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FARM CREDIT ADMINISTRATION

12 CFR Parts 611, 619, 620, 621, 624, 627, and 630

RIN 3052-AC11

Organization; Definitions; Disclosure to Shareholders; Accounting and Reporting Requirements; Regulatory Accounting Practices; Title IV Conservators, Receivers, and Voluntary Liquidations; and 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 disclosure and reporting regulations for Farm Credit System (System) institutions. The final rule clarifies and enhances existing disclosure requirements for reports to System shareholders and investors. The rule provides for “real time” disclosures to shareholders, investors, and the public by accelerating the time period for filing annual and quarterly reports. The final rule requires the Federal Farm Credit Banks Funding Corporation (Funding Corporation) to issue interim reports to investors in System-wide debt obligations based on policies and procedures it would have to adopt. Issuing interim reports will improve the timely and accurate distribution of System-wide financial information. The rule also supports financial accuracy certifications in periodic reports for all System institutions by requiring management of the Funding Corporation and the largest System institutions (with over \$1 billion in assets) to annually review and report on the internal control over financial reporting. The Funding Corporation will have to provide for an annual attestation from its external auditor on the Funding

Corporation’s assessment of internal control over financial reporting. Further, this rule creates a regulatory section on the independence of external auditors, adding restrictions on non-audit services and conflicts of interest, as well as requiring auditor rotation.

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. We will publish a notice of the effective date in the **Federal Register**.

Compliance Date: Compliance with all provisions of the rule must be achieved by the start of the fiscal year immediately following the effective date of this rule, unless the start of that fiscal year is within 3 months or less of the effective date. In that case, full compliance is delayed until the start of the next full fiscal year.

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SUPPLEMENTARY INFORMATION:

I. Objectives

Our objectives in this rulemaking are to:

- Incorporate recent changes in industry practices into our financial disclosure and reporting requirements for System institutions;
- Augment existing reporting timeframes with “real time disclosure” principles to improve shareholder, investor, and public access to material financial information used in informed investment decisionmaking;
- Strengthen the independence of System financial audits;
- Streamline the financial reporting certification requirement, making them easier to understand and use; and
- Enhance shareholders’ and investors’ understanding of, and confidence in, the System’s operations through improved transparency.

II. Background

The Farm Credit Act of 1971, as amended (Act),¹ authorizes FCA to issue regulations implementing the provisions of the Act. The 1985 Amendments to the Act² added provisions requiring FCA to regulate the disclosure and reporting practices of System institutions and require each System institution to prepare and publish annual financial reports to shareholders. The Act at section 5.19(b)(1) also requires that financial statements be prepared in accordance with generally accepted accounting principles (GAAP) and be audited by an independent public accountant.

Our existing regulations require each System institution to prepare annual and quarterly reports, identifying the minimum information requirements of the reports. Our existing regulations also set forth reporting timeframes and signatory requirements for the reports to ensure that System institutions provide timely and reliable financial information to multiple audiences, including borrowers, shareholders, investors and the public.

On March 14, 2006, we published a proposed rule (71 FR 13040) to amend those sections of parts 620, 621 and 630 affecting reporting timeframes, certifications and external auditors. We also proposed other amendments to our reporting and disclosure regulations. In the course of developing this rule, we considered the disclosure and reporting practices of publicly traded companies, reporting requirements of the Federal Deposit Insurance Corporation (FDIC) and other Federal bank regulatory agencies, the financial reporting and disclosure provisions of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley)³ and the Securities and Exchange Commission (SEC) implementing regulations. We also considered studies and public statements of individuals and organizations with knowledge and expertise in financial disclosure and reporting practices. Throughout this process we evaluated changes to our rules against our role as the safety and soundness regulator of the System and the System’s cooperative structure.

The comment period for the proposed rule closed on June 12, 2006.

¹ Pub. L. 92-181 (Dec. 10, 1971).

² Farm Credit Amendments Act of 1985, Pub. L. 99-205 (Dec. 23, 1985).

³ Pub. L. 107-204 (July 30, 2002).

III. Comments and Our Response

We received 14 comment letters on our proposed rule, all from individuals and entities associated with the System. Of the comments received, eleven were from System associations, two were from Farm Credit banks, and one was from the Farm Credit Council (FCC), acting for its membership and the Funding Corporation. In general, most commenters supported the proposed rule, but suggested changes to our proposal on internal control assessments, reporting timeframes and auditor rotation. One association commenter stated our proposed rule was generally burdensome and not cost effective, while another thanked us for focusing on eliminating unnecessary burdens for System institutions. Still another commenter asked us to mitigate the “negative impact” of the rule to allow more effective use of shareholder patronage dollars. We discuss and respond to the comments to our proposed rule below. Those provisions of the proposed rule on which we did not receive comments are finalized as proposed.

A. Definition of Qualified Public Accountant [new § 619.9270 and § 621.2(i)]

We received no comments on our proposed definition of “qualified public accountant” or on moving the term from § 621.2(i) to § 619.9270. We adopt this proposed provision as final. In conformance with this change, we remove the § 621.2(i) reference in §§ 611.1250(a)(3) and (b)(4), 611.1255(a)(3) and (b)(4), 620.5(m)(1), and 630.20(l).

B. Certification and Submission of Financial Reports [§§ 620.2, 620.3, 620.5, 627.2785(d), 630.3, 630.4 and 630.5]

1. Report Submissions, Signatures, and Certification of Financial Accuracy [§§ 620.2, 620.3, 620.5, 627.2785(d), 630.3, 630.4, and 630.5]

We received no comments on our proposal to remove the requirement that multiple copies of reports be sent to us. We also received no comments on our proposed changes to the signatory and financial accuracy requirements for reports. We adopt these proposed provisions as final with a minor clarification to redesignated § 630.4(c) to clarify that it is the signature and certification provisions of § 620.3 that are applicable to information submitted to the funding banks by associations for the System-wide report. We also adopt the conforming technical changes requiring all reports, regardless of the

recipient, to comply with §§ 620.3 and 630.5, as well as technical changes to §§ 630.20(h)(1); 620.5(m)(2); 630.4(a)(4), (b)(5) and (c)(1); and 627.2785(d).

We received six comments from five associations and one Farm Credit bank on our existing rule at § 630.4 dealing with the supply of information to the Funding Corporation. The Farm Credit bank supported our existing rule, but the associations stated that our rule at § 630.4 obligates the associations to provide their funding bank with the information necessary for the bank to provide accurate and complete district information to the Funding Corporation. The commenters stated it is inappropriate and burdensome to regulate the relationship between the associations and their funding bank and asked that the provision be removed. The commenters asked that the associations and banks be allowed to use contractual relationships to orchestrate how district information is provided to the Funding Corporation. The commenters suggested the general financing agreement (GFA) as an appropriate tool for negotiating how to submit the required information. One commenter explained that banks should work with associations to determine the information necessary, rather than giving the bank “regulatory authority.” Another commenter stated that the current information submission relationship works adequately and does not require a revision.

While we agree that the Funding Corporation, banks and associations should work together to identify the information provided for the System-wide report, we do not believe that a contractual relationship, or a GFA, is an appropriate method of ensuring the Funding Corporation receives information necessary to prepare the report to investors. It is essential that the banks and associations be held accountable to their regulator for providing the Funding Corporation with necessary financial information to ensure an accurate, timely and complete report is provided to System investors. We also point out that this requirement has been in existence since 1994 and is not a new proposal. We only proposed changes to the certification and signatory requirements to the existing submission requirements, as well as limiting access to the individual institution’s external auditor. These changes were proposed to reduce the burden on associations and banks by using the same signatures and certifications for both the Report to Shareholders and for the information submitted to the Funding Corporation. We are not removing the existing

requirement in § 630.4 that associations provide their funding bank with information needed by the Funding Corporation and adopt the proposed modifications to § 630.4 to require banks and associations to submit information complying with the signature and certification requirements in § 620.3. We also remove, as proposed, the provision that previously allowed the Funding Corporation and banks to question another System institution’s external auditor about submissions for the System-wide report.

