



April 29, 2014

Via Federal eRulemaking Portal

Ms. Laurie A. Rea
Director, Office of Secondary Market Oversight
Farm Credit Administration
1501 Farm Credit Drive
McLean, VA 22102-5090

Re: Comment Letter – RIN 3052-AC89

Dear Ms. Rea,

We are providing comments to the Farm Credit Administration (“FCA”) in response to the Advance Notice of Proposed Rulemaking concerning enhanced Farmer Mac Corporate Governance and Standards of Conduct. Our commentary will serve principally to direct the Farm Credit Administration towards two National Association of Corporate Directors (“NACD”) Commission Reports on risk oversight and governance. The recommendations promulgated by these two commissions contain what is considered today to be best practices in the area and will assist the FCA in the development of Farmer Mac governance standards. Additionally, we will discuss generally the application of these best practices to Farmer Mac with particular attention given to the questions posed by the FCA concerning (1) Board Responsibilities in Risk Governance and (2) Conflicts of Interest for Directors, Officers and Employees. In preparing this commentary, we have primarily reviewed the recommendations of these two NACD commission reports and the relevant sections of the Agricultural Credit Act of 1987¹ and the issuance of final rules by the Farm Credit Administration regarding Farmer Mac Board Governance and standards of conduct on March 1, 1994².

Report of the NACD Blue Ribbon Commission on Risk Oversight

In response to a series of business crises at the beginning of the decade, the NACD convened a Blue Ribbon Commission to address the question: “*what precisely is the board’s role with respect to risk and crisis?*”³ The result of the Commission’s efforts was published in 2002 as the NACD Blue Ribbon Commission on Risk Oversight⁴. In this report new standards of best practices for boards of directors were formulated and forcefully expressed – directors, the commission wrote, must make risk oversight a priority.⁵

¹ Agricultural Credit Act of 1987 (Pub. L. 100-233).

² 59 FR 9622

³ National Association of Corporate Directors, REPORT OF THE NACD BLUE RIBBON COMMISSION ON RISK OVERSIGHT, v (2002).

⁴ Id.

⁵ Id at vi (“Above all, *risk oversight must be a priority for all boards, especially in turbulent times*”).

The report insists that directors proactively engage with the risk exposure of the companies they were overseeing. It contends that directors must work with management to identify the specific material risks that the company faces and then consider management's plans for addressing and mitigating those risks.⁶ Additionally, boards should continually monitor these areas of concern, with adequate information and reporting systems serving as the foundation to effective oversight.

The commission stressed the importance of what it called the "spiral factor."⁷ One problem often triggers other problems producing an unstable chain reaction that can cause serious trouble for the entity concerned.⁸ Directors must, they wrote, identify and anticipate these "code red" types of risk.⁹ Once identified, directors must work with management to develop crisis management plans¹⁰ and to continually monitor and review, on at least an annual basis, these potential materially adverse exposures.¹¹ The report concludes with commentary on how companies can respond effectively to actual and developing crises.

In addition to the commission's substantive recommendations about board action in the area of risk governance and oversight, they also advocated that a foundation of good governance was necessary to ensure the active discharge of the directors' fiduciary duties. Of particular interest to the FCA are the commission's recommendations concerning conflicts of interest. Conflicts of interest, they wrote, "can cause a crisis, or permit one to occur through weak oversight."¹² It is important, they wrote, for directors to "identify and eliminate significant conflicts of interest, both for themselves and for other participants in a corporation's governance and management."¹³ In order to minimize conflicts directors must "disclose potential conflicts they may have, abstain from voting on those matters, and leave the room while the matters are being discussed."¹⁴ In connection to this area of concern, companies must, as a requirement of listing on the NYSE, adopt a code of business conduct and ethics (which should include policies about conflicts of interest) and disclose any waivers made.¹⁵ Conflicts of interest affect the independence of oversight, advice and counsel and must therefore be stringently policed by the board, both among themselves and among other parties which deal with the company.

