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Part II

Farm Credit Administration

12 CFR Part 611, et al.
Amendments to Regulations Governing the Farm Credit System; Final Rule

FARM CREDIT ADMINISTRATION

12 CFR Parts 611, 612, 614, 615, 618, 619, 620, and 630

RIN 3052–AC19

Organization; Standards of Conduct and Referral of Known or Suspected Criminal Violations; Loan Policies and Operations; Funding and Fiscal Affairs, Loan Policies and Operations, and Funding Operations; General Provisions; Definitions; Disclosure to Shareholders; Disclosure to Investors in System-Wide and Consolidated Bank Debt Obligations of the Farm Credit System

AGENCY: Farm Credit Administration.

ACTION: Final rule.

SUMMARY: The Farm Credit Administration (FCA, we, or our) issues this final rule amending our regulations affecting the governance of the Farm Credit System (System). The final rule enhances impartiality and disclosure in the election of directors; requires that Farm Credit banks and associations establish policies identifying desirable director qualifications; requires boards to have a director or an advisor who is a financial expert; requires System institutions to establish director training procedures; and ensures that boards conduct annual self-evaluations. The final rule addresses the term of service and removal of outside directors, while requiring all Farm Credit banks and associations with assets over $500 million to have at least two outside directors. The rule also provides associations with small boards an exemption from having at least two outside directors. The rule further requires that Farm Credit banks and associations have nominating committees and that all System institutions have audit and compensation committees. The final rule clarifies the current rule on disclosure of conflicts of interest and compensation. The final rule does not apply to the Federal Agricultural Mortgage Corporation (FAMC).

DATES: *Effective Date:* This regulation will be effective 30 days after publication in the **Federal Register** during which either or both Houses of Congress are in session except for §§ 611.210(a)(2), 611.220(a)(2)(i) and (ii), 611.325, and 620.21(d)(2) which will be effective one year from the effective date of this rule. We will publish a notice of the effective date in the **Federal Register**.

Compliance Date: Compliance with board composition requirements (§§ 611.210(a)(2) and 611.220(a)(2)(i) and (ii)) and establishment of bank nominating committees (§§ 611.325 and 620.21(d)(2)) must be achieved 1 year from the effective date of this rule. All other provisions require compliance on the effective date of this rule.

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SUPPLEMENTARY INFORMATION:

I. Objectives

The objectives of this rule are to:

- Protect the safety and soundness of System institutions by strengthening the independence of System institution boards and incorporating best governance practices; and
- Support borrower participation in the management, control and ownership of their respective System institutions.

II. Background

The Farm Credit Act of 1971, as amended (Act),[1] authorizes FCA to issue regulations implementing the provisions of the Act. FCA regulations ensure the safe and sound operations of System institutions and establish minimum disclosure levels of financial information to stockholders, investors, and potential investors in the System.[2] Congress explained in section 514 of the Farm Credit Banks and Associations Safety and Soundness Act of 1992 (1992 Act) that disclosure of financial information and the reporting of potential conflicts of interest by System directors, officers, and employees helps ensure the financial viability of the System.[3]

The System has continued to grow in complexity, with an increasing demand for System institutions to maintain qualified boards and provide transparency in reporting to stockholders and investors. Also, market expectations for investments, including System-wide debt obligations, have changed in response to passage of the Sarbanes-Oxley Act of 2002.[4] Congress enacted Sarbanes-Oxley after revelation of accounting and financial management scandals involving public companies, to strengthened financial disclosure, reporting, and accountability requirements for publicly traded companies and other entities registered with the Securities and Exchange Commission (SEC).

While Farm Credit banks and associations are not subject to the governance requirements of Sarbanes-Oxley, the FCA Board determined in September 2003 that our regulatory governance provisions needed updating to reflect the changing environment in which the System operates.[5] On January 19, 2005, we published a proposed rule (70 FR 2963) to amend those parts of our regulations affecting governance of System institutions. The proposed rule addressed five governance areas: (1) Director training, qualifications, and self-evaluations, (2) board composition, (3) nominating committees, (4) conflicts of interest, and (5) audit and compensation committees. We extended the comment period for the proposed rule from March 21, 2005 to May 20, 2005 at the request of several System institutions and the Farm Credit Council (FCC), acting for its membership.[6]

III. Comments and Our Response

We received 348 comment letters on our proposed rule, all but two from individuals and entities associated with the System. Of the comments received, 342 letters were from officers and directors of 85 System associations, each of the five Farm Credit banks, the Federal Farm Credit Banks Funding Corporation (Funding Corporation), and the FCC (System commenters). One borrower of the System and one member of the general public also provided comments on the rule. The majority of the System commenters supported the FCC comments, adding individual elaborations where they deemed appropriate. We also received five comments as part of our regulatory burden initiative addressing areas covered in the proposed rule and address them in this rule. We discuss the comments to our proposed rule and our responses below. Some commenters also responded to our request for comments on the existing rule for waiving the statutory compensation limit of Farm Credit bank directors, which we discuss separately below. Those areas of the proposed rule that did not receive comments are finalized as proposed.

[1] Pub. L. 92–181, 85 Stat. 583.

[2] Section 5.17(a)(8) to (10) of the Act (12 U.S.C. 2001, *et seq.*).

[3] Pub. L. 102–552, 106 Stat. 4131.

[4] Pub. L. 107–204, July 30, 2002.

[5] FCA Fall 2003 Unified Agenda, 68 FR 53168 (September 9, 2003).

[6] 70 FR 9016, February 24, 2005.

IV. General Issues

We received many comments on issues not directed to a single specific rule section. These comments are addressed here using the following nine categories: Our authority to regulate matters contained in System bylaws; the Regulatory Flexibility Act; our policy statement on rulemaking; nonregulatory approaches to governance; the extent of our examination and enforcement authorities; cooperative principles; independent directors; other general comments; and cost analysis.

A. System Institution Bylaws

A significant number of System commenters stated the proposed rule addressed issues reserved to System institutions through their bylaws and that we lack authority to regulate these issues. The commenters cited section 5.17(b) of the Act as precluding FCA's involvement in any area covered by institution bylaws. Some commenters acknowledged our previous assertion that the prohibition on bylaw approval doesn't preclude rulemaking on matters affecting an institution's bylaws, stating that our position applies to the operational conduct of System institutions, not board issues. The commenters explain that regulations in areas addressing boards of directors would directly supersede a subject Congress expressly left to an institution's bylaws, making section 5.17(b) meaningless. Commenters also suggested that any rule on governance is functionally equivalent to our approval of bylaws.

The Act at section 5.17(b) states that we may not approve bylaws, either directly or indirectly. Congress added the prohibition on bylaw approval in 1987 as a technical change.[7] As explained by Congress, this technical change removed the ''last vestiges of the former management role of the Farm Credit Administration.'' [8] This statement was in reference to the then statutory requirement that System institutions send bylaws to our offices for review and approval. This practice stopped when section 5.17(b) was enacted.

We recognize that section 5.17(b) removed our role in issuing prior approvals of bylaws. However, nothing in the language of 5.17(b) or its legislative history discusses our regulatory authority. Had Congress intended to limit our regulatory authority on any issue that may also be addressed in a System institution's bylaws, the addition of section 5.17(b) would not have been characterized as a technical change and Congress would have also removed or amended section 5.17(a)(9) of the Act. Section 5.17(a)(9) directs us to issue rules and regulations ''necessary or appropriate'' to carry out the Act. Congress left this authority, and others, in place when prohibiting bylaw approval. Thus, Congress did not remove or limit our authority to issue regulations governing any matter affecting institution bylaws by adding section 5.17(b).

In pursuit of ensuring a safe and sound System and carrying out the Act, institution bylaws are necessarily impacted by our rules. Issuing rules impacting bylaws does not mean we are approving bylaws in violation of section 5.17(b) of the Act. If we took the comments to the fullest extent, a System institution could supersede any regulation simply by adding a contrary bylaw provision. This is clearly not what Congress intended when adding section 5.17(b) to the Act. Section 5.17(b) went to a particular past practice and was not intended to exclude us from regulating all matters that may also be addressed by System bylaws. Additionally, while the authority of System institutions to establish bylaws is fairly broad, it is not without limits. Bylaws must be consistent with applicable laws and regulations and we retain the responsibility to examine institution bylaws to ensure compliance. Consequently, we may regulate the terms and conditions by which institutions exercise their powers through their bylaws, while not approving the bylaws themselves, and then examine compliance with our regulations.

B. Regulatory Flexibility Act Analysis

Commenters questioned our Regulatory Flexibility Act (RFA) [9] certification. In the proposed rule, we certified the rule will not have a significant economic impact on a large number of small entities. Our certification considered each Farm Credit bank together with ''its affiliated associations.'' The commenters objected to our combining associations with Farm Credit banks, stating that because each institution has to comply with the regulatory requirements each should be considered individually for purposes of identifying economic impact. Commenters from one association specifically objected to the implication that no ''small entity'' would be burdened by the rule.

Under the RFA, an agency must certify that a rulemaking will not have a significant economic impact on a substantial number of small entities. If the rulemaking will have such an impact, then the agency must conduct a regulatory flexibility analysis. The RFA definition of a small entity incorporates the Small Business Administration (SBA) definition of a ''small business concern,'' including its size standards. A small business concern is one independently owned and operated, and not dominant in its field of operation. The SBA explains that ''independently owned and operated'' is determined, in part, by the entity's affiliation with other businesses. Generally, an affiliate is one that is controlled by, or has control over, the entity. Businesses with ownership, management, and contractual relationships that make them economically dependent may also be affiliates. For purposes of the RFA, the interrelated ownership, control, and contractual relationship between associations and their funding banks are sufficient to permit them to be treated as a single entity.

Further, System institutions fall under the SBA ''Credit Intermediation and Related Activities'' size category for small business concerns and the ''All Other Non-Depository Credit Intermediation'' subcategory. This subcategory defines a small entity as one with average annual assets less than $6 million. As affiliates, the combined average annual assets of each Farm Credit bank and its affiliated associations exceed $6 million. Therefore, System institutions do not satisfy the RFA definition of ''small entities.''

C. Compliance With FCA Policy Statement 59 ''Regulatory Philosophy''

The FCC board of directors sent a separate letter from the FCC letter commenting on the entire rule, stating that the proposed governance rule was inconsistent with FCA Board Policy Statement 59 (FCA–PS–59 (1994)).[10] Two other commenters also stated that we violated FCA–PS–59 (1994). This policy statement sets out our philosophy on issuing regulations necessary to carry out the Act and promote the safety and soundness of the System. The FCA Board, independent of the comment letters received on the proposed governance rule, issued a

[7] Section 110 of the Agricultural Credit Act of 1987, Pub. L. 100–233.

[8] H. AMDT 425 on HR 3030 (August 4, 1987). In the Farm Credit Amendments Act of 1985 (Pub. L. 99–205), Congress amended the Act to make us an arm's-length regulator, while increasing our regulatory powers.

[9] 5 U.S.C. 601 *et seq.*

[10] Statement on Regulatory Philosophy, 59 FR 32189 (June 22, 1994). Updated May 16, 1995, 60 FR 26034.

revised FCA–PS–59 (1994) on June 8, 2005.

The FCC board asserted the proposed rule violates the guidelines contained in FCA–PS–59 (1994) in five areas. First, they claimed they found no reasoned determination on the beneficial value of the proposed rule relative to the cost, stating the rule will impose greater costs on System institutions. A separate commenter also stated we had not completed a cost-benefit analysis before proposing the rule. While we did consider the proposed rule's cost to System institutions, the proposed rule did not explain clearly our cost-benefit consideration. We have included our cost-benefit review at section IV.I. of this preamble.

Second, the FCC board remarked that we did not specifically identify risks or problems needing to be addressed in a rule. The provisions in FCA–PS–59 (1994) are not intended to limit us to issuing regulations only when there is an existing problem. The proposed rule explained that recent corporate scandals led us to reevaluate the preventive safeguards in our regulations. No existing problem of the nature leading to passage of Sarbanes-Oxley presently exists in the System, but our responsibility as a safety and soundness regulator requires us to be proactive, as well as reactive.

Third, the FCC board stated the proposed rule contained ''explicit operational direction'' instead of performance criteria as stated in FCA–PS–59 (1994). FCA–PS–59 (1994) states that we will, to the extent feasible, specify performance criteria and objectives, but does not preclude the use of operational constraints. FCA–PS–59 (1994) states that any operational constraints we regulate will be based on specific statutory requirements or achieving regulatory objectives. The rule provides performance criteria in many areas, most notably in director qualifications, training, and elections. Some operational direction was provided for board committees and for director removal to ensure these actions occurred in a manner considered suitable for safety and soundness or to protect the cooperative structure of the System. To address commenter concerns, we have more clearly explained our reason for each provision of this final rule in the section-by-section portion of this preamble.

Fourth, the FCC board challenged the statutory basis for the proposed rule because they did not find specific statutory provisions for most of the rule. We issued our proposed rule under our general authority at section 5.17(a)(9) and (10) of the Act, which empowers us to issue regulations for the safety and soundness of the System and to carry out provisions of the Act. Further, section 5.17(a)(8) authorizes us to regulate the preparation and distribution of information on the financial condition of System institutions to stockholders and investors. Many of the provisions in the rule relate to the financial condition of System institutions, such as the Annual Meeting Information Statement (AMIS), disclosure of conflicts of interest, and the role of audit committees in preparing financial reports.

Fifth, the FCC board claimed we did not consider the approach taken by other financial regulators, stating we inconsistently followed their approach and that we were applying Sarbanes-Oxley to the System, a law they state ''Congress specifically chose not to apply to the System.'' They also stated that events in the community of publicly traded companies are ''tenuous justification'' for updating our regulations. We stated in the preamble to the proposed rule that Farm Credit banks and associations are not subject to the governance provisions of Sarbanes-Oxley. We do not agree that our proposed rule is inconsistent with what other regulators require. We used Sarbanes-Oxley as a guide, along with the governance rules of the SEC, the Federal Housing Finance Board (FHFB) and other regulators, as well as the System's own governance efforts. The FCA, as an independent regulator of the System, is not required to follow the actions of other regulators. Instead, FCA–PS–59 (1994) states that we will consider the policy positions of other regulators to decide if we should follow them or take a different approach, which we did in the proposed governance rule.

Finally, the FCC board's letter discussed our use of the disclosure and conflict of interest provisions in section 514 of the Safety and Soundness Act of 1992. They stated that governance is unrelated to disclosures and conflicts of interest. They also commented that our last review of regulations implementing the 1992 Act, conducted more than 10 years ago, is sufficient absent a formal study or ''reliable source'' suggesting our regulations are inadequate. Good governance involves accountability and transparency, thus disclosing conflicts of interest and reporting to stakeholders directly responds to those issues. We are charged with examining and regulating the System. As part of that responsibility, we periodically review our regulations in response to changes within the System, the financial community, or agriculture. Proposals to modify rules are based on our careful study, research and analysis. A requirement that we hire a consultant to study the regulations before we amend them would be inappropriate.

D. Nonregulatory Approach to Governance

Most of the System commenters supported our objective of improving System governance, but questioned the need for regulations. Of these, 194 commenters asked that we withdraw the rule and work with the System to find nonregulatory ways to strengthen institution governance. These commenters remarked that System institutions are working to improve governance independent of FCA regulatory requirements and should be allowed to continue their efforts without having to incorporate potentially different governance standards. Some commenters suggested the rule should be withdrawn until the System completes its own self-governance efforts. Others explained that voluntary governance policies, incorporating both the spirit and intent of governance, are more appropriate for the System rather than prescriptive regulations designed to make the System conform to publicly traded companies.

We are not withdrawing the rule, but have withdrawn or amended certain provisions based on specific comments. Our governance rule sets a minimum level of performance that is mandatory for all System institutions, including those that may not endorse the System's voluntary initiatives. While voluntary governance is valuable, it does not replace the stability that rules provide in assuring System stakeholders of the safety and soundness of the System. We have a responsibility to address these issues given the importance of strong governance to the safe and sound operations of the System and the current business climate in which the System operates. Our intent is to ensure that appropriate governance standards exist for all System institutions. As we discuss in section IV.F. of this preamble, the cooperative structure of the System was a prime consideration in our governance rulemaking, and we reviewed the rules for public companies for information purposes and identification of the evolving practices of the marketplace. We believe the assurances derived from a regulatory minimum standard and the System's voluntary governance efforts will benefit the System by increased stockholder, investor, and public confidence.

Commenters stated that the rule seeks consistency across the System without explanation and does not appropriately consider the different management needs of each institution. System commenters asked that each institution be allowed to determine how to address governance areas based on the institution's size, complexity, risks, and resources. Some System commenters questioned if we recognized the different operational behaviors of the institutions. Another commenter stated that our governance rule tries to centralize a decentralized System. This commenter also remarked that the rule may inhibit growth due to its rigidity. As an alternative, many commenters asked that we rely on our examination and enforcement authorities or issue rules that require institutions to establish governance policies within identified areas and examine implementation of those policies based on individual institution operations.

While we believe it is important to preserve individual institution operating flexibility wherever and whenever possible, our responsibility as regulator requires us to issue regulations we determine appropriate for safety and soundness reasons. We carefully consider the size, complexity, risks, and resources of System institutions when developing our rules, and incorporate variations and flexibility as appropriate. Regulations necessarily place limits on individual institution flexibility to ensure appropriate business practices are consistently followed in all operating environments. The final rule includes regulatory relief in certain provisions, particularly for smaller institutions, where complexity and risks are limited. Further, we believe that this rule does not centralize the System but facilitates our ongoing examinations of System compliance with governance activities.