2. Bank and Association Assessment of Internal Control Over Financial Reporting [§ 620.3(d)]

We proposed adding a new § 620.3(d) requiring each institution with total assets over \$500 million (as of the end of the previous fiscal year) to perform a management assessment of the institution’s internal financial controls and report the results of the assessment in the annual and quarterly reports of the institution. We received comments from the FCC, two Farm Credit banks and nine associations opposing the type and frequency of the assessment of internal financial controls. The commenters first asked that we replace the phrase “assessment of the internal financial controls of the institution” with “assessment of internal control over financial reporting.” Commenters stated the suggested change conforms to the industry standard, explaining that any language different from the industry standard may be confusing or lead to misunderstandings. Commenters also said that an “assessment of internal control over financial reporting” is distinguishable from the general requirements for internal controls in part 618 of our regulations.

We agree that an assessment of internal control over financial reporting has a narrow focus when compared to the general requirements for internal controls in part 618 of our regulations; part 618 addresses an institution’s internal controls associated with enterprise risk management and corporate governance. We also agree that using the industry phrase “internal control over financial reporting” facilitates an application of uniform procedures in internal control assessments, minimizing potential confusion. The SEC, in adopting regulations implementing Sarbanes-Oxley, explained that “internal control over financial reporting” is the predominant term used by companies and auditors and best encompasses the

objectives of the Sarbanes-Oxley Act.”⁴ Although System institutions are not covered by this provision of Sarbanes-Oxley, nor regulated by the SEC, the SEC rule is generally regarded as the industry standard in this area.

Accordingly, we replaced the proposed references to “internal control over financial reporting” in the final rule.

Second, the commenters asked that the frequency of the assessment requirement be changed to an annual requirement, following industry standards and best practices. The commenters stated that current best practices only require such assessments on an annual basis, not quarterly as we proposed. One Farm Credit bank acknowledged that Sarbanes-Oxley requires a quarterly evaluation of internal controls, but does not require that the evaluation be disclosed or included in quarterly reports. Two commenters specifically asked that the quarterly update be part of the certification of financial accuracy. Three commenters stated that quarterly assessments create an undue burden and estimated the cost at \$30,000 for each assessment, increasing the association’s cost by \$90,000 over that of publicly traded companies who only conduct an annual assessment.

We agree that both a quarterly and annual assessment may be too burdensome given the cooperative nature of the System and have replaced the proposed quarterly requirement with a quarterly update on material changes in the internal control over financial reporting. Although most commenters suggested a quarterly update only at the System-wide level, we are keeping the requirement at the entity level for the same reasons that we are keeping the requirement for an annual assessment at the entity level. In the final rule, we require that an institution disclose any material change in the internal control over financial reporting occurring during the reporting period. We expect institutions to disclose changes that materially affected, or are reasonably likely to materially affect, the institution’s internal control over financial reporting. We believe disclosing material changes in internal control over financial reporting is more efficient and less costly than requiring an institution to perform a quarterly assessment and responds to commenters concerns in this area. Such a requirement is also more consistent with industry best practices. We decline the suggestion that the internal control assessment be

certification of financial accuracy to be a separate and extremely important process. Internal control updates, while they may impact the financial reporting, should not be blended into an accuracy certification. We expect internal control quarterly updates to be separate from the financial accuracy certification.

Third, some commenters objected to the assessment being required at an entity level (i.e., the individual institution level), stating that a System-wide assessment would provide the most meaningful protection to shareholders and investors. Commenters stated a significant amount of time and expense would be required for each System institution to perform an assessment of internal control over financial reporting. One commenter stated that an entity-level assessment would harm, not help, shareholders, while another argued entity-level assessments were not practical, cost effective and not beneficial to shareholders. The commenters also disagreed with our statement in the preamble of the proposed rule that most institutions already plan to prepare the assessments, stating System institutions assess their internal control over financial reporting as part of an overall System-wide evaluation of internal controls over financial reporting. The commenters clarified that the System has conducted an annual assessment of internal control over financial reporting for the System-wide Report to Investors since the 2005 reporting year. The FCC specifically described the nature of the current System-wide assessment, explaining the scope of work is limited at the bank and association level to information that would be provided to the Funding Corporation to develop the System-wide report. The commenters also asserted that the scope of work for this System-wide evaluation is at a much higher materiality level than an assessment made on an individual entity basis and, as a result, the amount of work necessary to perform an entity-level assessment is significantly greater than that currently being performed. One Farm Credit bank explained internal controls relevant to a System-wide assessment are different from controls needed at an entity level, making the two types of assessments fundamentally different. This commenter also asked us to weigh the benefit versus the cost, explaining the lack of traded stock at the entity level reduced the critical need for the assessment.

We recognize additional work may be required for an entity-level assessment and may involve additional time and expense. We do not agree, however, that

the benefit of an entity-level assessment is not as great as it may be for a System-wide assessment. We continue to believe that the requirement for management’s assessment of internal control over financial reporting provides a valuable assurance to System shareholders, investors, and potential investors that internal control procedures are periodically reviewed. While System stock is not publicly traded, we do not believe this fact necessarily minimizes the interest, financial and otherwise, that System stockholders have in the operations of the institutions of which they are members, and particularly if those institutions allocate patronage to their shareholders. Management’s responsibility for establishing and maintaining adequate internal control over financial reporting, and for assessing the effectiveness of that control, serves to enhance the quality of reporting by identifying potentially damaging practices within the institution. Furthermore, we believe the requirement to provide an assessment of internal control over financial reporting serves to enhance the safety and soundness of these institutions, reflects best practices and promotes comparability of reporting with other businesses in the financial services sector. While a requirement for an entity-level assessment may increase the costs, we believe these costs are justified, especially in the largest institutions, to maintain the quality of reporting in more complex operations and are mitigated somewhat by the current efforts of banks and associations to facilitate an assessment of internal control over financial reporting at the System level. We adopt as final the requirement that the Funding Corporation and the largest institutions provide an assessment of internal control over financial reporting in their annual reports.

Fourth, commenters asked that we change the minimum requirement for the assessment to more closely reflect industry practices. We agree that we do not need to regulate, at the present time, the specific content of the assessment since there are sufficient guidelines for System institutions to follow. The final rule requires a report on management’s assessment of internal control over financial reporting to be included in the annual report to shareholders without specifying the content of the internal control report. We believe removing this specificity gives institutions the flexibility to pattern the content of their management report, including any topics addressed or recitations made by

⁴ See 68 FR 36636 (June 18, 2003).

management, after industry standards and best practices. For example, institutions may wish to consider SEC rules for assessments of internal control over financial reporting in publicly traded companies. Publicly traded companies state in their assessment management's responsibility for establishing and maintaining adequate internal control over financial reporting for the institution; the framework used by management to evaluate the effectiveness of the internal control over financial reporting; and whether or not the internal control over financial reporting is effective. These companies also discuss any material weakness in internal control over financial reporting and may not conclude that the internal control over financial reporting is effective if one or more material weakness exists.