Report of the NACD Blue Ribbon Commission on Risk Governance: Balancing Risk and Reward

The NACD again convened a Blue Ribbon Commission in 2009 to update, clarify and add to the prior recommendations made in 2002 by the Blue Ribbon Commission on Risk Oversight. This commission sought to define a broader view of risk governance, in which greater attention was given to the central role of the strategic decision making process in the risk area. Risk, it is argued, is implicit in business generally and arises directly from a company's business model: "without risk, there is no reward."¹⁶ In this "Report of the NACD Blue Ribbon Commission on Risk Governance: Balancing Risk and Reward," the commission also

⁶ Id. at 5, 21-22.

⁷ Id. at 8-9.

⁸ Id. at 8.

⁹ Id.

¹⁰ Id. at 33-37.

¹¹ Id. at 32 ("On a periodic basis, at least annually, the board should review risks and possible "worst-case" scenarios.")

¹² Id. at 17.

¹³ Id.

¹⁴ Id. at 18.

¹⁵ Id. at 19.

¹⁶ National Association of Corporate Directors, REPORT OF THE NACD BLUE RIBBON COMMISSION ON RISK GOVERNANCE: BALANCING RISK AND REWARD, 4 (2002).

discusses the role and organization of the board and its standing committees with regard to risk oversight, recommends ten principles for effective engagement and oversight of oftentimes-necessary risk and provides many other strong recommendations for board action in the risk area.¹⁷

Most pertinent to the FCA's interests are the commission's recommendations concerning risk tolerance and risk committees. They counsel that boards must apprise themselves of the risks that are implicit in the company's business strategy, ensure that those "expected risks are commensurate with expected rewards" and oversee the implementation by management of a "system to manage, monitor, and mitigate risk."¹⁸ As for risk committees, the report states that "any committee with the word 'risk' in its title cannot be the sole overseer of risk" – risk oversight is the responsibility of the full board not its sub-committees.¹⁹

Conflicts of Interest for Directors Officers and Employees²⁰

As stated by the FCA, in accord with long-standing principles of corporate governance, "[the] directors [of Farmer Mac] owe fiduciary duties to the Corporation and all its shareholders."²¹ (Admittedly, this duty as applied to Farmer Mac is particularly contingent viz. directors owe a duty to the Corporation and all its shareholders *given that its public mandates are first fulfilled*.) Conflicts of interest create obstacles to the prudent and dispassionate discharge of those fiduciary duties. As such, it is imperative that conflicts be stringently policed by the board and management.

That said, the Farmer Mac directors, having been duly elected or appointed in accordance with the statutory by-laws, should not be constrained in the manner specified by the questions posed in the comment solicitation (questions (1), (2) and (3)). During their elected or appointed term, directors should be given wide latitude to exercise their judgment so as to determine, in good faith, the best means of promoting the interests of the Corporation and all its shareholders.

To unduly constrain the board in the manner suggested would deprive the board a priori of the option to pursue potentially advantageous courses of action which may very well have been overlooked during the process of statutory construction. This, in turn, would deprive those principal interests of the Corporation of the full power of the wisdom and representation of their agents on the board. This refers both to those elected to steward private financial interests in Farmer Mac and also those appointed for the benefit of the public. To mandate a recusal process, automatic removal or disciplinary measures would be, in our opinion, to overstep the bounds of prudential regulatory oversight.

Trust should rather be placed in the fair operation of the election process as the central mechanism of board-accountability. To facilitate an adequate consideration of the impartiality of board representation in corporate

¹⁷ Id.

¹⁸ Supra note 16 at 4.

¹⁹ Id. At 8.

²⁰ The Farm Credit Administration, in its Advance Notice of Proposed Rulemaking, encouraged comments on the following questions, among others: "(1) What, if any, recusal process should FCA require when there is an actual or potential conflict of interest? (2) Should FCA regulations authorize bylaw provisions for the automatic removal of an elected director found to have violated conflicts of interest prohibitions? If so, what types of prohibited actions related to conflicts of interest should warrant removal? (3) Should bylaw provisions addressing disciplinary actions for prohibited actions related to conflicts of interest be regulated, such as reduced pay, loss of committee memberships, etc.? If so, please explain why and to what extent."

