

GOVERNANCE

Final Rulemaking

Overview of the Governance Final Rule Provisions

Prepared by the Farm Credit Administration, March 2006.

Not to be used as a substitute for the actual rule.

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The Rulemaking Story

■ Proposed Rule

- Issued January 19, 2005 (*70 FR 2963*).
- Extended comment period closed May 20, 2005.

■ Final Rule

- FCA Board Action on final rule January 6, 2006.
- Final Rule published in Federal Register February 2, 2006 (*71 FR 5740*).
- **Effective April 5, 2006.**

Objectives of the Rule

- Strengthen the independence of System institution boards by incorporating best governance practices (safety and soundness).
- Support borrower participation in the management, control, and ownership of their institution.

Anticipated Benefits

- Improved System institution governance practices;
- Established governance standards throughout the System tailored to the System's cooperative structure; and
- Flexibility for smaller institutions with \$500 million in total assets or less (as of January 1 each year).

Key Provisions

- Board of Directors
 - Composition and Qualifications
 - Self-evaluations and Training
- Outside Directors
 - Definition and Number
 - Terms of service and removal
- Nominating Committees
- Director Elections and Candidate Disclosures
 - Annual meeting and election statements
 - Stockholder lists
- Enhanced Conflict-of-Interest & Compensation Disclosures
- Audit and Compensation Committees

Applicability

- All banks and associations
 - Certain exemptions for small associations with \$500 million or less in total assets (as of January 1 each year).
- Funding Corporation
 - Compensation Committee
 - System Audit Committee (SAC)

Implementation & Compliance

- Three provisions have a 12 month delayed compliance date.
 1. Financial expert on board of directors and audit committee, § 611.210(a)(2) and § 620.30(a).
 2. Second outside director, § 611.220(a)(2)(i) & (ii).
 3. Bank nominating committees, §§ 611.325 and 620.21(d)(2).
- All other provisions require compliance on the effective date.

February 24th Information Memorandum: For 2005 annual reports, institutions may follow existing rules in §§ 620.5 and 630.20.

Changes to Definitions

Entity

- Changed definition in § 612.2130(e) to include System institutions.
- Directors and employees will now have to report “transactions” with another System institution, including interest in or board service, to the institution’s Standards of Conduct official.
 - Includes “transactions” with Farmer Mac.

Changes to Definitions

Outside Director

- Added to part 619 so applies to all regulations (*§ 619.9235*).
- No longer allows bank agents to serve as outside directors.

Changes to Definitions

Senior Officer

- No longer necessary for board to specifically designate as a senior officer.
- Changed from “management function” to “major policy-making function.”
- CEO, COO, CFO, CCO, and GC (or those serving in these capacities under different title) named as senior officers in the definition.

Removed from § 620.1 and placed in part 619 (*§ 619.9310*).

Board of Directors

- Stockholder-elected directors must constitute at least 60 percent of the board of directors. § 611.220(a)(2).
- Each board must have a financial expert, but smaller institutions may have a financial advisor. § 611.210(a)(2).
- Each board must have the required number of outside directors. § 611.220(a)(2).

Financial Expert

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.

§ 611.210(a)(2)

Financial Expert

- Each bank must have a financial expert on its board of directors.
- Each association with more than \$500m in total assets (as of January 1 each year) must have a financial expert on its board.
- An association with \$500m in total assets or less (as of January 1 each year) has the option of retaining a financial advisor instead of having a director who is financial expert.

Financial Expert

An advisor retained by a small association to satisfy the financial expert requirement must:

- satisfy the definition of a financial expert;
- report only to the board;
- have no other affiliation with institution management or the external auditor; and
- advise only the board and board audit committee.

Outside Directors

- Farm Credit banks must have at least 2 Outside Directors.
- Large associations (more than \$500m in total assets as of January 1 each year) must have at least 2 Outside Directors.
 - *Unless would result in less than 75% of the board being elected by stockholders, then not required to have 2 outside directors.*
- Small associations (\$500m or less in total assets as of January 1 each year) must have at least 1 Outside Director.

Outside director rules located in § 611.220.