While we have removed some of the proposed content requirements of the internal control assessment, the final rule maintains the requirement that the assessment be reported to the institution's board. We also remind institutions that each audit committee has oversight responsibility for the internal control over financial reports under existing § 620.30(d)(3) and to involve them accordingly in the assessment reporting process.

Finally, the commenters asked that, should we retain the requirement for an entity-level assessment, we re-define a large institution as one with over \$1 billion in assets and that they be the only institutions required to conduct the assessment of internal control over financial reporting. The commenters stated that an entity-level assessment by institutions of this size conforms more closely to current best practices and such a requirement is consistent with other regulators. One Farm Credit bank specifically commented that the FDIC uses \$1 billion for commercial banks and that we offered no reason for proposing a lower level.

We continue to consider a large institution as one with \$500 million or more in total assets, but agree that a higher threshold for identifying institutions that must conduct the assessment of internal control over financial reporting is appropriate. We have changed the requirement to only require the largest institutions to conduct the internal control assessment, which we define as those institutions with total assets over \$1 billion (as of the end of the previous fiscal year). We were persuaded by the commenters' arguments that smaller institutions may have more difficulty in evaluating their internal control over financial reporting because they have more limited

resources and may not have as sophisticated a system of internal control over financial reporting as the largest institutions. We believe a \$1 billion threshold level appropriately balances the additional effort, resources, and costs against the benefits derived by the largest institutions, who tend to have more complex operations. We are also mindful that the \$1 billion threshold level encompasses approximately 70 percent of the System assets and includes institutions in each Farm Credit district.

While mandatory compliance with the provision for an annual management assessment of internal control over financial reporting is not required for those institutions with total assets of \$1 billion or less, we encourage those institutions to voluntarily assess their internal control over financial reporting as we believe it is representative of industry best practices. We also encourage System institutions to consider, where appropriate, enhanced disclosures to shareholders that address the work performed by an institution in evaluating its internal controls to facilitate the Funding Corporation management's assessment of internal control over financial reporting and related external auditor attestation regarding the System's assessment.

3. Funding Corporation Assessment of Internal Control Over Financial Reporting and Auditor Attestation [§ 630.5(d)]

We proposed requirements for the System-wide Report to Investors that are similar to those for banks and associations pertaining to management assessment of the internal control over financial reporting in the annual and quarterly reports. Commenters reiterated their earlier remarks regarding the terminology, frequency, and detail of the internal control assessment. For reasons discussed in Section III.B.2 of this preamble, we make the corresponding changes to § 630.5 for System-wide reports.

We proposed an additional requirement at the System-wide level for an external auditor attestation on management's assessment of the internal control over financial reporting. We received comments from the FCC, two banks and eight associations concerning this provision. The commenters, while not objecting to the external auditor attestation, stated that the external auditor might not be able to make the statement required by the proposed regulation. They explained that accounting firms must comply with Auditing Standard No. 2, "An Audit of

Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements," issued by the Public Company Accounting Oversight Board (PCAOB) for clients registered with the SEC.⁵ Commenters pointed out that the differences between our proposed rule and the PCAOB standard might cause a conflict for the external auditor and requested we reconcile our rule to the PCAOB standard.

We are removing specific statements that an auditor must make from the final rule provision on an auditor attestation. We agree that describing the content of the auditor's report on management's assessment of internal control over financial reporting may have potentially created a conflict between the rule and the relevant PCAOB standard. We believe that the external auditor's attestation report should conform to applicable industry standards. Accordingly, we have adopted as final the requirement for an attestation report in § 630.5(d)(2) in a manner that does not conflict with the PCAOB standard by removing any specificity as to the content of the report.

C. Timing of Periodic Reports to Shareholders and Investors

1. Annual and Quarterly Report Filing Deadlines

[§§ 620.4(a), 620.10(a) and 630.3(a)]

We proposed reducing the quarterly reporting deadline to 40 calendar days and reducing the annual reporting deadline to 75 calendar days. We received comments from the FCC, two banks and eight associations opposing the reduction of filing deadlines for quarterly or annual reports or both. Most commenters asked that the timeframes for quarterly reports remain at 45 days. Three commenters recommended that the reporting timeframe for quarterly reports be in the range of 75 days, the same as annual reports. Some commenters stated that 40 days does not provide adequate time to prepare the quarterly reports and address any unforeseen contingencies, such as litigation matters, and subsequent events. A Farm Credit bank commented that while technology has improved the ability to process and disseminate reports, time is still needed to ensure that information is accurate

⁵ See PCAOB Auditing Standard No. 2, "An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements." Among other things, Auditing Standard No. 2 establishes specific requirements for the elements that must be included in the auditor's report on management's assessment of internal control over financial reporting.

and timely. The bank also asked us to consider the variations in the sizes and complexities of the System institutions while remarking that though FCA filing deadlines appear longer than those of the SEC, they aren't. The SEC makes a distinction between accelerated filers and others, providing different deadlines due to market needs. The commenters asked us to balance the burden against the shareholder need before requiring the same deadlines as the SEC. We considered the same information presented by this commenter when proposing abbreviated deadlines and point out that the proposed deadlines are not the same as the SEC. The SEC gives 60 days to file annual reports and we proposed 75 days. While the commenter did not object to our annual report filing timeframe, they did object to the timeframe for quarterly reports. One Farm Credit bank specifically stated that the additional time is more critical for quarterly reports than annual reports and therefore did not object to the proposed reduction in annual report filing deadlines, only to quarterly report deadlines.

Commenters also stated it would be difficult for the Funding Corporation to meet the 40-day deadline in view of the information that must be provided by the associations to the banks and the banks to the Funding Corporation. The commenters explained that requiring System-wide information statements to be published within 40 days after the end of the quarter is an unduly tight timeframe given the need to combine approximately 100 entities. Commenters stated that, since it would only take one institution to cause the Funding Corporation to not make the deadline, they believe a more appropriate timeframe for quarterly reports is 45 days. They also remarked on the responsibility to provide information to the Funding Corporation while completing their own quarterly reports.

We continue to believe the System's ability to capture, process, and disseminate financial statement information has improved significantly with the advancement of technology. We also do not believe increasing the quarterly deadline to 75 days is a reasonable suggestion, especially as the existing rule provides a maximum of 45 days for bank and association quarterly reports and 60 days for the Funding Corporation. System institutions have enhanced technological resources that improve their ability to process financial data. Therefore, a longer filing deadline at the entity level cannot be justified, especially as industry practices call for faster, "real time"

disclosure to shareholders and investors. However, we understand the importance of having adequate time to prepare financial information that is accurate and meaningful, and the complications of having information reported from the associations to the banks, and by the banks to the Funding Corporation. Accordingly, we increased the deadline for the issuance of the System-wide quarterly report to investors to 45 calendar days, while keeping the quarterly reporting due date for banks and associations at 40 calendar days. We believe this change will facilitate furnishing information to the Funding Corporation without unduly delaying bank and association quarterly reports. However we are not increasing the proposed filing time for annual reports. We believe the 75-day filing requirement for bank, association, and System-wide annual reports is well within the reporting capabilities of these institutions and most commenters did not object to this requirement. The filing time for annual reports in both our existing rule and in this final rule is 30 days longer than the time provided for filing quarterly reports. While we appreciate that extra time may be desirable for compilation of the System-wide annual report to investors, we believe sufficient time is already incorporated into the overall annual reporting deadline so that a separate, longer filing deadline for the annual System-wide report is unnecessary. Accordingly, we adopt this proposed provision as final.