The FCC also stated that governance rules are not necessary because the System is the only government-sponsored enterprise (GSE) with a fully independent safety and soundness regulator having full enforcement powers and an entirely self-funded insurance fund under the direction of another independent regulator. They further commented that there are enough regulations already in place to address governance of System institutions. They also cited ''extensive self-regulating'' practices in place such as the general financing agreements (GFA), market access agreement (MAA), and contractual interbank performance agreement (CIPA). Commenters also highlighted the System-wide disclosure program managed by the Funding Corporation. One commenter claimed the System as a whole implemented the creation of the insurance fund, the System-wide disclosures, the GFA, the MAA, and other internal controls on a voluntary basis so governance rules are not needed.

We recognize the System has taken steps to enhance market discipline and transparency in its reporting and disclosures, but this rule is necessary to provide clear guidelines that will facilitate our on-going examinations of, and System compliance with, governance activities. The GFAs, MAA, and CIPA mentioned by commenters are supported by, and operate within, statutory authorities and regulatory constraints. While these System agreements support consistent and sound financial conditions, they do not focus directly on the governance practices of individual institutions. Additionally, we note that the insurance fund was created by Congress as part of the Agricultural Credit Act of 1987 [11] and is available to cover losses when an institution fails. Insurance funds are generally not considered governance tools. Proper governance helps prevent loss through better operations, thereby avoiding the need to use insurance funds and enforcement authorities to resolve problems.

Commenters remarked that the proposed rule implements no new statutory provision and does not respond to a specifically identified safety and soundness issue. The FCC also referenced the instructions of the Farm Credit System Reform Act of 1996 (1996 Act) [12] to reduce regulatory burdens, stating that any rulemaking after 1996 is held to a higher ''burden of proof'' that a need exists for a rule. One commenter specifically stated that a rule increasing reporting and disclosures to stockholders will not result in a more informed or involved membership. Another commenter stated that increasing regulations takes away the control of the board and management to effectively run their operations. Several commenters expressed concern that we were making changes just for the sake of change. Some stated the proposition that we should only issue rules when there is a problem, real or perceived. They also remarked that the rule might send the message to the marketplace that we, as the regulator, consider the System to have a governance problem. Another commenter stated we had gone beyond our role as a safety and soundness regulator.

We disagree that this rule is not needed or is a change for the sake of change. We believe the rule will result in a better informed and more involved membership. Congress charged us to issue regulations to ensure the safety and soundness of the System. With the recent growth of the System, increased sophistication in financial markets, and on-going scrutiny of public and agency financial activities and related reporting practices, we are obligated to review current practices and regulatory standards to ensure the continuing safety and soundness of System institutions both collectively and individually. As explained in section IV.C. of this preamble, we have flexibility to issue rules in response to a problem or proactively to ensure continued safe and sound business operation. Our proactive rulemaking in the area of governance should make it clear to the marketplace that we do not see a governance problem in the System, but instead are acting to update regulatory requirements that preserve the good standing of the System. We also disagree that the rule takes over or reduces board control. The rule clarifies existing board responsibilities and authorities while providing boards with more tools to carry out their fiduciary and oversight responsibilities. Finally, this rule complies with the 1996 Act. Section 212(b) of the 1996 Act requires us to continuously review our regulations to eliminate rules that are unnecessary, unduly burdensome, costly, or not based on law. The 1996 Act specifies that we are to make these eliminations only if they would be consistent with law, safety, and soundness. As explained throughout this preamble, this rule is consistent with the law, safety, and soundness concerns.

E. Examination and Enforcement Authority

Many System commenters cited our examination and enforcement authorities as a reason why regulations are unnecessary. The FCC explained that board members must certify receipt of an examination report, which is presented to an institution's board, and our examiners may then meet in executive session with the board to explain the report. Commenters also stated that we have all the enforcement powers necessary to correct any unsafe or unsound governance practice without this rule. A commenter stated that we may examine for governance, not impose operating procedures, and the examination process allows us to address specific issues as they arise instead of applying a rule to the entire System.

[11] Pub. L. 100–233 (January 6, 1988).

[12] Pub. L. 104–105, 110 Stat. 162 (February 10, 1996).

We examine to ensure the safety and soundness of System institutions and their compliance with laws and regulations. This role is not a substitute for our responsibility to issue regulations implementing the Act and ensuring the safety and soundness of System institutions. Our regulations provide minimum standards of performance by System institutions. Our examiners use our rules as the basis for compliance determinations and to require any necessary corrective actions. Regulations reduce the likelihood that exams will uncover unsafe and unsound practices and provide a minimum standard of performance to assure stakeholders of the safe and sound operations of the System. While we agree with the commenters that we have a high level of enforcement authority, we do not view them as our primary tool for ensuring the safety and soundness of the System. This is ensured by a clear set of rules and thorough regular examinations.

F. Cooperative Structure of the System

Most System commenters expressed the opinion that we did not give enough consideration to the cooperative nature of the System in our proposed rule. Some stated that the cooperative ownership of the System provides more extensive safeguards than non-cooperative businesses. Commenters also stated that we were trying to change the cooperative nature of the System. Other commenters stated that we do not understand that they, as fellow owners, are also directly affected by institution operations and stand to gain or lose by how it is run, unlike public companies. One commenter pointed out that System directors do not have the same motivations and temptations as corporate directors since System stock is not publicly traded and has no market value.

We drafted our rule with full consideration of the System's cooperative structure. In developing both the proposed and final rule, we first relied on the requirements of the Act, safety and soundness concerns, overriding public policy, and the cooperative structure of the System. We agree that a cooperative structure may provide greater safeguards than other structures for many of the reasons given by the commenters. However, the cooperative structure of the System relies on owner control and participation, supported by accurate and timely information to owner stockholders, as well as their directors, who act in stockholders' behalf. The rule provides flexibility for individual System institutions, while establishing standards for governance that support cooperative principles and complies with applicable statutory requirements.

Commenters also stated that issuing a regulation to implement best practices is unwise. Commenters pointed out that best practices change often while regulations change slowly. Another commenter remarked that using regulations to implement best practices inhibits System institutions from adjusting their governance practices in a timely manner. Still another commenter questioned the rationale in adopting best practices that may not be in the best interest of System stockholders. Others remarked that by issuing a rule on best practices, we demonstrate little respect for the ability of each institution's board to put best practices into place on its own.

We believe it is appropriate to use best practices in our rule. We used those best practices of System institutions and other corporations that we considered appropriate for the long-term safety and soundness of the System. We used corporate best practices because System institutions are, by requirements of the Act, incorporated and considered corporate entities for specific purposes. We do not feel this creates a conflict with the cooperative nature of the System, as most non-System cooperatives are corporate entities. While we recognize that details associated with best practices may change over time, the underlying principles have been identified in the rule with sufficient flexibility in their application to accommodate most changes in best practices.

One commenter said that our authority as a regulator to establish governance practices was transferred to the System in 1987 and we were establishing governance practices in conflict with SEC rules. The commenter also stated that our rule could hinder progress and we should not exceed the governance requirements of other regulators. Another commenter stated that our rule went beyond reasonable or appropriate regulatory guidance, instead becoming burdensome and interfering. This commenter also stated that our rule exceeds non-System regulatory schemes, which often only require companies to disclose whether or not a particular practice is adopted.

Our authority to regulate governance matters was not transferred to the System in 1987. To the extent that the commenter making this statement is referring to our authority to approve bylaws, we address that issue in section IV.A. of this preamble. We disagree with the commenters that our rule is inconsistent with, or more burdensome than, what other regulators require. Although we are not required to follow the actions of other regulators, we did consider their governance actions. We considered the governance actions of the FHFB and the cooperative lending institutions it regulates, because of the similarity in structure to the System. We also paid close attention to the SEC as the issuer of regulations carrying out Sarbanes-Oxley but relied less on the Office of the Comptroller of the Currency (OCC), Office of Thrift Supervision (OTS) and Office of Federal Housing Enterprise Oversight (OFHEO) individual governance rules because a portion of the entities they regulate register with the SEC and therefore fall under certain SEC governance rules. Many of the provisions in our proposed rule are similar to the rules of other regulators, deviating where we determined their rules were not consistent with our role as an arm's-length regulator or with the cooperative structure of the System.

G. Independent Directors

Several System commenters stated that our use of the word ''independent'' in the rule was inappropriate. They explained that director independence means that management does not serve on the board of directors and most System directors are independent. The FCC further stated that the Act, our existing regulations, and institution bylaws already mandate independence as defined by the commenters. Other System commenters stated we were misrepresenting all System directors, whom they stated have ''absolute independence from management.'' One commenter stated that the institutions' boards should develop a charter defining independence and operate accordingly.

We do not agree with the commenters' definition of independent when discussing System boards. The commenters rely on the corporate community's use of the term. We deliberately chose not to use the common corporate understanding of ''independent'' for the very reasons cited by the commenters. We instead used the term based on our existing conflict of interest rules at part 612 and certain sections of the Act. Our use of the word ''independent'' for committee memberships precludes employment, contractual business relationships, and lending relationships that would interfere with a director's ability to exercise disinterested and objective judgment. The term as applied to the outside director is restricted to the Act and legislative history of the Act discussing ''disinterested'' directors and is based on a lack of ownership interest in the institution or System, thereby offering a different perspective from the owner-directors.

H. Other General Comments

We received comments on portions of the proposed rule preamble language that do not address regulatory provisions and result in no change to the rule. Specifically, commenters stated that we proposed a requirement for a Code of Ethics without considering existing safeguards, that institutions should be allowed to adopt a Code in a manner they determine appropriate, and that we should not suggest a Code of Ethics for directors and all employees. In the preamble to the proposed rule, we encouraged each System institution to adopt a Code of Ethics; we made no proposal requiring a Code of Ethics. We explained that we were not regulating a Code of Ethics, but encouraging System institutions to follow current best practices.

Several System commenters also criticized us for indicating our willingness to participate in System training. The commenters stated that such participation was inappropriate for an arm's-length regulator and an unwarranted intrusion into System affairs and activities. We are now clarifying that our preamble statement reaffirmed our long-standing commitment to support System training, which does not compromise our role as arm's-length regulator.

A public commenter stated that we had left out the general public as a stakeholder when explaining the purpose of our rule. The commenter also suggested more public representation on System boards of directors. We disagree; we gave appropriate consideration to the public stakeholders when drafting our rule. The System is composed of private cooperative entities and, although its GSE status gives it a public policy purpose, it does not convert System institutions into governmental entities or public companies. As to public representation on System boards, the Act provides clear direction on System board composition. The cooperative nature of the System requires, at a minimum, a System board to be comprised primarily of stockholder-borrowers, thus preventing a majority public representation as requested by the commenter.

One commenter stated our rule was forcing associations to merge or consolidate into larger entities. Another commenter remarked that we did not acknowledge the legitimacy of small institutions, placing pressure on smaller associations to merge, similar to the pressure they receive from their district bank. We are not directly or indirectly forcing any institution to merge. The rule provides several small institution exemptions to primary governance issues out of concern for the economic burden smaller associations might encounter if required to follow all aspects of the rule.

I. Cost Analysis

Several commenters objected to our use of the word ''believe'' in the preamble out of concern that our proposal might be based more on conjecture than demonstrated need or facts. Commenters also questioned our consideration of the implementation cost of the rule. Use of the word ''believe'' expresses our conclusion that aspects of the proposed rule are needed, are in accordance with our careful study of the issues, and are based on our research, analysis, and statutory requirements or authorities. As most System commenters noted, while they objected to the added regulatory requirements, they supported the improved governance standards and, in fact, had already implemented many of them. This factored significantly in our consideration of the rule's cost to System institutions. We identified three provisions having potential cost implications: (1) The addition of a second outside director; (2) the implementation of director orientation and training programs; and (3) the inclusion of a financial expert on the board.

A second outside director will result in increased salary and benefit expenses for those institutions without two outside directors. Given its small percentage of overall System expenses, we do not believe this cost is significant enough to override the policy benefits of additional outside directors. However, we noted the impact to smaller associations could exceed our average cost computation and amended the rule accordingly. Likewise, director training and orientation may result in increased costs if an institution does not already have such a program. Based on comments received, most institutions already have strong training programs and our rule would likely result in changes to the types of courses taken rather than increasing the number of courses taken, thereby minimizing costs.

There may be added costs to locate a financial expert if none are currently on an institution's board. We considered the nature of an institution, its complexity, risks, and location to provide more flexibility and board discretion in how to meet this requirement. In doing so, we believe we have minimized the costs for most institutions. Since these added requirements and the minimally related costs associated with them are designed to enhance the safety and soundness of System institutions, we conclude the resulting benefits, including improved investor and stockholder confidence, will exceed the added costs.

V. Section-by-Section Analysis

A. Definitions

1. Entity [§ 612.2130]

We received 12 letters on the definition of ''entity'' in part 612 of our regulations. Eight generally objected to the change and four commented that they had no objection. One commenter disagreed with removing the exception for System institutions, explaining that transactions between institutions should not be treated differently from other non-System financial institutions under our standards of conduct rules. We make no changes to this provision in the final rule, but make a clarifying technical change to § 612.2150(d). Without this clarification, § 612.2150(d) may have been read to affect intra-System transactions.

2. Outside Director [New § 619.9235]

We received 23 System comment letters on our use of the terms ''outside'' and ''inside'' to identify director positions. Commenters stated that these terms were not found in the Act and suggested we use the terms ''Nonaffiliated Board Selected Director'' and ''Affiliated Board Selected Director.'' One commenter pointed out that agents may serve as outside directors for banks under the Act, but did not disagree with the definition excluding agents from serving as outside directors for any institution. We final this provision as proposed because there were no comments disagreeing with the actual definition of ''outside director.'' We also note that Congress uses and defines the term ''outside director'' in section 7.12 of the Act, so our use of the term is appropriate.

3. Senior Officer [§§ 611.1223, 612.2155, 620.1, 620.5, and New 619.9265]

We received nine System letters objecting to issuing a specific definition of ''senior officer'' instead of allowing each institution's board to define the term. Two commenters asked for clarification on the meaning of ''major policy-making function,'' explaining that only the board makes policy decisions. One commenter asked that we use the SEC definition of ''senior officer'' instead of the one proposed.

Another commenter expressed concern that the definition may end up including all officers.

Our definition of senior officer is similar to, but less inclusive than, the SEC definition of ''executive officer.'' [13] We included deviations from the named positions in the SEC definition based on System occupations and also limited the use of ''policy making'' to major policy making. We clarify that while the rule identifies the titles of the senior officers included in this definition, System institutions are not required to use these titles. Officers accomplishing the functions of these offices while using other titles are regarded as senior officers for purposes of our regulations. Each institution board retains the ability to designate who is a senior officer through their hiring practices and the extent to which they include officers, not named in our definition, in major policy making.

B. Bank and Association Boards of Directors

1. Director Qualifications and Training [New § 611.210]

a. Qualifications

We received 100 System letters on the requirement for boards to establish director qualifications. Of the comments received, 48 objected to being required to establish director qualifications and to our identifying specific areas of experience. Other commenters expressed concern that establishing qualifications would eliminate many people who are able to run a successful business or would fail to consider broader qualities that determine a candidate's ability to serve. They also stated that establishing director qualifications makes it difficult to attract qualified stockholders willing to serve on the board. Still other commenters stated that directors lacking established qualifications under this provision, especially young, beginning, and small (YBS) borrowers, are capable of learning the information they need to know after election to the board. A separate commenter stated that true cooperative principles mean that any borrower of the institution with an acceptable loan should have the right to be nominated. Seven commenters remarked on the conflict between established qualifications and floor nominations. Two thought the requirement was compatible with the outside director selection process but was not consistent with the cooperative principles of electing a board from its membership. A commenter said that associations already struggle with locating willing candidates with loans in good standing and our rule will make this task more difficult.

One commenter noted that a qualification for a director should be integrity, not knowledge of financial reporting or risk management. Others said that it is the board's responsibility to decide what qualifications are needed. A few other commenters said the criteria in the rule were too narrow, making it more difficult to fill director positions. These commenters expressed concern that we could establish a standard that was either irrelevant or could not be met by some institutions. Another commenter remarked that it is difficult to regulate meaningful standards for candidate education because candidate evaluations are subjective. The commenter further explained that production agriculture generally offers fewer titles and certifications for professional verification, not withstanding strong educational backgrounds. This same commenter concluded that our rule would impose an unnecessary burden on the nominating committee. Other commenters also objected to the inference that institutions conduct director recruitment. One of these commenters further stated that we demonstrated a lack of respect for the ability of stockholders to select qualified directors. One commenter said that we should encourage better communications between the board and the nominating committee within the confines of the Act.

Two commenters suggested that the institution identify in their bylaws the desirable areas of knowledge and expertise and have the nominating committee consider these attributes in searching for suitable candidates. Another commenter suggested replacing the standards with guidelines, recognizing that the necessary qualifications would vary depending on the size, strength, and complexity of the institution. We were asked to explain who will set the standards and how they will be applied. Commenters stated that stockholders must have the ability to determine who among the eligible candidates are best qualified to serve. Other commenters suggested that the regulatory language be revised to give latitude to the directors to articulate their own standards.

We agree that it is the board's responsibility to establish director qualifications. The Act requires bank and association boards to identify director qualifications in their bylaws and we proposed regulations to implement this provision of the Act. We have clarified the rule to clearly state institutions must establish policies addressing director qualifications. We also require the policy be periodically updated and provided to the institution's nominating committee. We make this change in response to commenter concerns for flexibility and the cooperative election process.

We also modified our rule by requiring identification of desirable director qualifications as opposed to prescribing them. In preserving the board's authority to determine relevant and needed qualifications, the identified qualifications must be adequate to meet the board's needs but broad enough to allow the nominating committee to identify at least two willing and qualified candidates for each open position without undue burden or difficulty. We have confidence that boards can identify relevant director qualifications for their respective institutions even though there is an element of subjectivity. We expect that the board's training program will be sufficient to enhance directors' skills and qualifications, such as for potential YBS directors, so that they can acquire needed skills and qualifications for board service. We also removed the suggested areas of experience from the final rule. While we proposed them as suggested areas, not requirements, commenters generally viewed them as obligatory. We address the comment that institutions do not engage in recruitment of directors in V.B.3. of this preamble.

