.

(2) Number. Stockholder-elected directors must constitute at least 60 percent of the members of each institution's board.

(i) Each Farm Credit bank must have at least two outside directors.

(ii) Associations with total assets exceeding \$500 million as of January 1 of each year must have no fewer than two outside directors on the board. However, this requirement does not apply if it causes the percent of stockholder-elected directors to be less than 75 percent of the board.

(iii) Associations with \$500 million or less in total assets as of January 1 of each year must have at least one outside director.

(3) Terms of office. Banks and associations may not establish a different term of office for outside directors than that established for stockholder-elected directors.

(c) Removal. Each institution must establish and maintain procedures for removal of outside directors. When the removal of an outside director is sought before the expiration of the outside director's term, the reason for removal must be documented. An institution's director removal procedures must allow for removal of an outside director by a majority vote of all voting stockholders voting, in person or by proxy, or by a two-thirds majority vote of the full board of directors. The outside director subject to the removal action is prohibited from voting in his or her own removal action.

Date: _____

Dale L. Aultman,
Secretary,
Farm Credit Administration Board.