2. System-wide Interim Reports

[new § 630.3(a)(3)]

We proposed that the Funding Corporation issue interim reports to disclose significant events or material changes in System-wide operations occurring after publication of a quarterly or annual System-wide report. We received no comments on this proposed requirement and adopt this provision as final.

D. Auditor Independence

[§§ 621.4(b), new 621.30, new 621.31, and new 621.32]

We proposed a new subpart in part 621 to facilitate external auditor independence within the System. We received limited comments on certain aspects of this subpart and discuss them below.

1. Prohibited Non-Audit Services

[new § 621.31(a)]

We proposed adding a new § 621.31 prohibiting external auditors of System institutions from providing certain non-

audit services. We also proposed, as a conforming change, removing the requirement that banks and associations include a provision in their audit engagement letters authorizing the external auditors to respond to questions from funding banks and the Funding Corporation. We received one comment on this section of our proposed rule. A Farm Credit bank commented that it did not object to the list of non-audit services, but asked that we clarify the prohibition at § 621.31(a)(8) against advocating an institution's interests in litigation, regulatory or administrative investigations and proceedings. The commenter remarked that SEC regulations on auditor independence place advocating an audit client's interests in litigation, or regulatory or administrative investigations or proceedings, under the general heading of "expert services" and is not a category unto itself. The commenter also explained that the SEC's commentary relative to this prohibition states that an accountant would not be precluded from performing internal investigations or fact finding at the request of the client's audit committee or legal counsel. The commenter also said that, under SEC rules, an auditor's work product may be used by the client and auditors may provide factual accounts or testimony about the work performed. This commenter also stated that our rule did not identify the basic principles of auditor independence. We note that auditor independence principles are contained in our proposed definition of an independent auditor at § 619.9270.

We have clarified the list of non-audit services to more clearly explain that the external auditor may not advocate an institution's interest in any area that is not the subject of audit work. The external auditor may not provide an expert opinion or other expert service for activities of the institution that fall outside the auditor's work reviewing financial statements. This prohibition does not preclude the external auditor from performing internal investigations or fact finding on items covered by an audit when requested by the institution's audit committee or legal counsel. We clarify that our rule follows the SEC regulations implementing section 201 of Sarbanes-Oxley, which explain that non-audit services may not include an accountant providing expert opinions or other services for the purpose of advocating an audit client's interests in litigation, regulatory or administrative investigations and proceedings. However, auditors may perform internal investigations or fact

findings that results in a report to the audit client. We clarify that, as an extension of their audit work, external auditors are allowed to use their work product and provide factual accounts or testimony about the audit work performed. We adopt all other proposed provisions of § 621.31 as final.

2. Permitted Non-Audit Services

[§§ 620.30, new 621.31 and 630.6]

We proposed requiring System institutions to obtain its audit committee's approval prior to contracting for permissible non-audit services from the external auditor. The proposed rule also amended the authorities of the audit committees to specifically include approval of non-audit services. One Farm Credit bank commented that the proposed regulation contemplates that, under certain circumstances, an audit committee may approve a non-audit service that is on the prohibited list but, does not provide any guidance on what circumstances might make a non-audit service acceptable. The commenter suggested including in our rule the three basic principles identified in SEC's regulations, on which the prohibited list of non-audit services is based: (1) An auditor cannot function in the role of management, (2) an auditor cannot audit his or her own work, and (3) an auditor cannot serve in an advocacy role for the audit client.

The commenter appears to have misinterpreted the requirements of proposed § 621.31(b). The proposed regulation does not allow an audit committee to approve non-audit services that are on the prohibited list. We have clarified the rule text to reflect that the audit committee may only approve non-audit services not specifically listed as prohibited in § 621.31(a). Further, the three basic principles of auditor independence identified by the commenter are already captured in new § 619.9270, defining independent external auditors. We received no other comments on § 621.31(b) and adopt it as final.

3. Auditor Conflicts of Interest and Rotation

[new § 621.32]

a. "Cooling Off" Period [new § 621.32(a)]

We received no comments on the proposed prohibition that a System institution may not engage the audit services of a qualified public accountant if the accountant, accounting partner (or concurring partner), or lead audit team member was an employee, officer or director of the System institution in the

12 months prior to contracting for audit services. Nor did we receive comments on the proposed prohibition that an institution may not make employment offers to an external auditor, accounting firm partner, concurring partner, or lead audit team member during the audit, or within 1 year of its conclusion. We adopt these proposed provisions as final.

b. Auditor Rotation [new § 621.32(b)]

We proposed prohibiting a System institution from engaging for 5 years the same lead and reviewing audit partner after 5 consecutive years of audit services to that institution. The commenters agreed that the lead (or concurring) audit partners for the System-wide report should be rotated after 5 years, with a 5-year timeout period, but asked that external auditors for banks and associations have a 7-year rotation. We received only one comment on the "time out" period. This commenter said the time out period of the lead (or concurring) audit partners for the banks and associations should be 2 years. The commenters explained that a 7-year rotation timeframe at the bank and association level is more consistent with the requirements for publicly traded companies.

The commenters contend a 7-year engagement at the bank and association level is justified because a partner must invest considerable time to develop an understanding of the System and requiring this learning process every 5 years would be inefficient. One Farm Credit bank commented that the System's relationship with the external auditor is managed at both a System-wide level and an individual institution level. The commenter stated this "two-tiered" relationship warrants a two-tiered rotation schedule where the lead and concurring auditor partners engaged for the System-wide report would have a 5-year rotation, but the lead and concurring auditor partners engaged by each bank and association would have a 7-year rotation and 2-year time out, similar to the SEC's rules for corporations and their subsidiaries. This commenter, and one other association commenter, explained that the SEC treatment of auditor rotation for subsidiaries, which may allow for a longer rotation period in certain circumstances, is more appropriate for the System.

After careful review, we concluded that the SEC's treatment of auditor rotation for subsidiaries is not an appropriate approach given the cooperative structure of the System. Unlike a subsidiary structure, associations are the borrowers,

members, and shareholders of the bank, consistent with the cooperative structure of the System. We also concluded that auditor engagements are appropriately handled using a uniform approach that recognizes the interdependency of System institutions, but preserves the independent authority of each institution to determine the engagement of its own external auditor. Basing an auditor rotation on a two-tier method modeled after the SEC's approach might be in conflict with this authority because a two-tiered rotation is designed to reflect a traditional subsidiary structure rather than the cooperative structure of the Farm Credit System.

We also do not agree that a longer engagement period at the bank and association level is necessary. A 5-year audit partner rotation and 5-year cooling off period for the lead and concurring audit partners is consistent with industry best practices and section 203 of Sarbanes-Oxley. While commenters are correct that the SEC allows for a 7-year audit partner engagement, this time period is restricted to other significant members of the audit team who are not the lead, concurring or reviewing partner. The SEC rule applies a 7-year rotation schedule to those partners who are not the lead, concurring, or reviewing partner but who are responsible for decisionmaking on significant auditing, accounting, and reporting matters affecting financial statements or who maintain regular contact with the audit client management and audit committee. The SEC imposes a 5-year "time-out" for the lead and concurring accounting partners and a 2-year "time-out" for other rotated partners before returning to a client.

While we used industry practice, as well as the SEC rule and Sarbanes-Oxley, as guides we also considered the time a lead partner must invest to acquire an understanding of the System. That consideration resulted in our limiting the rotation from the audited institution only, instead of requiring a rotation out of the entire System. Our final rule does not prohibit or otherwise limit lead and concurring partners from moving from one System institution to another, whether it is a bank or association. We adopt this proposed provision as final.