Outside Directors

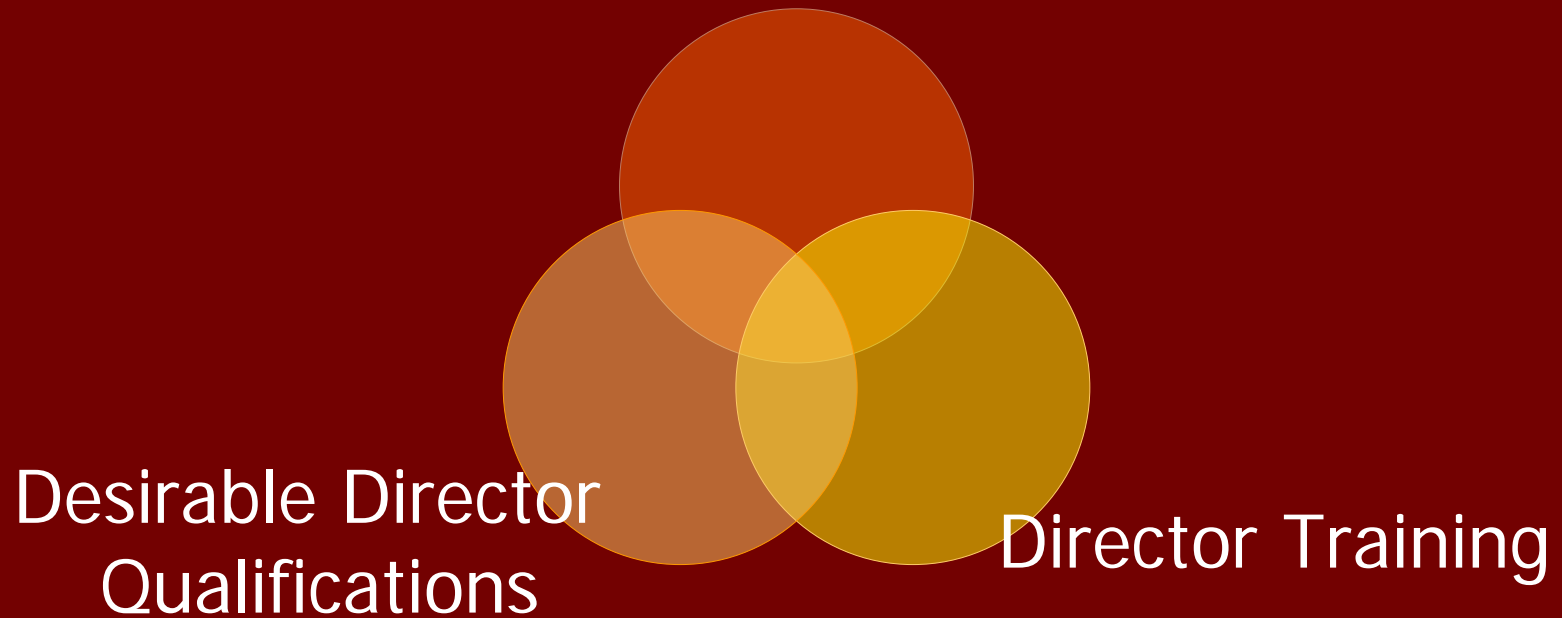
- Must have same terms of office as stockholder-elected directors.
- Farm Credit banks and associations must make a reasonable effort to select outside directors possessing some or all of the desired director qualifications.
- Banks and associations must establish and maintain procedures for removal of outside directors.

Outside Directors

- May be removed before his or her term expires by either a 2/3 vote of the **full** board or by action of the voting stockholders.
 - If removed by board action, all board members, except the director up for removal, must be allowed to vote in removal action.
- Reasons for removal must be documented.

Board Development

Board Self-Evaluation



Board Self-Evaluation

- Board of directors must conduct an annual self-evaluation.
- Evaluation must assess the capability and needs of the board.
 - May help identify desired qualifications.
 - May help identify training needs.
- Board determines the procedures to use.

Board Self-Evaluation

- Requirement found in § 615.5200—capital planning and § 618.8440—operational and strategic business planning.
 - Evaluation itself need not be included in business or strategic plan.
- Summary of board evaluation available to Nominating Committee upon its request.

Desirable Director Qualifications

- Board must establish and maintain a policy on desirable director qualifications.
- The policy must:
 - Explain type of knowledge/experience desired.
 - How the desired qualifications were identified.
 - Be periodically updated.
- Policy must be provided to Nominating Committee.

Director qualification rules located in § 611.210(a)(1).

Director Training

- Board must establish and maintain a policy on director training with implementing procedures.
- Policy must identify training areas that support the desired director qualifications.

Director training rules located in § 611.210(b).

Director Training

- New directors must attend training within one year of becoming a director.
- Incumbent directors must attend periodic training to advance skills.
- Specific training topics are board-determined.

Nominating Committees

- Each bank and association must have a Nominating Committee of no fewer than 3 members who are elected by the voting stockholders.
 - Electing members to a Farm Credit Bank nominating committee uses weighted voting procedures.
- Committee must have reasonable access to administrative resources to perform its duties.

Nominating committee rules located in § 611.325.