²¹ 59 FR 9622

elections, the New York Stock Exchange mandates a corporate “code of ethics” (which must address conflicts of interest) and the public disclosure of any “waivers” resulting from deviation from this code. Farmer Mac’s board and management should have prepared such a code, communicated its contents throughout the organization, implemented a process for monitoring compliance with the code and committed to prompt disclosure of any and all waivers

Finally, although we do not consider it advisable to mandate the corrective measures mentioned in the solicitation of comments, this certainly is not to say these measures should not be voluntarily taken by the board (we strongly believe that they should). In the event of a material conflict of interest arising, one approach is for the boards to create a committee of non-conflicted, independent directors to address the issue and recommend to the full board remedies and/or any necessary remedial action that the committee should determine to be appropriate.

Board Responsibilities in Risk Governance²²

Farmer Mac’s risk tolerance should fully consider its public policy purpose. Farmer Mac was incorporated expressly to establish a secondary market for agricultural real estate mortgages and to increase the availability of long-term loans to farmers at stable interest rates.²³ As the NACD Report on Risk Governance argued, “risk is integral to strategy and essential for business to succeed.”²⁴ The commission firmly recommended that “boards should encourage management to pursue prudent risks to generate sustainable corporate performance and value.”²⁵ The public purpose of Farmer Mac controls the determination of any corporate objectives, and the business planning around those objectives will entail risk that is inherent to the business model. The Report contends that there is a critical link between strategy and risk and that boards should therefore also consider risk along with potential reward in strategic discussions and planning. Farmer Mac’s risk tolerance determination is constrained to a degree that most other entities’ risk tolerance determinations are not. The statutory governing documents specifically outline minimum acceptable capital levels and the standards applicable to qualified loans, for instance. Nonetheless, management and the board certainly have an obligation to determine Farmer Mac’s risk tolerance, where the statute has allowed discretion, and should incorporate risk analysis into their strategic discussions. Where the underlying purpose and risk profile have been predetermined however, management and the board must, in large part, focus on mitigation, monitoring and planning efforts around the required risk.

In question 13, the FCA asked for guidance about the specific function, composition and performance of a potential “risk committee”. Rather than address these questions specifically, we will instead comment

²² The Farm Credit Administration, in its Advance Notice of Proposed Rulemaking, encouraged comments on the following questions, among others: “(11) To what extent should Farmer Mac’s risk tolerance consider its public policy purpose? How might that be measured? (12) How might the FCA ensure that the Farmer Mac board establishes an effective risk governance framework, including risk measurements (e.g. data collection), risk controls and reporting, and clearly articulated statements of risk tolerance? (13) If FCA requires the Farmer Mac board to have a risk committee, what guidelines should FCA provide regarding the formation and duties of the committee? What qualifications should risk committee members possess? What resources should be available to the committee? Should the committee have direct access to all members of the Farmer Mac management team?”

²³ Agricultural Credit Act of 1987 (Pub. L. 100-233).

²⁴ Supra note 16 at 6.

²⁵ Id.

generally about how a risk committee might fit into the board's whole sub-committee structure. This brief commentary will help the FCA to manage expectations about what such a committee could be expected to accomplish. Should a risk committee be required by the FCA it is important that it be largely thought of as a supplemental oversight group. The reason is simple, risk cannot be compartmentalized because rather than being a specific area of concern, risk management should rather be considered throughout all of the board's deliberations on matters of company operations and strategy. Business is uncertain, and risk oversight is nothing more than the recognition and active engagement of that uncertainty. In this respect, each board and sub-committee matter involves its own inherent risks. To the extent that a risk committee is useful to a board, it is in aggregating the specific areas of risk identified elsewhere into a coherent framework for discussion at the full board level of the inter-relations and overall risk profile of the entity. In any case, whether or not the FCA requires a risk committee, the area of risk oversight will nonetheless remain the responsibility of the full board, attendant upon their oversight in all other board matters.

Conclusion

Thank you for the opportunity to provide these comments. Please feel free to contact us if you have any questions or if you wish to discuss this matter further. We can be reached at the John L. Weinberg Center for Corporate Governance at (302) 831-6157.

Sincerely,



Charles M. Elson
Director and Edgar S. Woolard, Jr., Chair in Corporate Governance



Craig K. Ferrere
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