We make a technical change to correctly identify the location of the audit independence provisions as subpart E, not subpart F as stated in the proposed rule.

E. Contents of Periodic Reports

[§§ 620.5 and 630.20]

1. Description of Property

[§ 620.5(b)]

We received no comments on our proposal to remove the requirement at § 620.5(b) that Farm Credit banks and associations describe, in their annual reports, the terms and condition of agreements involving institution property subject to major encumbrances. We adopt this proposed provision as final.

2. Legal Proceedings and Enforcement

[§ 620.5(c)(1)]

We received no comments on our proposal to remove that portion of § 620.5(c)(1) requiring banks and associations to provide filing information on court proceedings, including a description of factual allegations, in annual reports. We adopt this proposed provision as final.

3. Selected Financial Data and Management Discussion and Analysis (MD&A)

[§§ 620.5(f) and 620.5(g)]

We received no comments on our proposed clarification in § 620.5(f)(1), (g)(1)(iii)(A) and (g)(1)(iv)(E) that disclosure of selected financial data, loan purchases and sales involving the Federal Agricultural Mortgage Corporation, and risk exposure need only be reported if they are material. Nor did we receive any comments on removing the reference in § 620.5(g)(1)(iv)(E) to section 8.7 of the Act or on revising the requirement for a discussion of the adequacy of loan loss allowances in § 620.5(g)(1)(iv)(B). We adopt these proposed provisions as final.

4. Fees to Qualified Public Accountants

[§ 620.5(l)(2)]

We received no comments on requiring System institutions to disclose the fees paid to their qualified public accountants. We adopt this proposed provision as final.

5. Selected Financial Data

[§ 630.20(f)]

We received no comments on our proposed clarification to § 630.20(f) that this section requires only material combined financial data for 5 years, not all financial data. We adopt this proposed provision as final.

6. Reporting on Young, Beginning and Small Farmers

[§§ 614.4165(c), 620.5(n) and 630.20(p)]

In the proposed rule we addressed comments on our existing regulations received before developing the proposed and final rule. These comments included a request to reduce regulatory burden by restricting the young, beginning and small farmers (YBS) reporting requirement to association annual reports and delete the specificity required by § 614.4165(c). We declined in our proposed rule to make these changes. Commenters renewed this request in response to our proposed rule.

We are making no changes to §§ 620.5(n) and 630.20(p), which require annual reports to shareholders and investors include information on YBS lending activities. As we discussed in the proposed rule, section 4.19 of the Act requires Farm Credit banks to submit an annual report to FCA summarizing the YBS operations and achievements of their affiliated associations. We continue to believe reporting to shareholders and the public on the YBS mission underscores the importance of the System's public purpose mission and the YBS mission, resulting in greater transparency to the public on the System's accomplishments in this area.

7. Financial Assistance Corporation (FAC)

[§§ 630.2, 630.4, and 630.20(b)]

We proposed removing references to the FAC from the definition of "disclosure entity" in § 630.2(c) and removing §§ 630.4(b) and 630.20(b)(3) outlining the responsibilities of the FAC. We received comments from the FCC and five associations requesting that we also remove § 630.20(a)(3) and (m)(2)(iii) where the FAC is mentioned. Commenters stated that these sections serve no useful purpose since there is no activity at the FAC and the FAC will be dissolved no later than June 2007. The FAC has discharged all of its responsibilities with respect to the repayment of FAC obligations and has no reportable financial data as of September 30, 2005. There is no existing § 630.20(a)(3) as referenced by the commenters, but we presume they meant § 630.20(b)(3). We proposed removing this reference and take this comment as agreement with our proposal. However, we did not propose removing § 630.20(m)(2)(iii) but agree with commenters that the reference to the FAC should be removed from § 630.20(m)(2)(iii) for the same reasons we used when proposing removal of

other FAC references in our rule. Accordingly, we remove this provision in the final rule and consider this additional change to be a conforming technical correction.

F. Other Issues

1. Regulatory Accounting Practices

[Part 624]

We received no comments on removing part 624, which authorized System institutions to use Regulatory Accounting Practices to defer certain interest costs and portions of the provision for loan losses. We adopt this proposed provision as final.

2. Report to Investor Cross Reference

[§§ 630.20(h), 630.20(i), and 630.4(a)(4)]

We proposed changing the cross-reference in § 630.20(h)(1) and (i) on how certain information would be available from § 630.3(f) to § 630.4(a)(5) and (a)(6). One commenter was unclear as to the basis for this change while another questioned the accuracy of the proposed cite. The existing rule contains an incorrect cross-reference that came about from prior revisions to the rule. We are correcting the reference at § 630.20(i) to reflect the correct cite of § 630.3(g), rather than the proposed cite of § 630.4(a)(5) and (a)(6). We are removing the cross reference from § 630.20(h)(1) entirely as it is not required.

3. Distribution of Annual Report to Shareholder

[§§ 620.1(q) and 620.4(a)]

a. Method of Distribution

We received comments from the FCC, a Farm Credit bank and six associations asking that the requirement in § 620.4(a) for each System institution to provide its shareholders an annual report be altered. In an effort to reduce regulatory burden and make annual report distribution more cost effective, the commenters asked that we allow annual reports to be issued in other than a printed "hard copy." Commenters also suggested that shareholders be allowed to "opt out" of automatically receiving a printed copy of the annual report. For those shareholders who elected not to receive a printed copy of the annual report, a copy would be available on the institution's Web site.

We proposed no changes to these sections. Because the comments are outside the scope of the proposed rule, we are not making any changes in response to the comments. We point out that, under our current regulations on E-Commerce, shareholders and their institutions already have a choice to

receive electronic copies of reports. Our rules provide that if all participants agree, electronic communication may be used. Therefore, if an individual shareholder and his or her institution agree, the shareholder may be given electronic reports. We caution that an institution, under our current E-Commerce rules, may not require a shareholder to use electronic commerce. This issue was also addressed in our July 26, 2002, Informational Memorandum entitled "Specific Guidance on Electronic Disclosures and Notices" in which we stated that System institutions may do business electronically if all parties agree. Comments received as part of any future rulemaking that addresses this area will be considered at that time.

b. Definition of "Shareholder"

We received comments from the FCC, a Farm Credit bank and six associations asking that we change our definition of "shareholders" contained in § 620.1(q). We define shareholder in § 620.1(q) as all equity holders in an institution. Commenters asked us to exclude Non-qualified Surplus Allocated—Retained shareholders from the definition, which would remove those equity holders from those required to receive annual reports. Commenters also asked to exclude from this group shareholders who have paid-off loans and retired stock. Because there are no plans to redeem this surplus, commenters argue that this group of shareholders has no vested interest in the institution and therefore no need for the annual report. The commenters also asserted that significant cost savings would result from only providing reports to "current common and preferred" shareholders.

We proposed no changes to this section. Because the comments are outside the scope of this rulemaking, we are not making any changes in response to the comments. We will, however, address any such future comments when applicable to other rulemaking.

4. Disclosures in the Quarterly and Annual Report to Shareholders [§§ 620.5 and 620.11]

We received comments from the FCC and six other commenters asking that we remove or revise certain disclosures made in the annual report to shareholders. Specifically, the commenters asked that we remove the requirements in § 620.5(i) to disclose the number of days served by a director and travel expense reimbursements in annual reports. Commenters also asked that we replace requirements in § 620.11(b) to account for business

combinations with ones that follow GAAP, arguing that pooling of interests is no longer permitted under GAAP. They also asked that we change the language of § 620.11(b)(6) to clarify whose statement, the accountant or management, is to be included as an exhibit. We proposed no changes to these sections. Because the comments are outside the scope of this rulemaking, we are not making any changes in response to them. We will, however, address any such future comments when applicable to other rulemaking.