Commenters objected generally to our interpreting the Act, looking at legislative history and issuing regulations on board composition, remarking that Congress spoke unambiguously and directly to director requirements. The FCC pointed out that institutions and their nominating committees are obligated to consider all eligible stockholders. A few commenters remarked that the Act reflects the Congressional intent that the System be governed by popularly elected directors without regard to expertise or other qualifications.

We do not agree that Congressional intent precludes consideration of expertise or other qualifications for directors. The Act specifies that director qualifications be included in an institution's bylaws. While it is the responsibility of the nominating committee to find candidates who meet, or potentially will meet through director

[13] SEC Rule 3b–7 defines an ''executive officer'' as the president, any vice president of the registrant in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy making function or any other person who performs similar policy making functions for the registrant.

training, board-identified qualifications, this does not preclude the nomination of director candidates from the floor or any other eligible stockholder from seeking nomination without regard to desirable director qualifications. In the end, it is the stockholders who have the right to decide, through the balloting process, which candidates will best serve their needs.

We moved the requirement for a board financial expert from § 611.220 on outside directors to this section of the rule. We address comments made on the financial expert proposal and resulting changes in the rule in the outside director section of this preamble at V.B.3.a.i.

b. Director Training

We received 17 System comments on this provision of the rule. Three commenters supported the requirement for director training and nine others suggested that we require each institution to adopt a policy on director training. Three commenters recommended we allow the institutions to determine appropriate training and one asked that training topics be suggested, not mandatory. Several others suggested we simply require director training and development programs, instead of specific topics, stating that the rule curtails flexibility in determining training needs. One commenter said that the provision is unnecessary because director training is already an accepted responsibility of the System. Another commenter remarked on the difficulty in making a director take training. One commenter agreed that training for new directors and their role should be completed within the year, but training for other directors should be left to the board's discretion. Two commenters stated we have sufficient ability to evaluate training when conducting our Capital, Asset quality, Management, Earnings, Liquidity, and Sensitivity to market risk (CAMELS) review and we can make recommendations when those findings occur, eliminating the need for a rule.

We continue to believe that director training is an essential component of good governance and the System's safety and soundness. However, we are persuaded by commenters that the facts and circumstances of each institution vary sufficiently to make specific training requirements useful in some instances and possibly irrelevant in others. Consequently, we have amended the rule by eliminating reference to specific training topics. We have further modified the rule to require the establishment of director training policies and implementing procedures. We believe it is more appropriate for institutions to identify their own training needs, becoming more proactive in considering how to improve their CAMELS review, rather than waiting for examiners to identify training deficiencies. We encourage institutions to coordinate director training with desired director qualifications to facilitate the ability of incumbent directors and YBS borrower-director candidates to meet those qualifications. The rule retains the requirement that new directors receive orientation training within the first year of becoming a director and that incumbent directors receive periodic training.

2. Board Evaluations [§§ 615.5200 and 618.8440]

We received 62 System letters generally supporting board self-evaluations, but 38 stated that a regulatory requirement was unnecessary. Fourteen of these stated that institution boards should determine their own best practices for self-evaluations, or be allowed the flexibility to choose the type and breadth of self-evaluations based on local needs. Another 10 commenters were against a rule requiring board evaluations, stating that their boards already conduct self-evaluations, which are an internal matter, making a regulation unnecessary and burdensome. Some commenters also claimed self-evaluations are redundant since the composition of boards does not significantly change. Two expressed concern that the regulatory requirement does not specify how board self-evaluations are to be conducted, and so may not adequately measure the performance of the board. Another commenter expressed concern that the evaluations will expose those directors who are slow to catch on or refuse to seek training. The FCC characterized the provision as ''arbitrary'' as self-evaluations alone will not improve a board's effectiveness. They also challenged the necessity for the provision based on the actions of other regulators, stating they knew of no other regulator requiring self-evaluations. They further objected to the provision since no recognition of existing safeguards already in place was given, such as FCA Standards of Conduct regulations. The FCC contends that without this recognition, an implication that ''something more is needed'' is made.

We agree that the institutions should determine the manner of conducting self-evaluations, which is why we did not specify the method and manner of conducting evaluations. Whatever method is selected, the goal of self-evaluations is to help a board identify its strengths and weaknesses and improve its own performance, especially in light of current and anticipated economic circumstances. Board self-evaluations are a tool for boards to enhance their effectiveness and should be conducted in a manner that best supports the board's strategic planning and oversight responsibilities. In our view, whether or not a board's composition changes does not alter a board's performance and does not make evaluations of that performance redundant. Even if the board composition does not change, the economic circumstances and related risks facing each institution change each year, sometimes dramatically. We also do not agree that System institution boards should not undertake self-evaluations because other regulators do not have similar standards; nor do we agree that a regulatory provision is not needed. Board self-evaluations are recognized as a best practice and we find that board evaluations are a necessary and essential component to an institution's strategic plan. Evaluations identifying board strengths and weaknesses, opportunities and challenges, and how the board plans to address those issues add value to the strategic planning process.

Commenters stated that regulations on this issue are not necessary because FCA already evaluates the effectiveness of management and the board in our examination process. These commenters also stated that we have the authority to recommend actions when an institution's board of directors is not functioning properly without a regulatory provision. The fact that we examine a board's effectiveness during an examination does not relieve each institution board of the responsibility for its own review of its performance. While there are existing safeguards present in System operations, none are designed to replicate or obviate the need for board self-evaluations as evidenced by the significant number of commenters who stated that their institutions are already conducting board evaluations. These evaluations are a useful planning tool for salaries, board committee membership, training, and other areas.

Other commenters stated that board evaluations do not belong in the business plan, but should remain under the control of the board. Some of these commenters explained that because the business plan is a tool for communicating with senior managers and others, candor in the evaluations may be lost. One commenter stated that our rule language could be read to be a requirement that the self-evaluations themselves be included in the strategic plan, expressing concern that the value of the evaluations would be lost if widely circulated. Others asked us to clarify if the evaluations must be included in business plans or if the board can make a general statement verifying the evaluations were done. The rule at § 618.8440(b) has been modified to clarify that the strategic plan must assess board needs based on a review of the annual board self-evaluations. The plan does not have to include the self-evaluation itself. We do, however, require at § 611.325(c) that a summary of the evaluations be given to the institution's nominating committee when requested.

Thirty-three System commenters expressed concern with the requirement that the self-evaluations occur annually. Many suggested conducting evaluations every 3 years or, at the most, every other year. Others suggested allowing boards to use their discretion to determine when and how often self-evaluations are needed. One commenter suggested delaying implementation of the rule to give boards time to develop meaningful programs, while another explained time was needed to implement findings from the previous year. A separate commenter advocated a cyclical format instead of a date-specific rule. We continue to believe that an annual evaluation is best because it coincides with an institution's annual planning and reporting cycle. It was for this reason we included consideration of the annual board self-evaluations as part of the 3-year operational and strategic business plan. This combined review is appropriate to ensure a complete assessment of the institution's risk environment, its strategic and operating plans, and its fiduciary and oversight responsibilities.

3. Outside Directors [New § 611.220]

In our proposed rule, we referred to recruiting outside directors. Several commenters said that System institutions do not recruit directors as System institutions must keep a neutral position in electing directors. The process for selecting outside directors is not subject to the referenced constraints on institution neutrality because outside directors are not elected by the voting stockholders but appointed by an institution's board. Therefore, referring to recruitment of outside directors, as well as conducting recruitments, is acceptable. Despite this, we have replaced the term ''recruit'' with ''select'' in the outside director provision of the rule in response to these comments.

One commenter said our language on outside director eligibility could be interpreted as forbidding a current outside director from being reappointed for a second term, suggesting we amend the rule to state that no candidate for an outside director position may be a director of any other System institution. We are not changing our rule, but clarify that an outside director may be reappointed for a second term as long as he or she has not acquired any of the prohibited affiliations with the System beyond that of his or her existing role as an outside director for that institution.

a. Expertise and Number

i. Financial Expertise

We received 161 System comments on requiring an outside director to be a financial expert. Thirty commenters agreed with the rule based on the current business environment. Commenters agreeing with the rule stated, however, the authority of each institution board to decide its own needs must be preserved. Most of the commenters disagreed with some aspect of the proposed requirements and others requested clarifications. Of the comments disagreeing with the provision, 79 stated there was no need for a financial expert on the board or to name any director as an expert. Some commenters considered a financial expert as unnecessary, stating boards don't need directors who are accountants. Other commenters stated that all directors become financial experts during their service on the board or have some financial understanding. Additional commenters expressed concern that a financial expert may not be suitable as he or she would not be familiar with a cooperative lending operation. A few other commenters stated that outside directors are needed for other areas of expertise besides financial skills, stating we should not restrict the requirement to financial expertise. One commenter questioned the value of a director expert while others said the requirement ''insults'' existing board members. Another commenter stated that a director's duty of care cannot be legislated and there is little sound logic in requiring financial expertise, while yet another commented that general business expertise is more valuable because good directors are generalists. A few other commenters stated that having a director with financial expertise is an attempt to add a sixth layer of review on financial operations. These commenters stated the audit committee, external auditor, and FCA exams all serve as reviewers of finances, making a financial expert on the board redundant and unnecessary. A separate 13 commenters stated that we should not be dictating board composition. Two commenters explained that too many specific qualifications cuts out too many good candidates. One remarked that because of the cooperative process, it will be difficult to find financial expertise in membership, making it difficult for elected members to meet our proposed definition.

We continue to believe that a financial expert is a necessary resource for System institution boards given the financial focus of System business activities and the increasingly sophisticated business environment in which they operate. Having financial expertise available within each board broadens the board's collective knowledge, improves its independence from management, and promotes its ability to carry out its fiduciary responsibilities for System stockholders and investors. Boards of directors need financial skills to carry out their fiduciary duties, as well as monitor management's reporting and disclosure responsibilities and treatment of the institution's assets. Boards must have information available to them that is not from the individuals or firms producing the financial information being reviewed. A board should, from its own resources, be able to question and evaluate the reports prepared by accounting firms and management. Regulatory examinations are not a substitute for a board's financial management and oversight. The safety and soundness of the institution's operations directly relates to the financial management of resources. The board's oversight of those same resources must come from a knowledgeable base. Requiring institution boards to have a financial expert provides a necessary, constant on-site source of financial information. We also point out that we do not require a board be comprised solely of financial experts. System institution boards need a broad mix of skills and expertise to adequately carry out their duties and we recognize the important contribution each board member makes. We agree with commenters that the institution boards are in the best position to decide these other areas of need. Therefore, we have changed the rule to require that all outside directors have some or all of the desired director qualifications identified by each institution's board under § 611.210(a) of this rule.

Twenty commenters objected to the term ''financial expert'' and two others expressed concern that our definition was more restrictive than the SEC and not an objective standard. Commenters also stated that no other regulator requires a financial expert on the board, asking why the System should be subject to a different standard. One of these commenters specifically remarked that the SEC only requires disclosure of whether there is an expert and does not require there to be one on the board. Another commenter questioned whether we had a compelling policy reason for requiring board expertise when other regulators do not. Another 20 commenters challenged our authority to issue regulations on the subject, stating the requirement goes beyond statutory requirements as the intent of the Act was to allow the institution, not the regulator, to decide what expertise is needed. Two commenters stated there was no need for us to interpret or issue regulations on board expertise to carry out the Act, nor to look at the legislative history of the Act. Many commenters stated that expertise may be more valuable to some institutions than to others, so selection of an expert should be done without regulatory qualifications. An additional 54 commenters suggested that expertise not be limited to outside directors, explaining that elected directors should be allowed to satisfy the requirement.

We recognize that other regulators only require disclosure of whether there is a financial expert on a registered entity's board, with an explanation of why one is not there. We point out that the entities subject to these regulations have boards that are predominantly composed of company management rather than stockholders. This is an important distinction, as these boards are more likely to include directors with financial experience due to their dual role within the company. Also, the December 2004 Moody's Investors Service's ''Corporate Governance Assessment: Update'' on the System identified the low level of financial expertise among System directors as a key area of concern. Our objective is to ensure each board has the tools necessary to carry out its oversight of financial reporting responsibilities. Thus, we continue to require each institution board have a financial expert on, or available to, the board. However, we agree that any director with financial expertise should be able to fill this role and have amended the final rule by removing the requirement that at least one outside director be a financial expert. Instead, § 611.210(a)(2) requires that each board have a director who is a financial expert as defined in the rule. In consideration of the difficulties smaller associations may have in locating available director-candidates who satisfy the definition of a financial expert, we have given these institutions the alternative of retaining an outside advisor. Those institutions with less than $500 million in total assets may, at their choice, retain an outside advisor to the board who is a financial expert. The financial advisor must report to the board and not institution management. Further, the financial advisor must have no affiliation with the institution's management or its external auditor. We believe this option for small institutions provides an acceptable source of financial expertise given the institution's size and financial complexity, without compromising our efforts to protect the safe and sound operations of the System.

Two commenters requested we reconcile the definition of financial expertise with the term financial expert used for the audit committee proposals. Another commenter asked that we reduce the requirement from expert to expertise, allowing greater recruitment opportunity. This same commenter asked us to define what constitutes financial expertise. Ten other commenters requested we define expertise more broadly, with seven suggesting we include business experience in the definition. One commenter stated our definition was too broad. Another commenter suggested expertise should be determined by an association's credit quality, capital position or other CAMELS rating factors instead of the manner of selection to the board.

We are modifying our definition of a ''financial expert'' and removing the definition of ''financial expertise'' from the audit committee provision for banks and associations. We are also removing the definition of ''financial expert'' from the outside director provision based on other changes to the rule. When proposing the rule, we intended the terms to be comparable, but no longer require the separate reference in the audit committee section. Instead, we include a definition in § 611.210(a)(2) of this rule, dealing with board qualifications. This definition replaces the definitions we proposed for a second outside director and Farm Credit bank and association audit committees. We have also adjusted our proposed definition of financial expert by linking expertise to the accounting and financial reporting issues that may occur within the individual institution. Each institution will now determine who is a financial expert based on its own specific financial complexities, resulting in a higher degree of expertise for institution's with more complex financial operations. We believe the modified definition clarifies that we aren't trying to place accountants on the board, but seeking to assure each board has an appropriate level of financial expertise available to it. We decline the request to expand the definition of ''financial expert'' to include business experience because it is not in keeping with our safety and soundness concerns. We point out that we have not used this definition for the System Audit Committee (SAC). As explained in section V.E.1.b. of the preamble, the SAC requires greater financial expertise because of its role on behalf of the entire System.

Twelve comments were made on the impact to board size that would occur from requiring an expert director; with 11 stating that incumbent directors would have to resign to keep the current board size. Some commenters pointed out that by requiring an outside director be a financial expert, the proposed small institution exemption for having two outside directors is canceled. A further 34 System commenters requested the size of the institution be a consideration in making such a requirement, suggesting a $500 million threshold. We are not providing a small institution exemption to the requirement for board financial expertise. Because of the changing nature and increasing complexity of the financial services marketplace, we believe all System institution boards must have at least one financial expert available to it. This promotes an institution's ability to carry out its fiduciary responsibilities to its stockholder-owners, helps to ensure the institution is functioning in a safe and sound manner, and creates greater confidence in a board's ability to exercise its financial oversight responsibilities. We also believe the changes we have made in who may qualify as a financial expert sufficiently address concerns on board size.

The remaining commenters expressed neither agreement nor disagreement for the provision, but remarked on the cost of complying with the requirement, questioning the benefit received or explaining it would be expensive and difficult for smaller institutions to comply. One commenter expressed concern that recruitment may be more difficult as the label ''expert'' holds a director to a higher level of safety and soundness and most candidates are not willing to assume the higher risk, at least not without higher compensation. We recognize that for those institutions that do not already have some financial expertise on their board this may impose some extra cost, but believe the benefits of an added financial expert will more than offset the costs incurred. We also believe allowing any director to fill this requirement and providing smaller institutions the opportunity to use an advisor, as well as the change in defining financial expertise, will mitigate some of the costs of this requirement, particularly for smaller institutions. Further, we do not agree that the requirement for a financial expert increases or alters existing board responsibility or liability. Since boards already have oversight and financial reporting responsibilities, we see the requirement for board financial expertise as an essential cost of doing business, a protection of stockholder, investor, and public interests, and a means of potentially mitigating board liability.

One commenter asked us to clarify if this section applies to the Funding Corporation. The rule clearly reads that the provision applies only to Farm Credit banks and associations. We did not extend the requirement for a financial expert to the Funding Corporation because the Act already places sufficient expertise requirements on the Funding Corporation board.[14]

ii. Number of Outside Directors

We received 146 letters on our proposal to require institutions with more than $150 million in assets to have at least two outside directors. Two System commenters agreed with our proposal, stating that all System institutions would benefit from increasing the number of outside directors. One member of the public supported increasing the number of outside directors on the board, stating that 50 percent of board members should be members of the public who have no financial ties to the System. One commenter asked that we suggest increasing the number of outside directors, not mandate it, while another asked that we remove the small institution exemption. One commenter asked us to explain the benefit of having two outside directors. Another commenter asked that the rule allow exceptions to ensure all director terms are staggered. One commenter expressed concern that a requirement to have two outside directors would create a significant non-elected director presence on the board. A couple of commenters stated that we arbitrarily picked a number instead of considering the costs and talent of existing boards.