Nominating Committees

■ Membership

- 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.
- Institution directors, officers, employees, and agents may not serve on the Nominating Committee.

Nominating Committees

■ Duties

- Determine if candidates meet director eligibility requirements.
- Endeavor to obtain candidate representation from all areas of the institution's territory.
- Identify as nearly as possible candidates from all types of agriculture practiced within territory.

Nominating Committees

■ Duties (Cont'd)

- Evaluate the qualifications of director candidates.
- Consider whether any obstacles exist that would prevent the candidate from performing his/her duties.
- Nominate at least two willing candidates for each open director position.

Nominating Committees

If a Nominating Committee cannot identify two willing nominees for each director position, the committee must provide written explanation to the board of its effort to locate candidates, including reasons for disqualifying any candidate, that resulted in fewer than two nominees for each position.

Director Elections & the AMIS

- Farm Credit institutions must remain impartial in director elections.
 - Clarifies that institutions are prohibited from distributing or mailing campaign materials on behalf of director candidates regardless of who pays the expense.
- Banks and associations may request from candidates biographical information as well as disclosure information required under the Annual Meeting Information Statement (AMIS).

Impartiality rules located in § 611.320.

Director Elections & the AMIS

Each Farm Credit bank and association must issue an *Annual Meeting Information Statement* at least 10 days before any annual meeting or any director election.

- A separate AMIS must be sent for elections not held in conjunction with an annual meeting.

AMIS rules located in § 620.21.

AMIS Components

- Date, time and place of meeting(s).
- Number of voting shareholders entitled to vote and voting requirements.
- Director names, attendance, resignations, and transactions.
- Director nominees, disclosures and voting procedures.
- Any other actions on which a shareholder vote is requested.
- Changes in or disagreements with external auditor.

Associations may report senior officer compensation in the AMIS.

Director Elections & the AMIS

- The AMIS must list all nominated director-candidates.
 - If fewer than two willing nominees for each position are named, the AMIS must describe the nominating committee's efforts in locating nominees.
- The AMIS must state whether nominations from the floor will be accepted.
 - Associations must accept floor nominations.

Director Elections & the AMIS

- Each director-candidate must prepare a disclosure statement.
 - Banks and associations may either restate information in a standard format or provide complete copies of candidate disclosures with the AMIS.
- Floor-nominated candidates must complete the same disclosure statement as candidates identified by the nominating committee.

Stockholder Lists

- Consists of name, address, and classes of stock held.
- Institution may only require that stockholder will use the list exclusively for permissible purposes.
- Institution may not place other restrictions on the release or use of the list.

Stockholder list rules located in § 618.8310.

Conflicts of Interest Disclosures

Each director and senior officer must include in the annual report a list of any other business interest where he/she serves on that business' board of directors or as a senior officer.

** Use FCA definition of "senior officer."*

** Include service on other System institution boards.*

Conflicts of interest rules located in § 620.5(h).

Compensation Disclosures

- Types of Compensation
 - Cash
 - NonCash
 - Perquisites
- Source of Compensation
 - Employing institution
 - Third Party

Annual disclosure of compensation rules located in § 620.5.

Compensation Disclosures

- Thresholds for reporting
 - Cash
 - All amounts received.
 - NonCash
 - Above \$5,000 based on annual aggregate value.
 - Combine with perquisites.
 - Perquisites
 - Above \$5,000 based on annual aggregate value.
 - Combine with other nonCash compensation.

Compensation Disclosure Differences

■ Directors

- Disclose compensation in annual report.
- Reported individually.
 - Separately identify compensation given for service on board committee.

■ Senior Officers

- Disclose compensation in annual report.
 - Associations may report in the AMIS.
- Reported in the aggregate.
 - CEO reported individually.

Compensation Disclosure

- Senior Officer Aggregated Reporting
 - All senior officers must be included in aggregate.
 - Plus those officers (who are not senior officers) receiving a salary that falls within the 5 highest amounts paid.
- Compensation received by all CEOs must be reported.
 - No more threshold.

Compensation Disclosure

Institutions reporting in the aggregate must make the individual officer's compensation information available at any time to requesting stockholders.

- No more threshold.
- Preamble to the rule explains that:
 - Institutions may not question the reason for a request.
 - Institutions may not record the request in the shareholder's file.
 - Institutions must provide the information without any contingencies on use or undue delay.

Bank Director Compensation

- Statutory limit of \$20,000, adjusted for CPI. *(Section 4.21 of Farm Credit Act of 1971, as amended).*
 - FCA may adjust limit for safety and soundness reasons.
 - FCA may waive limit for exceptional circumstances.
- FCA pre-approved use of exceptional circumstances “waiver” for up to 30%.
 - Farm Credit bank must have written policy on how compensation and use of waiver is determined.