5. Accounting for Loan Losses [§ 621.5(a)]

We received comments from the FCC and six other commenters asking that we revise the requirement in § 621.5(a) on the allowance for loan losses. The commenters asked us to revise the regulation to specifically require that the institutions' allowance for loan losses shall be maintained in accordance with GAAP. We proposed no changes to this section. Because the comments are outside the scope of this rulemaking, we are not making any changes in response to the comments. We also direct the commenters to existing § 621.3 instructing institutions to follow GAAP. This is further elaborated on in our April 26, 2004 Bookletter, "Adequacy of Farm Credit System Institutions' Allowance for Loan Losses and Risk Funds" (BL-049), where we explain that § 621.5(a) provides broad guidance in this area. Throughout BL-049, we reinforce the position that a System institution's allowance for loan losses should be maintained in accordance with GAAP.

V. 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 619

Agriculture, Banks, banking, Rural areas.

12 CFR Part 620

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

12 CFR Part 621

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

12 CFR Part 624

Accounting, Agriculture, Banks, banking, Rural areas.

12 CFR Part 627

Agriculture, Banks, banking, Claims, 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, 619, 620, 621, 624, 627 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 continues 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, 4.12A, 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, 2012, 2021, 2071, 2072, 2091, 2092, 2121, 2123, 2142, 2183, 2184, 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.

Subpart P—Termination of System Institution Status

§ 611.1250 [Amended]

■ 2. Amend paragraphs (a)(3) and (b)(4) of § 611.1250 by removing the words "as defined in § 621.2(i) of this chapter" from the end of the second sentence.

§ 611.1255 [Amended]

■ 3. Amend paragraphs (a)(3) and (b)(4) of § 611.1255 by removing the words "as defined in § 621.2(i) of this chapter" from the end of the second sentence.

PART 619—DEFINITIONS

■ 4. 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, 5.19, 6.22, 7.0,

7.1, 7.6, 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, 2254, 2278b-2, 2279a, 2279a-1, 2279b, 2279b-2, 2279f).

- 5. Amend part 619 by adding a new § 619.9270 to read as follows:

§ 619.9270 Qualified Public Accountant or External Auditor.

A qualified public accountant or external auditor is a person who:

- (a) Holds a valid and unrevoked certificate, issued to such person by a legally constituted State authority, identifying such person as a certified public accountant;
- (b) Is licensed to practice as a public accountant by an appropriate regulatory authority of a State or other political subdivision of the United States;
- (c) Is in good standing as a certified and licensed public accountant under the laws of the State or other political subdivision of the United States in which is located the home office or corporate office of the institution that is to be audited;
- (d) Is not suspended or otherwise barred from practice as an accountant or public accountant before the Securities and Exchange Commission (SEC) or any other appropriate Federal or State regulatory authority; and
- (e) Is independent of the institution that is to be audited. For the purposes of this definition the term “independent” has the same meaning as under the rules and interpretations of the American Institute of Certified Public Accountants (AICPA). At a minimum, an accountant hired to audit a System institution is not independent if he or she functions in the role of management, audits his or her own work, or serves in an advocacy role for the institution.

PART 620—DISCLOSURE TO SHAREHOLDERS

- 6. The authority citation for part 620 is revised to read as follows:

Authority: Secs. 4.19, 5.9, 5.17, 5.19, 8.11 of the Farm Credit Act (12 U.S.C. 2207, 2243, 2252, 2254, 2279aa-11); sec. 424 of Pub. L. 100-233, 100 Stat. 1568, 1656.

Subpart A—General

- 7. Amend § 620.2 as follows:
 - a. Remove paragraphs (b) and (c);
 - b. Add new paragraph (b);
 - c. Redesignate paragraphs (d) through (j) as paragraphs (c) through (i), consecutively; and
 - d. Revise paragraphs (a) and newly redesignated paragraph (c).

§ 620.2 Preparing and filing the reports.

For the purposes of this part, the following shall apply:

- (a) Copies of each report required by this part, including financial statements and related schedules, exhibits, and all other papers and documents that are a part of the report, must be sent to the Farm Credit Administration according to our instructions. Submissions must comply with the requirements of § 620.3 of this part. The Farm Credit Administration must receive the report within the period prescribed under applicable subpart sections.
- (b) The reports must be available for public inspection at the issuing institution and the Farm Credit Administration office with which the reports are filed. Farm Credit bank reports must also be available for public inspection at each related association's office(s).
- (c) The reports sent to shareholders must comply with the requirements of § 620.3 of this part. Shareholders must agree to electronic disclosures of reports required by this part.

* * * * *

- 8. Revise § 620.3 to read as follows:

§ 620.3 Accuracy of reports and assessment of internal control over financial reporting.

- (a) *Prohibition against incomplete, inaccurate, or misleading disclosures.* No institution and no employee, officer, director, or nominee for director of the institution shall make any disclosure to shareholders or the general public concerning any matter required to be disclosed by this part that is incomplete, inaccurate, or misleading. When any such person makes disclosure that, in the judgment of the Farm Credit Administration, is incomplete, inaccurate, or misleading, whether or not such disclosure is made in disclosure statements required by this part, such institution or person shall make such additional or corrective disclosure as is necessary to provide shareholders and the general public with a full and fair disclosure.
- (b) *Signatures.* The name and position title of each person signing the report must be printed beneath his or her signature. If any person required to sign the report has not signed the report, the name and position title of the individual and the reason(s) such individual is unable or refuses to sign must be disclosed in the report. All reports must be dated and signed on behalf of the institution by:
 - (1) The chief executive officer (CEO);
 - (2) The chief financial officer (CFO), or if the institution has no CFO, the

officer responsible for preparing financial reports; and

(3) A board member formally designated by action of the board to certify reports of condition and performance on behalf of individual board members.

(c) *Certification of financial accuracy.* The report must be certified as financially accurate by the signatories to the report. If any signatory is unable to, or refuses to, certify the report, the institution must disclose the individual's name and position title and the reason(s) such individual is unable or refuses to certify the report. At a minimum, the certification must include a statement that:

- (1) The signatories have reviewed the report,
- (2) The report has been prepared in accordance with all applicable statutory or regulatory requirements, and
- (3) The information is true, accurate, and complete to the best of signatories' knowledge and belief.

(d) *Management assessment of internal control over financial reporting.* Annual reports of those institutions with over \$1 billion in total assets (as of the end of the prior fiscal year) must include a report by management assessing the effectiveness of the institution's internal control over financial reporting. The assessment must be conducted during the reporting period and be reported to the institution's board of directors. Quarterly and annual reports for those institutions with over \$1 billion in total assets (as of the end of the prior fiscal year) must disclose any material change(s) in the internal control over financial reporting occurring during the reporting period.