Many commenters disagreeing with the provision stated that requiring smaller institutions to increase the minimum number of outside directors could be costly, pose recruitment difficulties, and dilute the influence of stockholder-elected directors. Most of these commenters requested we increase the small institution exemption to $500 million, similar to that of other financial regulators. Several other commenters suggested a $750 million or $1 billion exemption. A public commenter stated the $150 million exemption is too low, that a better level would be $1 billion. A System commenter stated our exemption was too low, referencing the RFA small entity definition and the Federal Deposit Insurance Corporation (FDIC) asset-size criteria. The commenter stated the RFA has size categories of $0–100 million, $500 million to $1 billion, $1–5 billion, and over $5 billion in recognition that one standard is not equitable for all. The commenter claimed smaller associations would be penalized if they had to comply with the same requirements of a $7 billion institution. A separate commenter suggested that we use a percentage of membership rather than asset size, explaining only 10 percent of the board should be outside directors. Another commenter suggested we have boards comprised of 70-percent elected directors. A couple of commenters asked us to consider the differences among institutions in product and service areas before requiring more directors. Two commenters objected to an exemption, with one explaining that one small association that is unstable could represent more of a threat to the System than a larger institution in sound condition. The other expressly objected to a requirement being applicable solely because of asset size or loan volume.

We do not believe that suggesting, instead of requiring, an increase in outside directors is sufficient to satisfy our objectives. System institutions operate in a rapidly changing economic environment, requiring more skills and broader board representation. We are convinced that a regulatory requirement for greater outside director representation is necessary to preserve the System's safety and soundness. However, we agree the proposed $150 million exemption level is too low given the costs and recruitment difficulties in smaller associations. We adjusted this rule to increase the exemption to $500 million, specifying that this exemption applies only to associations. All Farm Credit banks must have at least two outside directors. We selected a minimum number of two outside directors because we have observed the positive effect that two outside directors can have in System institutions, outweighing the added costs for larger institutions. By increasing the small institution exemption to $500 million, 10 percent of the System's assets are not covered by the requirement for a second outside director. We considered the other levels suggested by commenters when raising the exemption to $500 million. We do not believe a $750 million to $1 billion exemption would produce significant benefits, especially since a $1 billion exemption would exclude almost 75 percent of System institutions. We also do not believe using business activity is adequate, given normal business fluctuations or current changes in board size. We also do not agree with the commenter that suggested 50 percent of the board be members of the public. Congress expressly created the System as a cooperative, which requires borrower-controlled boards. In addition, no association is required to create a second outside director position when doing so would reduce the stockholder-elected director membership to less than 75 percent. For example, an association with over $500 million in assets and a five-member board would only have to have one outside director. Each Farm Credit bank and association is required by the Act to have at least one outside director; our rule is not to be construed to allow otherwise.

Many commenters objected to the proposed change on the basis that we exceeded our regulatory authority. One commenter stated that we were amending the Act by our rule. Still another commenter stated that the Act's sole check on outside directors is that there be one and our rule infringes on the flexibility provided by Congress. A commenter stated the Act does not direct or allow us to fix the number of outside directors. A few commenters questioned whether we had a compelling policy reason for taking the determination of board size and composition away from institutions. We have sufficient authority to regulate the number of outside directors. The Act establishes a minimum number of outside directors and directs us to issue rules necessary to protect the safety and soundness of the System. As explained above, requiring at least two directors of Farm Credit bank and large System association boards to be independent of the System is desirable and proper given the increasing complexity of today's business environment and the size of

[14] Section 4.9(d) of the Act (12 U.S.C. 2160).

the System institutions that are involved.

As mentioned earlier, some commenters suggested that only 10 percent of the board should be outside directors. One commenter expressed concern against creating a significant non-elected director presence on the board, while another commenter suggested we have boards comprised of 70-percent elected directors. We proposed requiring the majority of a board be composed of stockholder-elected directors, but agree with specific comments on this area that more than a simple majority is required to preserve the cooperative structure of the System. We are therefore finalizing the provision to require at least a 60-percent stockholder-elected director board composition.

b. Terms of Service and Removal

We received 133 letters on the terms of service and removal of outside directors. One commenter objected to the terms of service provision, stating that it is a matter left to the boards, while the remaining 132 commenters objected to requiring a majority vote of all voting stockholders to effect removal of an outside director. A few commenters expressed concern that removal for cause might conflict with the existing requirements of § 611.310(b), which mandates removal of any director under events prescribed in that section. One commenter agreed with the reasons for removing an outside director outlined in the rule, but stated that a rule is not necessary since the Act is clear on the issue. Another remarked that if cause exists for any director, the director should be removed automatically. The commenter explained that the outside director should be subject to the same removal provisions as stockholder-elected directors and not be provided more protection for wrongdoing. One commenter stated that the board should be able to remove any director at will, while another commenter asked if we meant a director could not be removed at the end of their term absent cause. Still another commenter asked why the System was being held to a different standard than the commercial banks.

We are finalizing the rule without the removal for cause provision. The rule requires those institutions seeking to remove a director before the expiration of his or her term to document the reason for removal. We believe our changes elsewhere in this section, and the existing requirements of § 611.310(b), provide sufficient protection to the independence of outside directors discussed in the preamble to the proposed rule. Moreover, we reaffirm our position that the terms of service and basis for the removal of an outside director be the same as those for directors elected by the stockholders.

A significant number of commenters noted that holding a stockholder vote for removal could produce a chilling effect, unwanted publicity, and possible lawsuits. They remarked that the requirement does not advance the cooperative principles of the System and that a regulatory requirement is unnecessary. Other System commenters remarked that due to the requirement that a director be removed for cause, the further protection of a stockholder vote is unnecessary. One commenter stated that stockholder votes for removal do not necessarily protect the interest of the institution and another commenter stated that any stockholder involvement in the removal of outside directors is inappropriate under basic cooperative principles. Another commenter stated that presenting a director to stockholders for removal and having stockholders reject the effort would create unmanageable tension on the board. Some commenters noted that the requirement for removal of the outside director by stockholder vote was more onerous than removal of an elected director, suggesting that removal requirements should be similar for both types of board members. A public commenter stated that requiring a majority vote of voting stockholders for removal is excessive; instead suggesting that removal for cause be done by elected directors and that stockholders should be able to remove an outside director for any reason. Other commenters pointed out that under corporate law the one hiring a director has the authority to fire a director. Others suggested requiring a board supermajority vote of two-thirds, stating it should be sufficient to provide protections against unjustifiable removal, while still others recommended a simple majority vote of elected directors. One commenter, when discussing their objections to the provision, suggested disclosing the reason for director removal in the AMIS as a means of accountability to stockholders. Many commenters asked us to clarify if we meant a majority of stockholders voting.

We are not withdrawing from the rule the authority of stockholders to remove a director. While we agree with commenters that corporate law generally recognizes the authority of the hiring official to fire those hired, we note that corporate law also recognizes a board gains its authorities from the stockholders it represents. However, we agree that restricting removal of an outside director to stockholder action in all cases may be excessive and could produce undesirable and unintended consequences. The final rule allows for the removal of an outside director by either stockholder action or by a two-thirds vote of the full board of directors. We caution that no institution may forbid stockholder action to remove any director, elected or otherwise, nor make burdensome procedural requirements on such stockholder action. Further, we make it clear that a full board vote includes all directors, no matter what their means of selection to the board, except for the individual outside director the board is seeking to remove. Any director, other than the outside director up for removal, must be allowed to vote in the removal action. We are not adopting the suggestion that board removals be disclosed in the AMIS.

In response to several comments, we have clarified in all appropriate areas of the rule that voting stockholders mean all voting stockholders voting in person or by proxy. We did not intend for the proposed language to be interpreted as requiring a majority vote of all stockholders eligible to vote, regardless of whether they actually voted. However, commenters read the language as requiring such, leading to our clarification. We also received one letter from an association asking we rescind Bookletter 009 (BL–009) on outside director terms of service. We will review, and possibly revise, BL–009 after publication of this rule.

4. Board-Selected Inside Directors

The proposed rule would have created a board-appointed inside director position, without requiring an institution to have such a position. We received 89 System comments on this provision, with most indicating various levels of support, but objecting to limits being placed on the position. A minority of commenters objected to creating the position, stating it violated the cooperative principles of the System and was not needed as the board has enough authority to satisfy diversity with current elected and outside director positions. Commenters stated that such a position carries a significant cost to smaller associations. Commenters supporting the position requested less stockholder involvement and more board control in determining board composition. Thirty commenters objected to requiring a stockholder vote on a bylaw provision creating the position, stating bylaws are the prerogative of the board and stockholder direct involvement will not further cooperative principles. Alternatively, some commenters agreed with a bylaw vote by stockholders. Thirty-three commenters asked that the 5-year cooling-off period be removed or reduced, with a few suggesting reduced cooling-off periods to 1, 2, or 3 years. While many commenters agreed with the proposed requirement that the number of appointed inside directors be limited to no more than two, others objected to a limitation. Twelve comments asked that the position be open to more than just stockholders.

We are not including the board-appointed inside director provision in the rule. The System's cooperative nature is designed to ensure that the stockholders elect the board, with minority representation from appointed directors. We proposed the restrictions on board-appointed inside directors as a means of balancing the public policy goal for diversity in board representation with the stockholder-controlled structure of the System. However, we believe our stated public policy purpose of facilitating diversity on institution boards is achievable through stockholder action, using existing authorities in the Act, and does not require FCA to adopt this provision. In conformance with our removal of the proposed board-selected inside director position, we are also withdrawing the proposed technical changes on this issue from § 615.5230.

C. Election of Directors

1. Director Candidate Campaigns

a. Director Candidate Campaign Material [§ 611.320]

We received 13 System comments, with 10 supporting the clarifications we made to our existing rule, explaining the importance of institution impartiality in the election process. The remaining commenters suggested exceptions to the rule, including allowing institutions to pay for one mailing of campaign material on behalf of each director candidate and allowing a candidate statement to accompany the director election materials, provided all candidates have equal opportunity to submit statements. One commenter asked for clarification on whether the existing rule allowed associations to pay the expenses of its candidates to bank boards. Another commenter asked if releases from the impartiality provisions of our rule could be requested from candidates, thereby allowing institutions to distribute candidate campaign material.

We final this section of the rule as proposed. We believe the rule is clear that no Farm Credit institution is allowed to distribute campaign materials, regardless of who bears the expense or the equality of access to the opportunity. An institution must also maintain neutrality in distributing the director-candidate disclosures required by § 620.21. To comply with § 611.320, those disclosures must not contain campaign materials, nor may they contain candidate statements. The election process must be free from even the appearance of an institution endorsing a director-candidate. Institutions are stockholder-owned and controlled; therefore, candidate endorsements are inappropriate. Additionally, candidates may not be asked to waive the requirement for impartiality provisions, nor may an institution pay its director-candidate's election expenses.

b. Release of Stockholder Lists [§ 618.8310]

We received 21 System letters expressing concern with confidentiality, identity theft, and enforcement in releasing stockholder lists to stockholders, even if for permissible purposes. Some commenters remarked that without further controls, the recipient's agreement to use the list only for permissible purposes is unenforceable. One commenter suggested an institution be allowed to add conditions to the release of a list, such as requiring its return after the need has been met, to protect confidentiality. Another commenter stated that it is not in the best interest of all stockholders to release the lists without further controls or confidentiality agreements because the list could be sold for financial gain. Some commenters asked that the requirement be removed entirely. Yet another commenter asked that the list not include the classes of stock held, explaining it won't make a difference to the requester what type of stock is held by others. A separate commenter stated that a stockholder list should refer only to voting stockholders, and not all stockholders, because banks cannot ascertain what outside institutions might be holding their preferred stock at any given time.

Stockholders have a right under the Act to obtain a list of the stockholders in their institution(s). Section 4.12A of the Act requires banks and associations to provide a current list of stockholders within 7 days of the request. Additionally, the Act provides for restrictions on the use of the lists, which we further clarified in our rule. We continue to believe that the certification a requesting stockholder must sign sufficiently addresses the confidentiality and privacy concerns raised. Further, because section 4.12A does not distinguish between voting and nonvoting stockholders, the rule specifies that a list of stockholders consists of each stockholder's name, address, and classes of stock held.

One commenter asked for clarification on who is included in the list of Farm Credit bank stockholders. The commenter remarked that banks, in providing lists of their stockholders, should also provide a list of directors of each association rather than just a list of the associations in the district. Section 4.12A of the Act does not require a bank to provide a list of their affiliated associations' stockholders to a requesting bank stockholder. However, § 620.5(h) requires each association to disclose in its annual report the names of all its directors. Anyone wishing to obtain these names may request a copy of the report from the association.

2. Director Candidate Disclosure [§§ 615.5230, 620.20, 620.21, 620.30, and 620.31]

We received 33 System letters addressing this provision. Many of the commenters objected to standardizing election procedures for banks and associations, specifically as it relates to floor nominations and the frequency of director elections. A few also objected to the perceived requirement that nominating committee reports be disclosed. Still others objected to detailed candidate disclosures. Eight commenters objected to imposing the election requirements of the AMIS on banks, with several suggesting that we reevaluate the need for election consistency between banks and associations. One specifically objected to requiring banks to accept floor nominations as banks do not currently permit floor nominations. The commenter went on to ask that if we issue the rule with this requirement, that the rule be reproposed and additional comments allowed. Another commenter expressed concern that the proposal would limit the open nomination process it currently employs. We also received, through our regulatory burden initiative, suggestions that we reduce the reporting requirements of the AMIS and eliminate requirements linking director elections to annual meetings. A commenter stated that the considerable costs in preparing and mailing the AMIS are not justified by the marginal benefits derived by shareholders.

We agree, in part, that the banks should not be required to follow all of the director election procedures that associations follow. As such, we have amended our rule to restore the existing floor nomination requirements for associations, but added language requiring Farm Credit banks to state in the AMIS whether they are allowing floor nominations. We also make clarifications that an AMIS must be issued prior to any director elections or any annual meeting. We make this change because not all director elections occur at the annual meeting, such as interim elections held to fill vacancies on a board.

Eight commenters stated that the full report of the nominating committee should not be included in the AMIS because it reveals too much of the deliberative process of the committee. We are not requiring that the full nominating committee report be released. The rule at § 620.21(d)(2) requires a description of the nominating committee efforts to locate two candidates; it does not require that the full nominating committee report be provided to voting stockholders. It is up to the institution to decide the manner in which that information is included in the AMIS. We only require distribution of complete nominating committee reports to the board of directors in § 611.325.

Three commenters objected to candidate disclosure statements being included in the election materials sent to voting stockholders, but two other commenters supported it. One commenter limited their objection to the prohibitive costs involved in complying with the requirement. This commenter asked that we keep the existing provision allowing associations to summarize candidate disclosures. Although our existing rule requires Farm Credit banks to provide complete signed copies of candidate disclosure statements, we find the argument regarding the prohibitive costs persuasive and are amending our rule to give institutions the option of providing complete copies or standardized summaries. The rule, however, clearly states that candidate disclosures, in full or summary form, must be distributed with the ballots.

Seven commenters expressed concerns on the specificity of candidate disclosures, suggesting we limit personal addresses to the town and state of residence. One commenter stated that the AMIS should not include identification of any candidate's familial relationships reportable under part 612. We agree that a candidate's residential city and state are sufficient for voting stockholders to consider geographic and regional representation. We have replaced the requirement for personal mailing addresses with a requirement for the city and state of residence. However, we disagree with the commenter requesting no disclosure of potential conflicts of interest. Because director candidates are seeking a position of trust in representing stockholders' interests, this information is clearly within stockholders' right to know. This disclosure of possible conflicts of interest by candidates outweighs the inconvenience and privacy concerns stated by the commenter.

One comment made under our regulatory burden initiative asked that we allow director candidate disclosures to be made in the AMIS or the annual report. We are not using this suggestion because annual reports and elections do not always coincide. The AMIS updates director and financial information provided in the annual report and includes candidate disclosure information that may not have been prepared when the annual report was published. We believe the AMIS, in order to be a valuable source of information for voting stockholders, must contain current information. We also make minor technical and grammatical changes to this area of the rule due to creating distinctions in association and bank election procedures.

3. Nominating Committees [New § 611.325]

We received a total of 104 System letters on this issue. Generally, most commenters supported the need for an open and fair nominating procedure; however, comments on how to achieve that objective varied widely. The majority of comments focused on bank nominating procedures. Commenters focusing on association nominating procedures generally sought clarification of existing requirements or modifications to suit their particular needs and interests. Other commenters were generally satisfied with existing procedures and could see no benefit to the proposed changes.

a. Bank Nominating Committees

Several commenters supported the need for changes in the current nominating process for both banks and associations. Many expressed dissatisfaction with existing bank nominating procedures, making it clear that nominating procedures vary widely from one bank to another. Other commenters specifically supported a defined district bank nomination process allowing all associations to participate in selecting candidates. These commenters asked that the process not be too regulated though. Yet others supported current bank nominating processes and expressed concern that our rule would place power with the larger associations. The FCC stated that the Act does not require nominating committees for banks and we should not require such as each bank has adopted its own process that ''works well for them.'' Other commenters stated that Farm Credit banks should not have to conform to the same nominating procedures as associations. Reasons ranged from Farm Credit banks not electing directors at annual meetings to banks requiring flexibility to choose from several different election processes, such as committees selected by the board or nominating ballots. Another reason given by commenters was that banks are treated differently in the Act so our rules should treat them differently. One commenter stated that the current regulations on nominating committees were appropriate, remarking that the rule might restrict access to the nomination process. Another commenter objected to requiring nominating committees for banks, stating the rule would limit all associations from participating in nominating candidates. This commenter further stated that the rule would put the nominating process in the hands of individuals who are not stockholders of the bank and have little or no stake in ensuring a highly qualified board. The commenter then asked that we craft the rule to make nominating committees permissible for banks, not mandatory. One commenter stated we should not require banks to use nominating committees at all since commercial banks are not required to have them.