Farm Credit bank compensation waiver located in § 611.400.

Bank Director Compensation

- **Bookletter 051** (issued December 15, 2005)
 - Alters statutory compensation level in section 4.21 of the Act to a maximum of \$45,740 due to safety and soundness reasons.
 - *Safety and soundness reasons were based, in part, on board responsibilities identified in the governance rule.*
 - *CPI adjustment for 2005 Annual Report is \$47,290.*
 - Institutions are to assess “unique circumstances and demands” when setting director compensation within the new limit.
- Institutions are to be “judicious” when exercising both waiver authority and BL-051.

Using the Compensation Waiver

- Describe the exceptional circumstance(s) that justify additional compensation.
 - Justification should be provided individually for each director.
- Describe the extraordinary time and effort in service of bank and shareholders.
- Describe amount, terms and conditions of additional compensation.

Disclosing Use of Waiver

- Farm Credit banks disclose use of waiver in Annual Report.
- Disclosure must describe the exceptional circumstances justifying additional compensation.
 - Sufficient to explain and support use of waiver.
 - Specify extraordinary event, along with the additional time and effort.

Annual reporting of compensation waiver located in § 620.5(i)(1).

Bank & Association Audit Committees

- Written charter and 3-year recordkeeping.
- At least three members, all from the board.
- Director designated as financial expert must serve on the committee.

Farm Credit bank & association audit committee rules
located in § 620.30.

System Audit Committee (SAC)

- Written charter and 3-year recordkeeping.
- At least three members.
 - At least 1/3 of committee members must be representatives of the System.
- Financial expert must chair committee.
- Reports to Funding Corporation Board of Directors.

Funding Corporation audit committee rules located in § 630.6(a).

Audit Committee Duties

Financial Reports

- Oversees preparation of annual and quarterly reports.
- Reviews annual and quarterly reports.
 - *Annual and quarterly reports must state that financial statements were prepared under the oversight of the audit committee.*
- Reviews impact of significant accounting developments, reviewing accounting policy changes.

Audit Committee Duties

External Auditor

- The external auditor reports directly to audit committee.
- Audit committee hires, supervises and determines compensation of external auditor.
- Audit committee reviews external auditor's work.

Audit Committee Duties

Internal Controls

- Oversees system of internal financial controls.
- Internal audit function subject to each bank and association audit committee's review and supervision.
 - *Reviewing and supervising internal auditor is not a duty of the SAC.*

Compensation Committees

- Written charter and a 3-year recordkeeping
- At least 3 members, all members from board.
- Name of committee not restricted to “compensation” as long as committee charter reflects compensation committee duties.

Farm Credit bank & association compensation committee rules
located in § 620.31.

Funding Corporation compensation committee rules located in § 630.6(b).

Compensation Committee Duties

- Reviews the compensation policies and plans for senior officers and other employees.
- Approves overall compensation program for senior officers.

Committees of the Board

Full board may function as the audit or compensation committee. If the full board functions as the audit or compensation committee, then:

- Must separately convene committee.
 - No intermittent committee actions or votes during regular board meeting.
- Must have separate agenda and meeting minutes.

Rule Cite "Cheat Sheet"

- Director qualifications § 611.210(a)(1)
- Financial expert § 611.210(a)(2)
- Director training § 611.210(b)
- Outside director § 611.220
- Nominating committees § 611.325
- Board self-evaluation
§ 615.5200(b)(1) & § 618.8440(b)(2)(ii)
- Stockholder list § 618.8310
- Definitions
 - Outside director § 619.9235
 - Senior Officer § 619.9310
- AMIS § 620.21
- Compensation Committee
 - Bank and Association § 620.31
 - Funding Corporation § 630.6(b)
- Audit Committees
 - Banks and Associations § 620.30
 - System Audit Committee § 630.6(a)
 - Audit committee oversight statement
 - § 618.8430 (d)
 - § 620.5 (m)(3)
 - § 620.11 (d)(5) and (e)
 - § 630.20 (l)
 - § 630.40 (d)
- Enhanced compensation & conflict-of-interest disclosures
 - § 620.5 (h) conflict of interest
 - § 620.5 (i)(1) director compensation
 - § 620.5 (i)(2) senior officer compensation
 - § 620.5 (i)(2)(i)(A) CEO reporting
 - § 620.5 (i)(2)(i)(B) aggregate Sr. Officer
 - § 620.5 (i)(2)(i)(D) Sr. Officer perks
 - § 620.5(i)(2)(iii) Sr. Officer compensation available on individual basis to stockholders

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