Subpart B—Annual Report to Shareholders

§ 620.4 [Amended]

- 9. Amend § 620.4(a) by removing the word “shall” and adding in its place the word “must”; and by removing the reference “90” and adding in its place the reference “75 calendar”.
- 10. Amend § 620.5 as follows:
 - a. Remove the word “shall” and add in its place, the word “must” in the introductory text to § 620.5 and in paragraph (a) introductory text;
 - b. Remove the last sentence in paragraphs (b) and (c)(1);
 - c. Add the words “, if material” at the end of paragraph (f) introductory text;
 - d. Add the word “material” before the word “participation” in paragraph (g)(1)(iii)(A);
 - e. Remove the words “to absorb the risk inherent in the institution's loan

portfolio” at the end of paragraph (g)(1)(iv)(B);

■ f. Add the word “material” before the word “obligations” and before the word “contributions” in the first sentence of paragraph (g)(1)(iv)(E) and remove the words “pursuant to section 8.7 of the Act” at the end of the first sentence;

■ g. Revise paragraph (l); and

■ h. Remove the words “, as defined in § 621.2(i) of this chapter,” in paragraph (m)(1); remove existing paragraph (m)(2) and redesignate paragraph (m)(3) as new paragraph (m)(2).

§ 620.5 Contents of the annual report to shareholders.

* * * * *

(l) *Relationship with qualified public accountant.*

(1) If a change or changes in qualified public accountants have taken place since the last annual report to shareholders or if a disagreement with a qualified public accountant has occurred that the institution would be required to report to the Farm Credit Administration under part 621 of this chapter, the information required by § 621.4(c) and (d) of this chapter must be disclosed.

(2) Disclose the total fees, by the category of services provided, paid during the reporting period to the qualified public accountant. At a minimum, identify fees paid for audit services, tax services, and non-audit related services. The types of non-audit services must be identified and indicate audit committee approval of the services.

* * * * *

Subpart C—Quarterly Report

§ 620.10 [Amended]

■ 11. Amend § 620.10(a) by removing the word “shall” and adding in its place the word “must” and by removing the reference “45” and adding in its place the reference “40 calendar”.

Subpart F—Bank and Association Audit and Compensation Committees

■ 12. Amend § 620.30 by revising paragraph (d)(2) to read as follows:

§ 620.30 Audit committees.

(d) * * *

(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;

(ii) Review the external auditor’s work;

(iii) Give prior approval for any non-audit services performed by the external auditor, except the audit committee may not approve those non-audit services specifically prohibited by FCA regulation; and

(iv) Comply with the auditor independence provisions of part 621 of this chapter.

* * * * *

PART 621—ACCOUNTING AND REPORTING REQUIREMENTS

■ 13. The authority citation for part 621 is revised to read as follows:

Authority: Secs. 5.17, 8.11 of the Farm Credit Act (12 U.S.C. 2252, 2279aa–11); sec. 514 of Pub. L. 102–552.

Subpart A—Purpose and Definitions

§ 621.2 [Amended]

■ 14. Amend § 621.2 by removing paragraph (i) and redesignating existing paragraph (j) as newly designated paragraph (i).

Subpart B—General Rules

■ 15. Amend § 621.4 by revising paragraph (b) to read as follows:

§ 621.4 Audit by qualified public accountant.

* * * * *

(b) The qualified public accountant’s opinion of each institution’s financial statements must be included as a part of each annual report to shareholders. The accountant must comply with the auditor independence provisions of subpart E of this part.

* * * * *

■ 16. Add a new subpart E, consisting of §§ 621.30, 621.31, and 621.32, to read as follows:

Subpart E—Auditor Independence

Sec.

621.30 General.

621.31 Non-audit services.

621.32 Conflicts of interest and rotation.

Subpart E—Auditor Independence

§ 621.30 General.

Each Farm Credit institution must ensure the independence of all qualified public accountants conducting the institution’s audit by establishing and maintaining policies and procedures governing the engagement of external auditors. The policies and procedures must incorporate the provisions of this subpart and § 612.2260 of this chapter.

§ 621.31 Non-audit services.

Non-audit services are any professional services provided by a qualified public accountant during the

period of an audit engagement which are not connected to an audit or review of an institution’s financial statements.

(a) A qualified public accountant engaged to conduct a Farm Credit institution’s audit may not perform the following non-audit services for that institution:

- (1) Bookkeeping,
- (2) Financial information systems design,
- (3) Appraisal and valuation services,
- (4) Actuarial services,
- (5) Internal audit outsourcing services,
- (6) Management or human resources functions,
- (7) Legal and expert services unrelated to the audit, and
- (8) Advocating an institution’s interests in litigation, regulatory or administrative investigations and proceedings unrelated to external audit work.

(b) A qualified public accountant engaged to conduct a Farm Credit institution’s audit may only perform non-audit services, not otherwise prohibited in this section, if the institution’s audit committee pre-approves the services and the services are fully disclosed in the annual report.

§ 621.32 Conflicts of interest and rotation.

(a) *Conflicts of interest.* (1) A Farm Credit institution may not engage a qualified public accountant to conduct the institution’s audit if the accountant uses a partner, concurring partner, or lead member in the audit engagement team who was a director, officer or employee of the Farm Credit institution within the past year.

(2) A Farm Credit institution may not make an employment offer to a partner, concurring partner, or lead member serving on the institution’s audit engagement team during the audit or within 1 year of the conclusion of the audit engagement.

(b) *Rotation.* Each institution may engage the same lead and reviewing audit partners of a qualified public accountant to conduct the institution’s audit for no more than 5 consecutive years. The institution must then require the lead and reviewing audit partners assigned to the institution’s audit team to rotate out of the audit team for 5 years. At the end of 5 years, the institution may again engage the audit services of those lead and reviewing audit partners.

PART 624—[REMOVED AND RESERVED]

■ 17. Remove and reserve part 624.

PART 627—TITLE IV CONSERVATORS, RECEIVERS, AND VOLUNTARY LIQUIDATIONS

■ 18. The authority citation for part 627 continues to read as follows:

Authority: Secs. 4.2, 5.9, 5.10, 5.17, 5.51, 5.58, 5.61 of the Farm Credit Act (12 U.S.C. 2183, 2243, 2244, 2252, 2277a, 2277a-7, 2277a-10).

Subpart C—Conservators and Conservatorships

■ 19. Amend § 627.2785 by revising paragraphs (b) and (d) to read as follows:

§ 627.2785 Inventory, examination, audit, and reports to stockholders.

* * * * *

(b) The institution in conservatorship shall be examined by the Farm Credit Administration in accordance with section 5.19 of the Act. The institution must also be audited by a qualified public accountant in accordance with part 621 of this chapter.

* * * * *

(d) Each institution in conservatorship must prepare and issue published financial reports in accordance with the provisions of part 620 of this chapter, and the certifications and signatures of the board of directors or management provided for in § 620.3 of this chapter must be provided by the conservator of the institution.

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

■ 20. 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

■ 21. Amend § 630.2 by revising paragraph (c) to read as follows:

§ 630.2 Definitions.

* * * * *

(c) *Disclosure entity* means any Farm Credit bank and the Federal Farm Credit Banks Funding Corporation (Funding Corporation).

* * * * *

■ 22. Amend § 630.3 by revising paragraphs (a), (f) and (h) as follows:

§ 630.3 Publishing and filing the report to investors.

(a) The disclosure entities shall jointly publish the following reports in order to

provide meaningful information pertaining to the financial condition and results of operations of the System to investors and potential investors in FCS debt obligations and other users of the report:

(1) An annual report to investors within 75 calendar days after the end of each fiscal year;

(2) A quarterly report to investors within 45 calendar days after the end of each quarter, except for the quarter that coincides with the end of the fiscal year.

(3) Interim reports, as required by the Funding Corporation's written policies and procedures, disclosing significant events or material changes in information occurring since the most recently published report to investors.