We continue to be convinced that Farm Credit bank nominating committees are appropriate and enhance the process for identifying stockholders to run for bank director positions. Section 4.15 of the Act tasks us to issue regulations governing the election of bank directors to assure a choice of nominees for each elective office to be filled. Although we crafted our rule in more general terms to allow banks some flexibility in bank director nominations, we are concerned that an incumbent bank director may run unopposed for re-election because there is no central accountability point in the bank nomination process. We also note that while the current director nomination and election practices of the banks vary, some stockholders in the banks may not be given equal opportunity to nominate viable candidates. Therefore, the rule requires banks to have nominating committees elected by the voting stockholders voting, in person or by proxy. We also encourage Farm Credit Banks to address the selection of nominating committee members to alleviate the concerns about unequal opportunity expressed by some commenters.

b. Term and Selection of Committee

A commenter asked that we not require the selection of nominating committees at annual meetings. The commenter stated that the committees should be selected at any time, and in any manner, that suits the institution. Some commenters requested more than a 1-year term of service for nominating committee members as a way to improve efficiency for the nominating process; a few suggested staggered terms of 2–3 years. One commenter also asked that nominating committee members face opposition to prevent unwarranted re-nomination and that committees receive training. Another commenter remarked that our rule gave very little attention to the process of selecting the nominating committee. One commenter stated that nominating committee members should be eligible to be nominated from the floor.

We recognize that some banks do not conduct all director elections at annual meetings and have removed this provision from the final rule. We also removed language from the rule requiring all nominating committees to serve for 1 year. This, however, does not relieve associations of the requirements of section 4.15 of the Act. Section 4.15 of the Act requires each association to elect a nominating committee at the annual meeting to serve for the following year. We are declining to issue rules on the manner of selecting a nominating committee or requiring training for committee members. We believe this is best left to the judgment of each institution. We note, however, that the rule does not prohibit floor nominations for a person's candidacy to the nominating committee.

One commenter stated that the requirement prohibiting elected directors to serve on the nominating committee is counterproductive and overreaching, particularly at the bank level. One commenter suggested that retired board members be allowed to serve on the nominating committee. Another commenter stated that we should allow retiring directors, who aren't candidates for re-election for the coming year but are still serving as directors, be eligible to serve on the nominating committee. A few commenters stated that we should allow nominating committee members to become director candidates as long as they resign from that committee. One commenter supporting the restriction on candidates serving on the nominating committee asked us also to address the conflict of interest created when family members of a candidate serves on the nominating committee.

We continue to believe that an open and fair nominating process must be free of potential conflicts that could result if sitting board members serve on nominating committees. A director who is not fully retired from the board may not serve on the committee if he or she is still a director at the time of service on the committee. In taking this position, we are mindful that a ''retiring'' director may decide to run again for election to the board. However, a retired board member is sufficiently removed from obvious conflicts to serve on the nominating committee. We also disagree with suggestions that director candidates be allowed to serve on the nominating committee. Nominating committee members may not be candidates for director positions during the same election cycle. While we understand that a person elected to the nominating committee may decide during the course of service to run for a director position, it is inappropriate for the person to continue as a nominating committee member because he or she now has a conflict of interest as well as access to information on other candidates not generally available. In such an event, the member has a duty to defer candidacy until the following election cycle. We share the concerns of the commenter regarding family members of a candidate serving on the nominating committee and leave it to each institution's board of directors to develop, consistent with our conflict of interest regulations, a written policy on this issue.

c. Duties

One commenter raised concerns that increasing committee duties and time commitments will reduce the willingness of stockholders to serve on the committee. One commenter expressed concern that the rule would prevent stockholders from seeking election due to the nominating committee selection process. Another commenter asked that we remove restrictions on directors and employees assisting the committee in identifying candidates. A separate commenter stated that nominating committees should operate independent of institution management. We also received a comment stating it is unproductive to require all director-candidates to have opposition, especially when no interest is indicated. Still another commenter questioned if the committee could nominate someone who was unwilling to serve.

We agree that locating at least two willing and qualified candidates for each open board position may be difficult and our rule does not require two nominees. Our rule instead requires nominating committees to document their efforts when unable to find two nominees. We do not agree that the nominating committee selection process will deter willing and able candidates from seeking election to the board. To the contrary, we believe that the transparency will facilitate the efforts of stockholders who might be interested in seeking elective office. We also clarify that nominees must be willing participants. A nominating committee cannot nominate someone unwilling to be a director in the institution. Likewise, nominating committees cannot rely on employees of the institution to locate nominees. The provisions of § 611.320(b) explain the limitations with respect to the assistance that employees may offer the nominating committee.

Several commenters stated the requirement that nominating committees conduct independent evaluations may be impractical or too time consuming and some commenters asked that we remove the ''independent evaluation'' component from the committee's duties. Other commenters asked us to clarify how committees are to identify qualified candidates, how to determine suitability beyond what is in the Act and institution bylaws, and how much information the associations can disclose with respect to prospective candidates. One commenter stated that requiring the committee to use established qualifications opposes the plain meaning of the Act and frustrates Congressional intent. The commenter suggested making consideration of desirable qualifications set forth in bylaws an option for committees, not a requirement. One commenter raised confidentiality concerns if the nominating committee is provided detailed candidate information necessary to conduct its evaluation process.

We agree with the commenters concerns regarding the time burden the proposed nominating committee duties would create. In response to these comments, we have removed from the rule the requirement for an independent critical evaluation, instead requiring only an evaluation of candidate qualifications. We have also specified that the evaluation consider known obstacles preventing a candidate from performing his or her duties. We clarified that the committees nominate, not seek, individuals who meet the eligibility requirements. As to the committee's consideration of director qualifications, we do not agree that director qualifications defeat the purpose of the Act, especially as the Act provides for qualifications to be included in each institution's bylaws. However, we modified our rule on director qualifications to express them as desirable, thereby clarifying a perceived mandatory requirement. We decline to regulate how nominating committees should fulfill their duties. While the final rule provides for a pledge of confidentiality from nominating committee members with regard to sensitive and personal information provided to them in the course of their committee duties, we leave it to each institution's board of directors to develop, consistent with this rule, a written policy on how best to treat sensitive information.

d. Resources

A few commenters objected to providing nominating committees a copy of the current operational or strategic business plan that contains the board self-evaluation, noting that it may include confidential information. One commenter asked that banks not be required to provide a list of stockholders to the committee as it would serve no purpose to give the name of an association. Another commenter asked us to define ''pledge of confidentiality'' for the purpose of providing proprietary information to the nominating committee.

We re-evaluated our reasons for providing a nominating committee an institution's business plan, finding the reasons insufficient in light of the comments received. We also removed the requirement that committee resources be addressed in institution bylaws. While we removed these requirements, we continue to require institutions to provide a summary of the current board self-evaluation when requested by their nominating committee. We also, as a conforming change, require institutions to provide their nominating committees their director qualifications policies.

D. Conflict of Interest and Compensation Disclosure [§ 620.5]

1. Disclosure of Other Business Interests

Three commenters opposed requiring senior officers to make the same disclosure of other business interests as is currently required by directors. Other comments indicated no objection to the provision, although one commenter questioned the need for a regulatory requirement. Another commenter asked for clarification on whether unpaid positions with other businesses would have to be disclosed. The three commenters opposing the change stated the disclosure was an impingement on the privacy rights of directors and senior officers and we had not claimed a failure to make such disclosures put stockholders at risk. The commenters stated the disclosure provision provided no valuable information to stockholders and was redundant of other reporting requirements. One commenter stated the Standards of Conduct Officer reports any such business interests so a regulation requiring public disclosure does not improve the process in any way.

We are making no changes to this provision of the rule. In proposing this provision, we considered the reporting requirements of part 612 and the specific business interests that could create a real or potential conflict of interest. We also looked to the reporting requirements of other regulators. We concluded that directors and senior officers, who represent stockholders in a position of trust and who voluntarily seek this position, have an obligation to disclose other business interests that may present real or perceived conflicts of interest. Whether a position is paid or not does not remove the potential conflict of interest. Therefore, both paid and unpaid business affiliations must be disclosed.

2. Disclosure of Compensation

Eight commenters agreed with reporting director compensation for serving on a board committee. We received no comments in disagreement with this aspect of the rule. We final this provision as proposed.

One commenter suggested we require the disclosure of business expenses to facilitate stockholder evaluation of the value of services received. One commenter remarked that travel expenses are not compensation. We are not changing the rule in response to these comments. We did not propose changes to disclosure of business or travel expenses, but will take the comments under advisement.

a. Noncash and Third-Party Compensation

We received a total of 82 comments on this provision of the rule. One commenter supported the provision while another requested we maintain the ''status quo.'' Most System commenters disagreed with the general provision on noncash disclosure and one expressed concern that disclosure of this type of compensation may become a deterrent to directors and officers in their interactions with borrowers and constituents. Many commented that existing regulations are fine and others commented that this level of reporting is burdensome and not cost efficient. Two commenters opposed this provision because noncash compensation is a small percentage of an association's overall budget and therefore does not require detailed disclosure. Two commenters remarked that a rule provision of this nature would create a negative impression and three others commented that the provision was unacceptable and unnecessary for stockholder disclosure. One commenter asked for justification based on safety and soundness needs. Two other commenters stated that we should be consistent with Sarbanes-Oxley and another two commented that this type of reporting puts the institution at a competitive disadvantage.

Nineteen commenters requested clarification of what we consider noncash compensation and when disclosure is necessary. One commenter asked how this level of disclosure would enhance transparency. A separate 16 commenters requested we only require disclosure of compensation received directly from the reporting institution, eliminating the third-party provision. Another 11 commenters questioned the need to report reimbursed expenses, under the assumption that third-party payments are reimbursed by the employing institution or absorbed by the third-party as a business expense. Many commenters questioned why reimbursed expenses would be considered compensation. Forty-six commenters requested we restore some threshold level for noncash compensation reporting to eliminate burdensome reporting of minor noncash items, such as the receipt of a cup of coffee. Two commenters suggested $1,500-$5,000, six others requested a level not tied to overall compensation received, one commenter requested a threshold amount based on an inflation-adjusted dollar minimum and another commenter suggested a materiality standard for noncash compensation disclosure. Eleven other commenters requested we base the interpretation of what constitutes compensation on Internal Revenue Service (IRS) rules.

We do not consider reporting noncash compensation a deterrent to normal interactions with borrowers and constituents, but important to prevent improper or excessive exchanges of noncash items. We also do not believe that it creates a negative impression but validates the integrity of System directors and senior officers. Section 514 of the 1992 Act recognizes the benefits when directors, officers and employees of the System disclose financial information and potential conflicts of interest. The 1992 Act further requires FCA to ensure our regulations provide adequate disclosures to stockholders and other interested parties. Despite the cost and related reporting burden, both the need for transparency and the need to avoid potential conflicts of interest require that noncash compensation above a *de minimis* level be disclosed, notwithstanding the relatively small share it represents in an institution's overall budget. We also note that Sarbanes-Oxley contains no salary disclosure provision, but addresses stock and stock option compensation.

We agree that a reporting threshold would alleviate most of the anticipated reporting burdens and modified the rule to restore a threshold for reporting noncash compensation. The $5,000 annual aggregate dollar threshold applies to director disclosures and senior officer perquisite reporting. We discuss perquisite reporting in section V.D.2.d.ii. of this preamble. We are not including any adjustments for inflation at this time since the threshold is set at the upper limit of the range suggested by commenters.

We agree that adopting an IRS definition of compensation would provide consistency and facilitate recordkeeping. The IRS defines noncash compensation as a fringe benefit or perquisite. The IRS considers fringe benefits as compensation, unless the employee pays the market value of the benefits or the benefits are specifically excluded from income by law.[15] Under IRS rules, the provider of the benefits does not have to be the employer, but may be a client or customer of the employer; so a System institution would be deemed to be the provider of a benefit given to a director or senior officer if it is given for services performed on behalf of the institution.[16] We selected the IRS rules instead of a materiality rule because IRS rules add a greater level of clarity on third-party compensation. Similar to the IRS rules, our rule requires reporting as compensation the value of gifts, unreimbursed payments of trips, or use of property received from third parties, which are made to directors and senior officers for acting in their official capacity with the institution. We believe that disclosure of cash and noncash compensation and compensation from third-parties increases transparency and helps ensure that directors and senior officers are not unduly influenced. This provision was not generated out of a concern for the integrity of System directors and senior officers, but was designed to address the unwitting acceptance of items and how the receipt of such items may be perceived as a conflict of interest, adversely affecting shareholder and investor confidence. Accordingly, we are retaining the requirement for inclusion of third-party compensation. We also clarify that compensation is any unreimbursed item, as it would not be compensation if the employee reimbursed the institution or third-party.

b. Stock and Stock Options

We received 31 comments on reporting stock and stock options in the annual report. One commenter supported disclosing of all sources of compensation. Other commenters disagreed with the provision; stating the System does not compensate management or directors with stock. One commenter neither agreed nor disagreed with the provision, but suggested placing a restriction on the issuance of stock and stock option compensation instead of creating a disclosure program. Eight other commenters asked us to remove the provision and a separate nine stated they were unaware of any stock compensation. Seven commenters stated that System institutions are not able to use stock or stock options to compensate staff and one commenter expressed the opinion that it was inappropriate for us to include this provision given the cooperative nature of the System. Four commenters asked us to clarify why we included this provision in the rule, with several suggesting we require disclosure only where stock or stock options are actually received.

We are not requiring a specific disclosure of stock or stock options in the final rule. We had proposed the specific disclosure to address situations where bank and association officers serve, in their capacity as institution officers, on the FAMC board. The Act requires the FAMC board to consist, in part, of five directors elected by stockholders of System institutions (banks and associations). These individuals serve on the board of FAMC as representatives of the System and FAMC compensation of its board members has included stock and stock options. We are satisfied that the reporting of any other business interest of directors and senior officers, which would include reporting service on the FAMC board, clarifies the reason for the enhanced disclosure and achieves the stated objectives of the original proposed provision. However, we clarify that any stock or stock option received as part of a compensation package from the reporting institution would be considered noncash compensation for purposes of our rule. We strongly encourage banks and associations to inform stockholders of the availability of FAMC compensation information and that such compensation may include stock or stock options in FAMC. We believe that a Farm Credit bank or association making this type of disclosure for affected directors and officers would satisfy the intent of the 1992 Act disclosure requirements and our policy concerns.

c. Chief Executive Officer (CEO) Compensation Threshold

Ten commenters supported removing the $150,000 CEO compensation disclosure threshold. Six other commenters specifically opposed the removal of the reporting threshold for CEO compensation without further explanation. We found no basis for retaining the $150,000 minimum reporting limit and final the rule as proposed. All institutions must report their CEO's compensation, regardless of the amount.

d. Senior Officer Compensation Disclosure

(i) Individual Compensation Disclosure

We received 198 letters addressing individual senior officer compensation disclosure, with all but one opposing all or part of the provision. One member of the public supported the requirement, stating it was time System institutions provided full disclosure. The FCC stated that the existing regulation already requires disclosure of individual compensation information to stockholders upon request. They commented that we referenced disclosure as a best practice without explaining why it is a best practice, indicating that the SEC requires officer compensation disclosure for publicly traded companies because management also serves on the boards of these companies. These board members are in a position to influence board approval of compensation arrangements, which the FCC asserts does not apply to System institutions.

A few commenters remarked that the aggregated reporting enabled stockholders to determine a ''ballpark range'' of salaries. One commenter

[15] *See generally* 26 U.S.C. 132.

[16] 26 CFR 1.61–21(a)(5).

stated we were imposing Sarbanes-Oxley on institutions in a ''misguided attempt'' to satisfy others. Two commenters remarked that aggregate disclosure was sufficient as it enables the boards to evaluate the institution's operating rate and cost structure. They stated that individual compensation disclosure is not meaningful and its potential value to stockholders and investors is not strong enough to override the privacy and confidentiality interests of those individuals whose compensation would be disclosed in a public report. Some commenters stated that individual disclosure would be especially burdensome for associations. Still others commented that the information would be misused or misstated, would give competitors an edge, enabling them to lure away valuable employees, or would create employee dissatisfaction issues.

Another commenter asserted that such individual disclosures would compromise the CEO's ability to differentiate salary at the management level. Other commenters added that individual disclosure would serve no purpose other than to create distractions, animosity, and jealousy among employees. One commenter requested we consider how disclosure would interfere with the board and management prerogatives as well as individual privacy interests. Other commenters stated that individual reporting disclosure would impinge on the privacy rights of senior officers, presenting opportunities for outsiders to distort the information for their own benefit and purposes. Still other commenters stated they did not understand why we would require greater disclosure to the public when the public has no legitimate business purpose for the information. Several commenters stated that we can deal with any safety and soundness concerns regarding senior officers' salaries through our examination and enforcement functions. Another commenter asserted that concerns over the amount of compensation paid to senior officers are for the boards to handle, not us, but that we could note our concerns during the examination process. Some commenters stated that if we were to proceed with individual disclosures that it should be limited to the five most highly compensated senior officers or to follow the SEC compensation disclosure rules. Some of these commenters suggested instead that the current threshold for individual disclosure, as in the case of the CEO, should be extended to the other senior officers. One commenter stated that if we proceeded with individual disclosure we should set a dollar threshold, suggesting $150,000.

We are withdrawing this provision of the rule and restoring the existing aggregate disclosure of senior officer compensation. We instead clarify that the existing requirement for aggregate reporting includes all senior officers, plus those officers (who are not senior officers) receiving among the five highest levels of compensation. The former rule's use of the phrase ''at a minimum'' may have been read to permit reporting the top five officers' aggregated compensation instead of all senior officer aggregated compensation and any additional officers whose compensation was one of the five highest paid. As explained in the 1986 rulemaking,[17] this portion of the rule was intended to address oversights in reporting that may have resulted from a highly paid officer functioning as a senior officer but not having a formal designation as such. We are also amending the means of determining which other officers are included in the senior officer aggregate based on comments received. Institutions will be required to include in the senior officer aggregated compensation report any other officer receiving a compensation package that is among the five highest paid, not the five highest paid officers. This is different from the former rule because it focuses on the dollar amount, not the number of officers, as requested by many commenters. We believe tying the level of aggregated reporting to the compensation paid, instead of a number of officers, alleviates past questions regarding which other officers are included in the senior officer compensation report when more than five receive the same amount of compensation. We did not go as far as the commenters asked by setting a dollar threshold for the aggregation as we are mindful of compensation variances based on locality and institution business volume.

Although we are withdrawing the provision on individual compensation disclosure, we continue to believe that reporting compensation improves transparency. The objective of this type of disclosure is to provide stockholders with information to assess whether senior officer compensation is appropriate in view of the institution's financial condition and to hold the board accountable for the level of compensation paid to its senior officers. We may therefore reconsider the viability of aggregated compensation reporting in future rulemaking.

[17] 51 FR 2136, June 12, 1986.

The FCC stated that we had an opportunity to impose detailed disclosure requirements following passage of the 1992 Act yet did not do so. They stated that we failed to impose such requirements following passage of the 1992 Act, even after we had studied Congressional statements associated with that legislation. We maintain our prerogative to change the reporting and disclosure requirements when we determine there is a need. As explained in section IV.C. of this preamble, our authority to promulgate rules is not limited to those that respond to particular Congressional mandates, such as the ones in the 1992 Act. In addition, Congressional mandates do not become inapplicable after the passage of time. We also note that we made changes to our disclosure rules after passage of the 1992 Act. In 1993 we proposed individual senior officer compensation disclosures to satisfy the objectives of section 514 of the 1992 Act. The 1993 proposed rule was intended to benefit System stockholders by providing them with senior officer compensation information comparable to that available to stockholders of other financial institutions. However, based on System objections to the 1993 proposal, we limited individual compensation disclosure to CEOs, while providing individual senior officer compensation disclosure on shareholder request.

Forty-six commenters specifically opposed disclosure of senior officer compensation in the annual report instead of in the AMIS, while nine commenters supported this change in disclosure locations. A few commenters stated that the AMIS provides controlled disclosure to stockholders as opposed to the annual report which is used as marketing or promotional material. The FCC stated that disclosing compensation in the annual report does not improve the quality of the disclosure and that the purported benefit of consistency between the Farm Credit banks, which report such information in their annual reports, and the associations ignores the critical distinctions in the composition of the banks' and associations' respective stockholder groups. They also remarked that the commercial banks do not provide the information in their annual reports but in proxy statements filed with the SEC.

In conformance with withdrawing the proposed disclosure of individual senior officer compensation, we do not final some of the proposed changes at § 620.5(i)(2) regarding the location of senior officer compensation disclosure. Specifically, we retain the existing provision allowing associations the option of reporting senior officer compensation in the AMIS instead of the annual report. We are, however, clarifying that the AMIS must be available for public inspection at the reporting association's offices. The AMIS is required to be available for public inspection under our existing rule at § 620.2(a) and to avoid confusion of AMIS availability, we require that associations state in the annual report that the AMIS is available for public inspection.

A number of commenters stated that the current regulation already provides for disclosure of individual compensation information to stockholders upon request, and that it is not burdensome for stockholders to make such requests. In conformance with withdrawing the proposed disclosure of individual senior officer compensation, we do not final some of the proposed changes at § 620.5(i)(2)(iii). Specifically, we keep the existing provision requiring disclosure of individual senior officer compensation to requesting shareholders. We are, however, removing the $50,000 threshold for making these disclosures. One commenter had recommended we raise the reporting threshold for disclosure of any individual senior officer's compensation upon request by a stockholder to $60,000 from $50,000 to keep pace with current market wages. We are not raising or keeping the threshold. Although the public disclosure requirement for individual senior officer compensation is limited to CEOs in the final rule, we continue to believe that it is important for stockholders of reporting institutions to have access to individual compensation information of their senior officers without restriction. Therefore, the required disclosure statement in the annual report or the AMIS (if the association chooses) is modified to require institutions to disclose to requesting stockholders the compensation information for any individual senior officer and any other officer included in the aggregate. We take this opportunity to emphasize that institutions may not question the reason for a request of individual senior officer compensation, nor record the request in the shareholder's files. Institutions must promptly provide the information to their shareholders without any contingencies or undue delay.

(ii) Senior Officer Perquisites

Ten System commenters opposed lowering the reporting level for perquisites from $25,000 to $5,000. One commenter stated that the disclosure for perquisites was inconsistent with Sarbanes-Oxley and requirements for other corporate lending institutions. A second commenter stated that the disclosure of perquisites should be included in the aggregate for all senior officers. As stated in the proposed rule, perquisites by their nature are nominal privileges and benefits. As such, we believe the $5,000 disclosure level for the reportable loan transaction threshold at § 620.5(j) is a reasonable level. Due to our withdrawing the reporting of individualized senior officer compensation, the reporting of perquisites continues to be reported in the aggregate and listed separately from salary, bonus and other compensation. We also note that reporting senior officer perquisites is consistent with SEC reporting requirements.

E. Audit and Compensation Committees

1. Audit Committee

a. Bank and Association Audit Committees [§ 620.30]

We received 150 comment letters on this provision. Several commenters supported audit committees for banks and associations, but expressed objections to certain aspects of our rule. One commenter remarked that higher auditing standards are needed within the System to avoid accounting problems experienced by other GSEs.

i. Chairmanship

We received 140 comment letters opposing the requirement that a director with financial expertise serve as the audit committee's chair. These commenters stated that the board or the audit committee should be free to designate its own chair, with one commenter explaining that a board might logically name the director with the most financial expertise as chair but should have the flexibility to do so. Another explained that they like to rotate their committee chairs and our rule restricts their ability to do so. Another commenter stated that putting an outside director in the chairmanship position lessens the director's independent perspective. One commenter stated that the authority for the committee to hire experts negated the need for the director with expertise to chair the committee. Many commenters said it was unreasonable to equate financial expertise with the ability to serve as an effective chair, particularly if the financial expert is new to the institution. Still others explained that leadership skills, past experience, knowledge of institution operations and lending activities, and history of service on the board may be more useful qualities for an audit committee chair than placing a new director with financial expertise in this position. These commenters further stated that removing a financial expert from the chairmanship would not limit his or her involvement in the committee's activities or restrict his or her ability to present contrary views. Other commenters suggested that we require a financial expert serve on the audit committee, without requiring him or her to be the chair. A few commenters remarked that there was no need for a financial expert as all committee members were being required to have some level of financial knowledge.

We agree that chairing the audit committee may require other skills or experience beyond financial expertise. We are therefore amending the rule to only require that any director identified as a financial expert, as defined in the rule, serve on the audit committee. This director does not have to chair the committee, but should not be automatically excluded from doing so. We believe this change to the rule addresses all the comments without compromising a financial expert's role on the committee. We further require any financial expert adviser, retained by smaller associations under § 611.210(a)(2), serve as adviser to the institution's audit committee. We believe it is important for a board's financial expert, whether drawn from a director or contracted adviser, be available to the institution's audit committee. The final rule does not require outside director participation on the audit committee. Elsewhere in the rule, we removed the requirement that an outside director be a financial expert. Continuing to require an outside director to serve on the audit committee, combined with the requirement that committee members have a level of financial knowledge, would, in effect, still require institutions to appoint a financial expert as an outside director.

ii. Association Exemption

Twelve commenters objected to requiring audit committees for associations, stating that we are interfering with the authority of the board of directors to establish board committees and determine committee composition and structure. One commented that associations should have the ultimate discretion to determine what committees they have and how they are staffed. Another commenter requested a small institution exemption from the audit committee requirement of $500 million on the basis that other regulators have similar exemptions and the requirement is unduly burdensome for small associations.

We are not providing an exemption for small institutions. As explained in the proposed rule, requiring the establishment of audit committees and identifying basic composition is necessary to the safe and sound operations of System institutions. The increasing size, complexity, and sophistication of today's financial markets and the pivotal role the board of directors and its audit committee has in ensuring accurate oversight and reporting to stockholders, investors, and the public make certain basic operating practices essential.

Two commenters stated that the full board should be able to function as the audit committee. One commenter stated that each stockholder-elected director must fulfill his fiduciary responsibility with regard to auditing issues and objected to a ''separation of duties'' whereby only a few directors serve on an audit committee that would operate autonomously. Our rule establishes a minimum size, not a maximum, making it possible for an entire board to serve as the audit committee. We caution the institutions considering this approach that larger committee membership may reduce the efficiency and effectiveness of the committee. The committee, all of whose members should have some level of financial knowledge, is responsible for overseeing the financial statements of the institution, among other duties. These specific, and potentially complex, duties may require smaller group discussions than what may be achieved with an entire board. The audit committee does not function independently of the board, but functions under a board charter and reports to the board on a regular basis.

iii. Knowledge, Duties, and Resources

Fourteen commenters opposed requiring all audit committee members to be knowledgeable in financial matters. Some commenters instead asked that most committee members have this knowledge, suggesting it might be difficult to find qualified board members to adequately staff the audit committee. One commenter cited the OCC, explaining that they do not require commercial banks to have directors with financial expertise unless the bank has $3 billion or more in assets. To perform its duties, audit committee members must be knowledgeable in at least one of the areas cited in the rule. We agree that some institution directors, upon election or appointment to the board, might not have sufficient financial knowledge to serve on an audit committee. This is one of the reasons we are requiring institutions to establish a director training policy. Institution directors lacking sufficient financial experience should receive training so they might serve on the audit committee.

Two commenters disagreed with requiring a supermajority vote of the board of directors to deny an audit committee's request for resources. The commenters said that the board should decide what level of approval was needed for this purpose. While we believe that the board should have a check on audit committee spending, we believe the committee should have sufficient autonomy to carry out its duties. A supermajority vote by the board prevents abuse but ensures the committee's access to needed resources.

Other commenters asked that we change the duties of the committee from having oversight over the preparation of financial reports to one of a review function. We disagree; part of the board's oversight and fiduciary duty is to assure stockholders that financial reports are subject to review by the board or its committee, independent of management. This function is delegated to, and conducted by, the audit committee, which has a special set of skills for dealing with financial audits. A simple review would not discharge all of the board's responsibility regarding financial reporting to stockholders, investors, and the public in general. Therefore, we make no change in the final rule dealing with the required statement by the audit committee that financial statements were prepared under its oversight.

As a technical change, we are reorganizing into paragraphs the provisions regarding audit committee oversight of the external auditor.

b. System Audit Committee [§ 630.6]

We received three comment letters on our provision dealing with the System Audit Committee (SAC). Generally, the commenters discussed the structural and operational changes to the existing SAC that the proposed rule would have required. One commenter remarked that Funding Corporation board members are financially literate but there is no assurance that the board will have a financial expert as defined by the SEC. Another commented that requiring audit committees to be comprised of members from a board of directors may work for individual System institutions, but not for the SAC. The SAC requires broader representation and greater financial experience due to the unique role it plays in representing the interests of all System institutions and in organizing financial statements on behalf of the entire System. We agree that an audit committee at the System-wide level need not be composed solely of Funding Corporation board members. Therefore, we are not adopting the proposed requirement that the SAC be comprised entirely of members of the Funding Corporation's board. However, a System-wide audit committee should include representation from the System and we are modifying the membership requirements for the SAC to require at least one-third of the SAC members be from the System. When calculating the number of required System representatives, fractions of 0.5 or more should be rounded up to the nearest whole number. For example, one-third of a five-member committee equals 1.66 members, so there would have to be two System representatives on a five-member SAC.

We also remove the requirement that a Funding Corporation outside director serve on the SAC. However, the SAC must have at least one financial expert. Unlike bank and association audit committees, the expert must chair the SAC. Because the SAC membership is not restricted to the Funding Corporation board of directors, the same recruitment issues leading to our changing this aspect of the rule for banks and associations do not arise. We believe that since the SAC assists in setting the reporting and disclosure standards for the entire System, it should have broader representation from System institutions and deeper and broader financial knowledge and experience than other System institution audit committees. We also retain the definition of financial expertise used in the proposed rule. This definition is less restrictive than that used by the SEC as it allows for experience in either internal controls or in preparing and auditing financial statements, but not both. Given this less restrictive definition and the significant responsibilities of the SAC, we believe the requirement that the financial expert chair the SAC is both prudent and appropriate.

As a technical change, we are reorganizing into paragraphs the provisions regarding audit committee oversight of the external auditor. We also make minor technical and grammatical changes because of changes made to the SAC composition.

2. Compensation Committee [§§ 620.31 and 630.6]

We received 125 System comment letters on the requirement for compensation committees. Of these, 11 commenters supported the provision; 43

commenters expressed opposition to a regulatory requirement for a compensation committee; and the rest of the commenters suggested revisions to the rule without expressly agreeing or disagreeing with it. Commenters opposed to this requirement stated that each institution should have the discretion to determine what board committees are necessary. Some stated that their institution already provides adequate oversight to compensation packages. Some expressed the view that the entire board is responsible for compensation and should not be forced to delegate that duty. Other commenters stated that the best practice is to have compensation committees responsible for communicating policies and strategies, not making decisions. We are not changing the requirement that all institutions have compensation committees. While we agree that System institutions should have broad discretion to manage their internal affairs; we also believe that System institutions need to comply with certain standards facilitating safety and soundness and promoting the cooperative principles of user control and accountability.

One hundred and one commenters requested we not require compensation committees to set or approve senior officer compensation. They stated that the CEO is responsible for setting the compensation of senior officers and the committee's approval would undermine the CEO's authority. The commenters also stated that such a requirement would compromise the ability of the board to hold the CEO accountable for hiring and promoting officers. These commenters stated that such a requirement could result in the committee members evaluating the performance of senior officers, instead of the CEO. One commenter stated that individual pay packages for senior managers should remain the prerogative of the CEO. Another commented that although compensation committee salary reviews may be a best practice, we have gone farther by requiring the committee to approve compensation paid. The commenter stated that the committee should determine their own level of involvement in monitoring the activities of the CEO. Yet another commenter stated that the provision weakens governance by blurring the line between the board and CEO in compensation matters. Five commenters requested the committee's authority be limited to reviews and recommendations, with approval authority reserved for the full board. The commenters remarked that this change should provide sufficient oversight of the CEO in his administration of the institution's compensation program.

We are persuaded by the commenters that control over individual senior officer compensation is better handled by the CEO. However, we continue to believe the compensation committee must take an active role in monitoring compensation. Therefore, we are modifying our rule to require the compensation committee approve the overall compensation program for senior officers. We believe this modification strengthens governance and provides a clear distinction between boards and CEOs in compensation matters. We believe the rule provides institution boards with sufficient flexibility to delegate or apportion many of these compensation matters in ways that they deem most appropriate.

A few commenters asked for a small institution exemption, noting that small institutions with few employees should not be required to have a compensation committee. We disagree and are not providing a small institution exemption. We continue to believe that a well-defined compensation program, administered by a qualified, objective board committee will ensure that institutions have the needed structure for this important function, regardless of their size.

Three commenters stated that they already had committees performing these functions but with different committee names, such as the executive committee or human resource committee. These commenters requested that the final rule allow deviations from the proposed committee name. We are not changing the rule because the rule does not require the committee be named a ''compensation committee.'' A board committee performing the duties of the compensation committee, with a charter that satisfies committee requirements may fill the role of a compensation committee, even though it has a different name.

VI. Miscellaneous

1. Bank Director Compensation [§ 611.400]

We asked for comments on whether we should change our existing regulation allowing a waiver of the statutory limit on Farm Credit bank director compensation. We did not propose changes to our existing rule, but asked whether we should retain, reduce, increase, or remove the current regulatory 30-percent waiver amount and at what level we should remove the authority of Farm Credit banks to exercise the waiver without prior submission to FCA. We also sought comment on what constitutes an appropriate exceptional circumstance.

We received nine System letters and one letter under our regulatory burden initiative on this issue. All commenters supported an increase in the compensation cap because of increased governance responsibilities, the changing legal climate, heightened standards of accountability, and recruitment difficulties. None offered suggestions on the appropriate amount or exceptional circumstances needed to trigger the waiver amount. The FCA Board reviewed the comments submitted and on December 15, 2005 issued Bookletter 051 to increase the maximum bank director compensation to $45,740.

2. Implementation Date

We proposed a 1-year delay in the implementation date of the rule in two areas: A director who has financial expertise and a second outside director. Two commenters urged us to consider extending implementation beyond 1 year. However, many commenters noted that their respective institutions were already in compliance with many of the provisions of the rule. We are not extending the 1-year implementation date but are changing the areas where it applies. We delay for 1 year the board composition requirements on financial experts (§ 611.210(a)(2)) and additional outside directors (§ 611.220(a)(2)(i) and (ii)). We also delay for 1 year the nominating committee requirement (§§ 611.325 and 620.21(d)(2)) for Farm Credit banks only. All other provisions require compliance by the effective date of this rule.

3. Other Comments Received

We received two comments that fall outside the scope of this rule. One commenter requested we revisit the intent and effective result of our cumulative voting regulations. The commenter stated that as institutions grow in size the effect of cumulative voting may produce the opposite of its intended purpose and larger associations effectively control the outcome of bank elections under this process. The second commenter requested we modernize our regulatory framework and the Act because it is necessary for the System to be able to meet the changing capital needs of rural America. We will consider these comments in our regulatory burden initiative.

VII. Regulatory Flexibility Act

Pursuant to section 605(b) of the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*), FCA hereby certifies that the final rule will not have a significant economic 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, Farm Credit System institutions are not ‘‘small entities’’ as defined in the Regulatory Flexibility Act.

List of Subjects

12 CFR Part 611

Agriculture, Banks, banking, Rural areas.