* * * * *

(f) Information in documents prepared for investors in connection with the offering of debt securities issued through the Funding Corporation may be incorporated by reference in the annual and quarterly reports in answer or partial answer to any item required in the reports under this part. A complete description of any offering documents incorporated by reference must be clearly identified in the report (e.g., Federal Farm Credit Banks Consolidated System-wide Bonds and Discount Notes—Offering Circular issued on [insert date]). Offering documents incorporated by reference in either an annual or quarterly report prepared under this part must be filed with the Farm Credit Administration according to our instructions either prior to or at the time of submission of the report under paragraph (h) of this section. Any offering document incorporated by reference is subject to the delivery and availability requirements set forth in § 630.4(a)(5) and (a)(6).

* * * * *

(h) Complete copies of the report must be filed with the Farm Credit Administration according to our instructions. All copies must comply with the requirements of § 630.5 of this part.

■ 23. Amend § 630.4 as follows:

■ a. Revise paragraph (a)(4);

■ b. Remove paragraph (b);

■ c. Redesignate paragraphs (c) and (d) as (b) and (c);

■ d. Revise newly redesignated paragraphs (b)(4), (b)(5), and (c).

§ 630.4 Responsibilities for preparing the report to investors.

(a) * * *

(4) File the reports with the FCA in accordance with § 630.3(f) and (h) and § 630.5.

* * * * *

(b) * * *

(4) Respond to inquiries from the Funding Corporation relating to preparation of the report.

(5) Certify to the Funding Corporation that all information needed for preparation of the report to investors has been submitted in accordance with the instructions of the Funding Corporation and the information submitted complies with the signature and certification provisions of § 620.3(b) and (c), respectively.

(c) *Responsibilities of associatios.*

Each association must:

(1) Provide its related bank with the information necessary to allow the bank to provide accurate and complete information regarding the bank and its related associations to the Funding Corporation for preparation of the report. The financial information provided by the association to its related bank must be signed and certified in the same manner as provided in § 620.3(b) and (c), respectively.

(2) Respond to inquiries of the related bank pertaining to preparation of the combined financial data of the association and its related bank.

■ 24. Revise § 630.5 to read as follows:

§ 630.5 Accuracy of reports and assessment of internal control over financial reporting.

(a) *Prohibition against incomplete, inaccurate, or misleading disclosure.* Neither the Funding Corporation, nor any institution supplying information to the Funding Corporation under this part, nor any employee, officer, director, or nominee for director of the Funding Corporation or of such institutions, shall make or cause to be made any disclosure to investors and the general public required by this part that is incomplete, inaccurate, or misleading. When any such institution or person makes or causes to be made disclosure under this part that, in the judgment of the FCA, is incomplete, inaccurate, or misleading, whether or not such disclosure is made in published statements required by this part, such institution or person shall promptly furnish to the Funding Corporation, and the Funding Corporation shall promptly publish, such additional or corrective disclosure as is necessary to provide full and fair disclosure to investors and the general public. Nothing in this section shall prevent the FCA from taking additional actions to enforce this section pursuant to its authority under title V, part C of the Act.

(b) *Signatures.* The name and position title of each person signing the report must be printed beneath his or her signature. If any person required to sign

the report has not signed the report, the name and position title of the individual and the reasons such individual is unable to, or refuses to, sign must be disclosed in the report. All reports must be dated and signed on behalf of the Funding Corporation by:

- (1) The chief executive officer (CEO);
- (2) The officer in charge of preparing financial statements; and
- (3) A board member formally designated by action of the board to certify reports of condition and performance on behalf of individual board members.

(c) *Certification of financial accuracy.* The report must be certified as financially accurate by the signatories to the report. If any signatory is unable to, or refuses to, certify the report, the institution must disclose the individual's name and position title and the reason(s) such individual is unable or refuses to certify the report. At a minimum, the certification must include a statement that:

- (1) The signatories have reviewed the report,
- (2) The report has been prepared in accordance with all applicable statutory or regulatory requirements, and
- (3) The information is true, accurate, and complete to the best of signatories' knowledge and belief.

(d) *Management assessment of internal control over financial reporting.* (1) Annual reports must include a report by the Funding Corporation's management assessing the effectiveness of the internal control over financial reporting for the System-wide report to investors. The assessment must be conducted during the reporting period and be reported to the Funding Corporation's board of directors. Quarterly and annual reports must disclose any material change(s) in the internal control over financial reporting occurring during the reporting period.

(2) The Funding Corporation must require its external auditor to review, attest, and report on management's assessment of internal control over financial reporting. The resulting attestation report must accompany management's assessment and be included in the annual report.

■ 25. Amend § 630.6 by revising paragraph (a)(4)(ii) to read as follows:

- (a) * * *
- (4) * * *

(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;

(B) Review the external auditor's work;

(C) Give prior approval for any non-audit services performed by the external auditor, except the audit committee may not approve those non-audit services specifically prohibited by FCA regulation; and

(D) Comply with the auditor independence provisions of part 621 of this chapter.

* * * * *

Subpart B—Annual Report to Investors

- 26. Amend § 630.20 as follows:
- a. Remove paragraph (b)(3);
- b. Remove paragraph (m)(2)(iii);
- c. Redesignate paragraphs (m)(2)(iv) through (vi) as paragraphs (m)(2)(iii) through (v); and
- d. Revise the introductory text, paragraphs (f) introductory text, (h)(1), (i), (k), and (l) introductory text to read as follows:

§ 630.20 Contents of the annual report to investors.

The annual report must contain the following:

* * * * *

(f) *Selected financial data.* At a minimum, furnish the following combined financial data of the System in comparative columnar form for each of the last 5 fiscal years, if material.

* * * * *

(h) *Directors and management.*

(1) *Board of directors.* Briefly describe the composition of boards of directors of the disclosure entities. List the name of each director of such entities, including the director's term of office and principal occupation during the past 5 years, or state that such information is available upon request.

(2) * * *

(i) *Compensation of directors and senior officers.* State that information on the compensation of directors and senior officers of Farm Credit banks is contained in each bank's annual report to shareholders and that the annual report of each bank is available to investors upon request pursuant to § 630.3(g).

* * * * *

(k) *Relationship with qualified public accountant.*

(1) If a change in the qualified public accountant who has previously examined and expressed an opinion on the System-wide combined financial statements has taken place since the last annual report to investors or if a disagreement with a qualified public accountant has occurred that the

Funding Corporation would be required to report to the FCA under part 621 of this chapter, disclose the information required by § 621.4(c) and (d).

(2) Disclose the total fees paid during the reporting period to the qualified public accountant by the category of services provided. At a minimum, identify fees paid for audit services, tax services, and non-audit services. The types of non-audit services must be identified and indicate audit committee approval of the services.

(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 shall 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 System. The System-wide combined financial statement and accompanying supplemental information shall be audited in accordance with generally accepted auditing standards by a qualified public accountant. The System-wide combined financial statements shall include the following:

* * * * *

Dated: December 12, 2006.

Roland E. Smith,
Secretary, Farm Credit Administration Board.
[FR Doc. E6-21529 Filed 12-19-06; 8:45 am]
BILLING CODE 6705-01-P

NATIONAL CREDIT UNION ADMINISTRATION

12 CFR Part 703

RIN 3133-AD27

Permissible Investments for Federal Credit Unions

AGENCY: National Credit Union Administration (NCUA).

ACTION: Final rule.

SUMMARY: NCUA is amending its investments rule to allow federal credit unions (FCUs) to enter into investment repurchase transactions in which the instrument consists of first-lien mortgage notes subject to certain limitations. The final rule expands FCU authority to invest in mortgage-related securities while addressing safety and soundness concerns associated with this new investment activity.

DATES: This rule is effective January 19, 2007.