12 CFR Part 612

Agriculture, Banks, banking, Conflicts of interest, Crime, Investigations, Rural areas.

12 CFR Part 614

Agriculture, Banks, banking, Foreign trade, Reporting and recordkeeping requirements, Rural areas.

12 CFR Part 615

Accounting, Agriculture, Banks, banking, Government securities, Investments, Rural areas.

12 CFR Part 618

Agriculture, Archives and records, Banks, banking, Insurance, Reporting and recordkeeping requirements, Rural areas, Technical assistance.

12 CFR Part 619

Agriculture, Banks, banking, Rural areas.

12 CFR Part 620

Accounting, Agriculture, Banks, banking, Reporting and recordkeeping requirements, Rural areas.

12 CFR Part 630

Accounting, Agriculture, Banks, banking, Organization and functions (Government agencies), Reporting and recordkeeping requirements, Rural areas.

■ For the reasons stated in the preamble, parts 611, 612, 614, 615, 618, 619, 620, and 630 of chapter VI, title 12 of the Code of Federal Regulations are amended as follows:

PART 611—ORGANIZATION

■ 1. The authority citation for part 611 is revised to read as follows:

Authority: Secs. 1.3, 1.4, 1.13, 2.0, 2.1, 2.10, 2.11, 3.0, 3.2, 3.21, 4.12, 4.15, 4.20, 4.21, 5.9, 5.10, 5.17, 6.9, 6.26, 7.0–7.13, 8.5(e) of the Farm Credit Act (12 U.S.C. 2011, 2013, 2021, 2071, 2072, 2091, 2092, 2121, 2123, 2142, 2183, 2203, 2208, 2209, 2243, 2244, 2252, 2278a–9, 2278b–6, 2279a–2279f–1, 2279aa–5(e)); secs. 411 and 412 of Pub. L. 100–233, 101 Stat. 1568, 1638; secs. 409 and 414 of Pub. L. 100–399, 102 Stat. 989, 1003, and 1004.

■ 2. Add a new subpart B, consisting of §§ 611.210 and 611.220 to read as follows:

Subpart B—Bank and Association Board of Directors

Sec.
611.210 Director qualifications and training.
611.220 Outside directors.

Subpart B—Bank and Association Board of Directors

§ 611.210 Director qualifications and training.

(a) *Qualifications.* (1) Each bank and association board of directors must establish and maintain a policy identifying desirable director qualifications. The policy must explain the type and level of knowledge and experience desired for board members, explaining how the desired qualifications were identified. The policy must be periodically updated and provided to the institution's nominating committee.

(2) Each Farm Credit institution board must have a director who is a financial expert. Boards of directors for associations with $500 million or less in total assets as of January 1 of each year may satisfy this requirement by retaining an advisor who is a financial expert. The financial advisor must report to the board of directors and be free of any affiliation with the external auditor or institution management. A financial expert is one recognized as having education or experience in: Accounting, internal accounting controls, or preparing or reviewing financial statements for financial institutions or large corporations consistent with the breadth and complexity of accounting and financial reporting issues that can reasonably be expected to be raised by the institution's financial statements.

(b) *Training.* Each bank and association board of directors must establish and maintain a policy for director training that includes appropriate implementing procedures. The policy must identify training areas supporting desired director qualifications. Each Farm Credit bank and association must require newly elected or appointed directors to complete director orientation training within 1 year of assuming their position and require incumbent directors to attend training periodically to advance their skills.

§ 611.220 Outside directors.

(a) *Eligibility, number and term.* (1) *Eligibility.* No candidate for an outside director position may be a director, officer, employee, agent, or stockholder of an institution in 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.

(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.

(b) *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.

Subpart C—Election of Directors and Other Voting Procedures

■ 3. Amend § 611.320 by revising paragraphs (b) and (e) to read as follows:

§ 611.320 Impartiality in the election of directors.

* * * * *

(b) No employee or agent of a Farm Credit institution shall take any part, directly or indirectly, in the nomination or election of members to the board of directors of a Farm Credit institution, or make any statement, either orally or in writing, which may be construed as intended to influence any vote in such nominations, or elections. This paragraph shall not prohibit employees or agents from providing biographical and other similar information or engaging in other activities pursuant to policies and procedures for nominations and elections. This paragraph does not affect the right of an employee or agent to nominate or vote for stockholder-elected directors of an institution in which the employee or agent is a voting member.

* * * * *

(e) No Farm Credit institution may in any way distribute or mail, whether at the expense of the institution or another, any campaign materials for director candidates. Institutions may request biographical information, as well as the disclosure information required under § 620.21(d), from all declared candidates who certify that they are eligible, restate such information in a standard format, and distribute or mail it with ballots or proxy ballots.

■ 4. Add a new § 611.325 to read as follows:

§ 611.325 Bank and association nominating committees.

Nominating committees must conduct themselves in the impartial manner prescribed by the policies and procedures adopted by their institution under § 611.320.

(a) *Composition.* The voting stockholders of each bank and association must elect a nominating committee of no fewer than three members. No individual may serve on a nominating committee who, at the time of selection to or during service on a nominating committee, is an employee, director, or agent of that bank or association. A nominating committee member may not be a candidate for election to the board in the same election for which the committee is identifying nominees.

(b) *Responsibilities.* It is the responsibility of each nominating committee to identify, evaluate, and nominate candidates for stockholder election to a bank or association board of directors.

(1) Each nominating committee must nominate individuals whom the committee determines meet the eligibility requirements to run for director positions. The committee must endeavor to assure representation from all areas of the institution's territory and as nearly as possible all types of agriculture practiced within the territory.

(2) The nominating committee must evaluate the qualifications of the director candidates. The evaluation process must consider whether there are any known obstacles preventing a candidate from performing the duties of the position.

(3) Each committee must nominate at least two candidates for each director position being voted on by stockholders. If two nominees cannot be identified, the nominating committee must provide written explanation to the existing board of the efforts to locate candidates or the reasons for disqualifying any other candidate that resulted in fewer than two nominees.

(c) *Resources.* Each bank and association must provide its nominating committee reasonable access to administrative resources in order for the committee to perform its duties. Banks and associations must, at a minimum, provide their nominating committees with a current list of stockholders, the most recent bylaws, the current director qualifications policy, and a copy of the policies and procedures that the bank or the association has adopted pursuant to § 611.320(a) assuring impartial elections. On the request of the nominating committee, the institution must also provide a summary of the current board self-evaluation. The bank or association may require a pledge of confidentiality by committee members prior to releasing evaluation documents.

Subpart F—Bank Mergers, Consolidations and Charter Amendments

§ 611.1030 [Removed and reserved]

■ 5. Remove and reserve § 611.1030.

Subpart P—Termination of System Institution Status

■ 6. Amend § 611.1223 by revising paragraph (d)(9) to read as follows:

§ 611.1223 Information statement—contents.

* * * * *

(d) * * *

(9) *Employment, retirement, and severance agreements.* Describe any employment agreement or arrangement between the successor institution and any of your senior officers or directors. Describe any severance and retirement plans that cover your employees or directors and state the costs you expect to incur under the plans in connection with the termination.

* * * * *

PART 612—STANDARDS OF CONDUCT AND REFERRAL OF KNOWN OR SUSPECTED CRIMINAL VIOLATIONS

■ 7. The authority citation for part 612 continues to read as follows:

Authority: Secs. 5.9, 5.17, 5.19 of the Farm Credit Act (12 U.S.C. 2243, 2252, 2254).

Subpart A—Standards of Conduct

■ 8. Amend § 612.2130 as follows:

■ a. Add the word ''currently'' after the word ''who'' each time it appears in paragraph (a);

■ b. Remove paragraph (d);

■ c. Redesignate existing paragraphs (e) through (u) as paragraphs (d) through (t), consecutively; and

■ d. Revise newly redesignated paragraph (e) to read as follows:

§ 612.2130 Definitions.

* * * * *

(e) *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.

* * * * *

■ 9. Amend § 612.2150 by revising paragraph (d) to read as follows:

§ 612.2150 Employees—prohibited conduct.

* * * * *

(d) Serve as an officer or director of an entity other than a System institution that transacts business with a System institution in the district or of any commercial bank, savings and loan, or other non-System financial institution, except employee credit unions. For the purposes of this paragraph, ''transacts business'' does not include loans by a System institution to a family-owned entity, service on the board of directors of the Federal Agricultural Mortgage Corporation, or transactions with nonprofit entities or entities in which the System institution has an ownership interest. With the prior approval of the board of the employing institution, an employee of a Farm Credit Bank or association may serve as a director of a cooperative that borrows from a bank for cooperatives. Prior to approving an employee request, the board shall determine whether the employee's proposed service as a director is likely to cause the employee to violate any regulations in this part or the institution's policies, e.g., the requirements relating to devotion of time to official duties.

* * * * *

■ 10. Amend § 612.2155 by revising paragraph (a) introductory text to read as follows:

§ 612.2155 Employee reporting.

(a) Annually, as of the institution's fiscal yearend, and at such other times as may be required to comply with paragraph (c) of this section, each senior officer must file a written and signed statement with the Standards of Conduct Official that fully discloses:

* * * * *

PART 614—LOAN POLICIES AND OPERATIONS

■ 11. The authority citation for part 614 continues to read as follows:

Authority: 42 U.S.C. 4012a, 4104a, 4104b, 4106, and 4128; Secs. 1.3, 1.5, 1.6, 1.7, 1.9, 1.10, 1.11, 2.0, 2.2, 2.3, 2.4, 2.10, 2.12, 2.13, 2.15, 3.0, 3.1, 3.3, 3.7, 3.8, 3.10, 3.20, 3.28, 4.12, 4.12A, 4.13B, 4.14, 4.14A, 4.14C, 4.14D, 4.14E, 4.18, 4.18A, 4.19, 4.25, 4.26, 4.27, 4.28, 4.36, 4.37, 5.9, 5.10, 5.17, 7.0, 7.2, 7.6, 7.8, 7.12, 7.13, 8.0, 8.5 of the Farm Credit Act (12 U.S.C. 2011, 2013, 2014, 2015, 2017, 2018, 2019, 2071, 2073, 2074, 2075, 2091, 2093, 2094, 2097, 2121, 2122, 2124, 2128, 2129, 2131, 2141, 2149, 2183, 2184, 2201, 2202, 2202a, 2202c, 2202d, 2202e, 2206, 2206a, 2207, 2211, 2212, 2213, 2214, 2219a, 2219b, 2243, 2244, 2252, 2279a, 2279a–2, 2279b, 2279c–1, 2279f, 2279f–1, 2279aa, 2279aa–5); sec. 413 of Pub. L. 100–233, 101 Stat. 1568, 1639.

Subpart N—Loan Servicing Requirements; State Agricultural Loan Mediation Programs; Right of First Refusal

§ 614.4511 [Removed and reserved]

■ 12. Remove and reserve § 614.4511.

PART 615—FUNDING AND FISCAL AFFAIRS, LOAN POLICIES AND OPERATIONS, AND FUNDING OPERATIONS

■ 13. The authority citation for part 615 continues to read as follows:

Authority: Secs. 1.5, 1.7, 1.10, 1.11, 1.12, 2.2, 2.3, 2.4, 2.5, 2.12, 3.1, 3.7, 3.11, 3.25, 4.3, 4.3A, 4.9, 4.14B, 4.25, 5.9, 5.17, 6.20, 6.26, 8.0, 8.3, 8.4, 8.6, 8.7, 8.8, 8.10, 8.12 of the Farm Credit Act (12 U.S.C. 2013, 2015, 2018, 2019, 2020, 2073, 2074, 2075, 2076, 2093, 2122, 2128, 2132, 2146, 2154, 2154a, 2160, 2202b, 2211, 2243, 2252, 2278b, 2278b–6, 2279aa, 2279aa–3, 2279aa–4, 2279aa–6, 2279aa–7, 2279aa–8, 2279aa–10, 2279aa–12); sec. 301(a) of Pub. L. 100–233, 101 Stat. 1568, 1608.

Subpart H—Capital Adequacy

■ 14. Amend § 615.5200 by revising paragraph (b)(1) to read as follows:

§ 615.5200 Capital planning.

* * * * *

(b) * * *

(1) Capability of management and the board of directors;

* * * * *

Subpart I—Issuance of Equities

■ 15. Amend § 615.5230 by revising paragraphs (a)(1) introductory text, (a)(2) introductory text, (a)(3) introductory text, and (b)(5) to read as follows:

§ 615.5230 Implementation of cooperative principles.

(a) * * *

(1) Each voting shareholder of an association or bank for cooperatives must:

* * * * *

(2) Each voting shareholder of a Farm Credit Bank must:

* * * * *

(3) The regional election of stockholder-elected directors is permitted under the following conditions:

* * * * *

(b) * * *

(5) Each bank must endeavor to assure that there is a choice of at least two nominees for each elective office to be filled and that the board represents as nearly as possible all types of agriculture in the district. If fewer than two nominees for each position are named, the efforts to locate two willing nominees must be documented in the records of the bank and provided as part of the Annual Meeting Information Statement of part 620, subpart E of this chapter. The bank must also maintain a list of the type or types of agriculture engaged in by each director on its board.

PART 618—GENERAL PROVISIONS

■ 16. The authority citation for part 618 continues to read as follows:

Authority: Secs. 1.5, 1.11, 1.12, 2.2, 2.4, 2.5, 2.12, 3.1, 3.7, 4.12, 4.13A, 4.25, 4.29, 5.9, 5.10, 5.17 of the Farm Credit Act (12 U.S.C. 2013, 2019, 2020, 2073, 2075, 2076, 2093, 2122, 2128, 2183, 2200, 2211, 2218, 2243, 2244, 2252).

Subpart G—Releasing Information

■ 17. Amend § 618.8310 by revising paragraph (b) to read as follows:

§ 618.8310 Lists of borrowers and stockholders.

* * * * *

(b)(1) Within 7 days after receipt of a written request by a stockholder, each Farm Credit bank or association must provide a current list of its stockholders' names, addresses, and classes of stock held to such requesting stockholder. As a condition to providing the list, the bank or association may only require that the stockholder agree and certify in writing that the stockholder will:

(i) Utilize the list exclusively for communicating with stockholders for permissible purposes; and

(ii) Not make the list available to any person, other than the stockholder's attorney or accountant, without first obtaining the written consent of the institution.

(2) As an alternative to receiving a list of stockholders, a stockholder may request the institution mail or otherwise furnish to each stockholder a communication for a permissible purpose on behalf of the requesting stockholder. This alternative may be used at the discretion of the requesting stockholder, provided that the requester agrees to defray the reasonable costs of the communication. In the event the requester decides to exercise this option, the institution must provide the requester with a written estimate of the costs of handling and mailing the communication as soon as practicable after receipt of the stockholder's request to furnish a communication. However, a stockholder may not exercise this option when requesting the list to distribute campaign material for election to the institution board or board committees. Farm Credit banks and associations are prohibited from distributing or mailing campaign material under § 611.320(e) of this chapter.

(3) For purposes of paragraph (b) of this section ''permissible purpose'' is defined to mean matters relating to the business operations of the institutions. This includes matters relating to the effectiveness of management, the use of institution assets, the distribution by stockholder candidates of campaign material for election to the institution board or board committees, and the performance of directors and officers. This does not include communications involving commercial, social, political, or charitable causes, communications relating to the enforcement of a personal claim or the redress of a personal grievance, or proposals advocating that the bank or association violate any Federal, State, or local law or regulation.

Subpart J—Internal Controls

■ 18. Amend § 618.8430 by revising the introductory text and adding a new paragraph (d) to read as follows:

§ 618.8430 Internal controls.

Each Farm Credit institution's board of directors must adopt an internal control policy, providing adequate direction to the institution in establishing effective control over, and accountability for, operations, programs, and resources. The policy must include, at a minimum, the following:

* * * * *

(d) The role of the audit committee in providing oversight and review of the institution's internal controls.

■ 19. Amend § 618.8440 by revising paragraphs (b) introductory text and (b)(2) to read as follows:

§ 618.8440 Planning.

* * * * *

(b) The plan must include, at a minimum, the following:

(1) * * *

(2) An annual review of the internal and external factors likely to affect the institution during the planning period. The review must include:

(i) An assessment of management capabilities,

(ii) An assessment of the needs of the board, based on the annual self-evaluation of the board's performance, and

(iii) Strategies for correcting identified weaknesses.

* * * * *

PART 619—DEFINITIONS

■ 20. The authority citation for part 619 is revised to read as follows:

Authority: Secs. 1.4, 1.7, 2.1, 2.4, 2.11, 3.2, 3.21, 4.9, 5.9, 5.12, 5.17, 5.18, 6.22, 7.0, 7.1, 7.6, 7.7, 7.8, 7.12 of the Farm Credit Act (12 U.S.C. 2011, 2015, 2072, 2075, 2092, 2123, 2142, 2160, 2243, 2244, 2252, 2253, 2278b–2, 2279a, 2279a–1, 2279b, 2279b–1, 2279b–2, 2279f).

■ 21. Amend part 619 by adding new § 619.9235 to read as follows:

§ 619.9235 Outside director.

A member of a board of directors selected or appointed by the board, who is not a director, officer, employee, agent, or stockholder of any Farm Credit System institution.

■ 21a. Amend part 619 by adding a new § 619.9310 to read as follows:

§ 619.9310 Senior officer.

The Chief Executive Officer, the Chief Operations Officer, the Chief Financial Officer, the Chief Credit Officer, and the General Counsel, or persons in similar positions; and any other person responsible for a major policy-making function.

PART 620—DISCLOSURE TO SHAREHOLDERS

■ 22. The authority citation for part 620 continues to read as follows:

Authority: Secs. 5.17, 5.19, 8.11 of the Farm Credit Act (12 U.S.C. 2252, 2254, 2279aa–11) sec. 424 of Pub. L. 100–233, 101 Stat. 1568, 1656.

Subpart A—General

■ 23. Amend § 620.1 as follows:

■ a. Remove paragraph (p);

■ b. Redesignate existing paragraphs (q) through (s) as paragraphs (p) through (r), consecutively; and

■ c. Revise paragraph (a).

§ 620.1 Definitions.

* * * * *

(a) *Affiliated organization* means any organization, other than a Farm Credit organization, of which a director, senior officer or nominee for director of the reporting institution is a partner, director, officer, or majority shareholder.

* * * * *

Subpart B—Annual Report to Shareholders

■ 24. Amend § 620.5 as follows:

■ a. Revise paragraphs (h)(3), (i)(1), (i)(2) introductory text, (i)(2)(i), and (i)(2)(iii); and

■ b. Add new paragraph (m)(3).

§ 620.5 Contents of the annual report to shareholders.

* * * * *

(h) * * *

(3) For each director and senior officer, list any other business interest where the director or senior officer serves on the board of directors or as a senior officer. Name the position held and state the principal business in which the business is engaged.

* * * * *

(i) * * *

(1) *Director compensation.* Describe the arrangements under which directors of the institution are compensated for all services as a director (including total cash compensation and noncash compensation). Noncash compensation with an annual aggregate value of less than $5,000 does not have to be reported. State the total cash and reportable noncash compensation paid to all directors as a group during the last fiscal year. If applicable, describe any exceptional circumstances justifying the additional director compensation as authorized by § 611.400(c) of this chapter. For each director, state:

(i) The number of days served at board meetings;

(ii) The total number of days served in other official activities, including any board committee(s);

(iii) Any additional compensation paid for service on a board committee, naming the committee; and

(iv) The total cash and noncash compensation paid to each director during the last fiscal year. Reportable compensation includes cash and the value of noncash items provided by a third party to a director for services rendered by the director on behalf of the reporting Farm Credit institution. Noncash compensation with an annual aggregate value of less than $5,000 does not have to be reported.

(2) *Senior officer compensation.* Disclose the information on senior officer compensation and compensation plans as required by this paragraph. Farm Credit System associations may disclose the information required by this paragraph in the Annual Meeting Information Statement (AMIS) required under subpart E of this part. Associations exercising this option must include a reference in the annual report stating that the senior officer compensation information is included in the AMIS and that the AMIS is available for public inspection at the reporting association offices pursuant to § 620.2(a).

(i) The institution must disclose the total amount of compensation paid to senior officers in substantially the same manner as the tabular form specified in the following Summary Compensation Table (table):

SUMMARY COMPENSATION TABLE

			Annual			
Name of individual or number in group (a)	Year (b)	Salary (c)	Bonus (d)	Deferred/ perquisite (e)	Other (f)	Total (g)
CEO	20XX 20XX					

SUMMARY COMPENSATION TABLE—Continued

		Annual				
Name of individual or number in group (a)	Year (b)	Salary (c)	Bonus (d)	Deferred/ perquisite (e)	Other (f)	Total (g)
	20XX					
Aggregate number of senior officers:						
(X)	20XX					
(X)	20XX					
(X)	20XX					

(A) For each of the last 3 completed fiscal years, report the total amount of compensation paid and the amount of each component of compensation paid to the institution's chief executive officer (CEO), naming the individual. If more than one person served in the capacity of CEO during any given fiscal year, individual compensation disclosures must be provided for each CEO.

(B) For each of the last 3 completed fiscal years, report the aggregate amount of compensation paid, and the components of compensation paid, to all senior officers as a group, stating the number of officers in the group without naming them. If applicable, include in the aggregate the amount of compensation paid to those officers who are not senior officers but whose total annual compensation is among the five highest amounts paid by the institution for the reporting period.

(C) Amounts shown as ''Salary'' (column (c)) and ''Bonus'' (column (d)) must reflect the dollar value of salary and bonus earned by the senior officer during the fiscal year. Amounts contributed during the fiscal year by the senior officer pursuant to a plan established under section 401(k) of the Internal Revenue Code, or similar plan, must be included in the salary column or bonus column, as appropriate. If the amount of salary or bonus earned during the fiscal year is not calculable by the time the report is prepared, the reporting institution must provide its best estimate of the compensation amount(s) and disclose that fact in a footnote to the table.

(D) Amounts shown as ''deferred/ perquisites'' (column (e)) must reflect the dollar value of other annual compensation not properly categorized as salary or bonus, including but not limited to:

(*1*) Deferred compensation earned during the fiscal year, whether or not paid in cash; or

(*2*) Perquisites and other personal benefits, including the value of noncash items, unless the annual aggregate value of such perquisites is less than $5,000. Reportable perquisites include cash and the value of noncash items provided by a third party to a senior officer for services rendered by the officer on behalf of the reporting institution.

* * * * *

(iii) The annual report or AMIS must include a statement that disclosure of information on the total compensation paid during the last fiscal year to any senior officer or to any other officer included in the aggregate is available and will be disclosed to shareholders of the institution and shareholders of related associations (if applicable) upon request.

* * * * *

(m) * * *

(3) State that the financial statements were prepared under the oversight of the audit committee, identifying the members of the audit committee.

* * * * *

Subpart C—Quarterly Report

■ 25. Amend § 620.11 by adding a new paragraph (d)(5) and revising paragraphs (d) introductory text and (e) to read as follows:

§ 620.11 Content of quarterly report to shareholders.

* * * * *

(d) *Financial statements.* The following financial statements must be provided:

* * * * *

(5) State that the financial statements were prepared under the oversight of the audit committee.

(e) *Review by independent public accountant.* The interim financial information need not be audited or reviewed by an independent public accountant prior to filing. If, however, a review of the data is made in accordance with the established professional standards and procedures for such a review, the institution may state that the independent accountant has performed such a review under the supervision of the institution's audit committee. If such a statement is made, the report of the independent accountant on such review must accompany the interim financial information.

* * * * *

Subpart E—Annual Meeting Information Statement

■ 26. Revise the heading of subpart E to read as set forth above.

§ 620.20 [Removed and reserved]

■ 27. Remove and reserve § 620.20.

■ 28. Amend § 620.21 by revising the introductory paragraph, paragraphs (c)(2) and (d) to read as follows:

§ 620.21 Contents of the information statement and other information to be furnished in connection with the annual meeting or director elections.

Each bank and association of the Farm Credit System must prepare and provide an information statement (''statement'' or ''AMIS'') to its shareholders at least 10 days prior to any annual meeting or any director elections. The AMIS must reference the annual report required by subpart B of this part and such other material information as is necessary to make the required statement, in light of the circumstances under which it is made, not misleading. The AMIS must address the following items:

* * * * *

(c) * * *

(2) State the name of any incumbent director who attended fewer than 75 percent of the board meetings or any meetings of board committees on which he or she served during the last fiscal year.

* * * * *

(d) *Nominees.* (1) For each nominee, state the nominee's name, city and state of residence, business address if any, age, and business experience during the last 5 years, including each nominee's principal occupation and employment during the last 5 years. List all business interests on whose board of directors the nominee serves or is otherwise employed in a position of authority, and state the principal business in which the business interest is engaged. Identify any family relationship of the nominee that would be reportable under part 612 of this chapter if elected to the institution's board.

(2) If fewer than two nominees for each position are named, describe the efforts of the nominating committee to locate two willing nominees.

(3) If association directors are nominated or elected by region, describe the regions and state the number of voting shareholders entitled to vote in each region.

(4) State whether nominations will be accepted from the floor. Associations must accept floor nominations. Any director nominee from the floor must be an eligible candidate for the director position for which the person has been nominated.

(i) For association directors not elected by region:

(A) If the annual meeting is to be held in more than one session and paper mail or electronic mail balloting will be conducted upon the conclusion of all sessions, state that nominations from the floor may be made at any session or, if the association's bylaws so provide, state that nominations from the floor shall be accepted only at the first session.

(B) If shareholders will not vote solely by paper mail or electronic mail ballot upon conclusion of all sessions, state that nominations from the floor may be made only at the first session.

(ii) For association directors elected by region:

(A) If more than one session of an annual meeting is held in a region, and if paper mail or electronic mail balloting will be conducted at the end of all sessions in a region, state that nominations from the floor may be made at any session in the region or, if the association's bylaws so provide, state that nominations from the floor shall be accepted only at the first session held in the region.

(B) If shareholders will not vote solely by paper mail or electronic mail ballot upon conclusion of all sessions in a region, state that nominations from the floor may be made only at the first session held in the region.

(5) For each nominee who is not an incumbent director, except a nominee from the floor, provide the information referred to in § 620.5(j) and (k) and paragraph (d)(1) of this section. If shareholders will vote by paper mail or electronic mail ballot upon conclusion of all sessions, each floor nominee must provide the information referred to in § 620.5(j) and (k) and paragraph (d)(1) of this section in paper or electronic form to the Farm Credit institution within the time period prescribed by the institution's bylaws. If the institution's bylaws do not prescribe a time period, state that each floor nominee must provide the disclosure to the institution within 5 business days of the nomination. The institution must ensure that the information is provided to the voting shareholders by delivering the ballots for the election of directors in the same format as the comparable information contained in the information statement. If shareholders will not vote by paper mail or electronic mail ballot upon conclusion of all sessions, each floor nominee must provide the information referred to in § 620.5(j) and (k) and paragraph (d)(1) of this section in paper or electronic form at the first session at which voting is held.

(6) Each bank and association must adopt policies and procedures that assure a disclosure statement is prepared by each director candidate. No person may be a nominee for director who does not make the disclosures required by this subpart. Candidate disclosure information must be distributed or mailed with ballots or proxy ballots to all shareholders eligible to vote in the election. Institutions may either restate such information in a standard format or provide complete copies of candidate disclosure information.

* * * * *

■ 29. Revise subpart F to read as follows:

Subpart F—Bank and Association Audit and Compensation Committees

Sec.
620.30 Audit committees.
620.31 Compensation committees.

Subpart F—Bank and Association Audit and Compensation Committees

§ 620.30 Audit committees.

Each Farm Credit bank and association must establish and maintain an audit committee. An audit committee is established by adopting a written charter describing the committee's composition, authorities, and responsibilities in accordance with this section. All audit committees must maintain records of meetings, including attendance, for at least 3 fiscal years.

(a) *Composition.* Each member of an audit committee must be a member of the Farm Credit institution's board of directors. An audit committee may not consist of less than three members and must include any director designated as a financial expert under § 611.210(a)(2) of this chapter. All audit committee members should be knowledgeable in at least one of the following: Public and corporate finance, financial reporting and disclosure, or accounting procedures.

(b) *Independence.* Every audit committee member must be free from any relationship that, in the opinion of the board, would interfere with the exercise of independent judgment as a committee member.

(c) *Resources.* Farm Credit institutions must permit their audit committees to contract for independent legal counsel and expert advisors. If an institution hires a financial expert advisor pursuant to § 611.210(a)(2), that advisor will also serve as an advisor to the audit committee. Each institution is responsible for providing monetary and nonmonetary resources to enable its audit committee to contract for external auditors, outside advisors, and ordinary administrative expenses. A two-thirds majority vote of the full board of directors is required to deny an audit committee's request for resources.

(d) *Duties.* Each audit committee must report only to the board of directors. In its capacity as a committee of the board, the audit committee is responsible for the following:

(1) *Financial reports.* Each audit committee must oversee management's preparation of the report to shareholders; review the impact of any significant accounting and auditing developments; review accounting policy changes relating to preparation of financial statements; and review annual and quarterly reports prior to release. After the audit committee reviews a financial policy, procedure, or report, it must record in its minutes its agreement or disagreement with the item(s) under review.

(2) *External auditors.* The external auditor must report directly to the audit committee. Each audit committee must:

(i) Determine the appointment, compensation, and retention of external auditors issuing audit reports of the institution; and

(ii) Review the external auditor's work.

(3) *Internal controls.* Each audit committee must oversee the institution's system of internal controls relating to preparation of financial reports, including controls relating to the institution's compliance with applicable laws and regulations. Any internal audit functions of the institution must also be subject to audit committee review and supervision.

§ 620.31 Compensation committees.

Each Farm Credit bank and association must establish and maintain a compensation committee by adopting a written charter describing the committee's composition, authorities, and responsibilities in accordance with this section. All compensation committees will be required to maintain records of meetings, including attendance, for at least 3 fiscal years.

(a) *Composition.* Each compensation committee must consist of at least three members. Each committee member must be a member of the institution's board of directors. Every member must be free from any relationship that, in the opinion of the board, would interfere with the exercise of independent judgment as a committee member.

(b) *Duties.* Each compensation committee must report only to the board of directors. In its capacity as a committee of the board, the compensation committee is responsible for reviewing the compensation policies and plans for senior officers and employees. Each compensation committee must approve the overall compensation program for senior officers.

(c) *Resources.* Each institution must provide monetary and nonmonetary resources to enable its compensation committee to function.

PART 630—DISCLOSURE TO INVESTORS IN SYSTEM-WIDE AND CONSOLIDATED BANK DEBT OBLIGATIONS OF THE FARM CREDIT SYSTEM

■ 30. The authority citation for part 630 continues to read as follows:

Authority: Secs. 5.17, 5.19 of the Farm Credit Act (12 U.S.C. 2252, 2254).

Subpart A—General

■ 31. Revise § 630.6 to read as follows:

§ 630.6 Funding Corporation committees.

(a) *System Audit Committee.* The Funding Corporation must establish and maintain a System Audit Committee (SAC) by adopting a written charter describing the committee's composition, authorities, and responsibilities in accordance with this section. The SAC must maintain records of meetings, including attendance, for at least 3 fiscal years.

(1) *Composition.* All SAC members should be knowledgeable in at least one of the following: Public and corporate finance, financial reporting and disclosure, or accounting procedures.

(i) At least one-third of the SAC members must be representatives from the Farm Credit System.

(ii) The SAC may not consist of less than three members and at least one member must be a financial expert. A financial expert is one who either has experience with internal controls and procedures for financial reporting or experience in preparing or auditing financial statements.

(iii) The chair of the SAC must be a financial expert.

(2) *Independence.* Every audit committee member must be free from any relationship that, in the opinion of the Funding Corporation board, would interfere with the exercise of independent judgment as a committee member.

(3) *Resources.* The Funding Corporation must permit the SAC to contract for independent legal counsel and expert advisors. The Funding Corporation is responsible for providing monetary and nonmonetary resources to enable the SAC to contract for external auditors, outside advisors, and ordinary administrative expenses. A two-thirds majority vote of the full Funding Corporation board of directors is required to deny any SAC request for resources.

(4) *Duties.* The SAC reports only to the Funding Corporation board of directors. In its capacity as a committee of the board, the SAC is responsible for the following:

(i) *Financial reports.* The SAC must oversee the Funding Corporation's preparation of the report to stockholders and investors; review the impact of any significant accounting and auditing developments; review accounting policy changes relating to preparation of the System-wide combined financial statements; and review annual and quarterly reports prior to release. After the SAC reviews a financial policy, procedure, or report, it must record in its minutes its agreement or disagreement with the item(s) under review.

(ii) *External auditors.* The external auditor must report directly to the SAC. The SAC must:

(A) Determine the appointment, compensation, and retention of external auditors issuing System-wide audit reports; and

(B) Review the external auditor's work.

(iii) *Internal controls.* The SAC must oversee the Funding Corporation's system of internal controls relating to preparation of financial reports, including controls relating to the Farm Credit System's compliance with applicable laws and regulations.

(b) *Compensation committee.* The Funding Corporation must establish and maintain a compensation committee by adopting a written charter describing the committee's composition, authorities, and responsibilities in accordance with this section. The compensation committee will be required to maintain records of meetings, including attendance, for at least 3 fiscal years.

(1) *Composition.* The committee must consist of at least three members. Each committee member must be a member of the Funding Corporation's board of directors. Every member must be free from any relationship that, in the opinion of the board, would interfere with the exercise of independent judgment as a committee member.

(2) *Duties.* The compensation committee must report only to the board of directors. In its capacity as a committee of the board, the compensation committee is responsible for reviewing the compensation policies and plans for senior officers and employees. The compensation committee must approve the overall compensation program for senior officers.

(3) *Resources.* The Funding Corporation must provide monetary and nonmonetary resources to enable its compensation committee to function.

Subpart B—Annual Report to Investors

■ 32. Amend § 630.20 by revising the introductory heading for paragraph (h), paragraphs (h)(2) and (l) introductory text to read as follows:

§ 630.20 Contents of the annual report to investors.

* * * * *

(h) *Directors and senior officers.*

* * * * *

(2) *Senior officers.* List the names of all senior officers employed by the disclosure entities, including position title and length of service at current position.

* * * * *

(l) *Financial statements.* Furnish System-wide combined financial statements and related footnotes prepared in accordance with GAAP, and accompanied by supplemental information prepared in accordance with the requirements of § 630.20(m). The System-wide combined financial statements must provide investors and potential investors in FCS debt obligations with the most meaningful presentation pertaining to the financial condition and results of operations of the Farm Credit System. The System-wide combined financial statement and accompanying supplemental information must be audited in accordance with generally accepted auditing standards by a qualified public accountant (as defined in § 621.2(i) of this chapter) and indicate that the financial statements were prepared under the oversight of the System Audit Committee, identifying the members of the audit committee. The System-wide combined financial statements must include the following:

* * * * *

Subpart C—Quarterly Reports to Investors

■ 33. Amend § 630.40 by revising paragraph (d) introductory text to read as follows:

§ 630.40 Contents of the quarterly report to investors.

* * * * *

(d) *Financial statements.* Interim combined financial statements must be provided in the quarterly report to investors as set forth in paragraphs (d)(1) through (4). Indicate that the financial statements were prepared under the oversight of the System Audit Committee.

* * * * *

Dated: January 24, 2006.

James M. Morris,

Acting Secretary, Farm Credit Administration Board.

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