December 13, 2001

Alfred M. Pollard
General Counsel
Office of Federal Housing Enterprise Oversight
Fourth Floor
1700 G Street N.W.
Washington, DC 20552

Re: Corporate Governance Rule (66 Fed. Reg. 47557 [Sept. 12, 2001])

Dear Mr. Pollard:

FM Watch, a coalition of eight trade associations, appreciates the opportunity to submit its views concerning the Office of Federal Housing Enterprise Oversight's ("OFHEO") proposed regulation (the "Proposed Rule" or "Rule") to establish minimum requirements for corporate governance practices and procedures of Fannie Mae and Freddie Mac (the "Enterprises"), published in the *Federal Register* on September 12, 2001.

Summary

We commend OFHEO for proposing that the Enterprises meet formal minimum standards of internal governance. As OFHEO notes in the preamble to the proposal,

> "[G]ood corporate governance practices and procedures are essential to the safe and sound operations of the Enterprises and accomplishment of their public policy purposes."

66 Fed. Reg. at 47577.

Sound corporate governance, including strong oversight by the board of directors, is particularly important for the Enterprises because other control and enforcement mechanisms are absent. In contrast to fully private companies, the Enterprises are not subject to effective market discipline because of their government-granted duopoly position, the implicit guarantee of access to the Treasury, and their special tax and regulatory status. Unlike other publicly traded companies, the Enterprises are not required to file registration statements and

reports with the Securities and Exchange Commission ("SEC") and they are exempt from most class-action securities lawsuits and SEC enforcement actions. In contrast to regulated financial institutions, the Enterprises are not subject to comprehensive examination by a regulator with the resources and authority to ensure both safety and soundness and fulfillment of their public mission.

As recent events have shown, traditional financial accounting can be extremely misleading when applied to a company that, like the Enterprises, maintains an unconventional, highly-leveraged financial structure dominated by off-balance-sheet exposures. Thus, the Enterprises must have strong boards and internal management structures to ensure that they are operated in a safe and sound manner.

As OFHEO notes, sound corporate governance is also essential to ensuring that the Enterprises fulfill their public mission. There is no formal mechanism corresponding to Community Reinvestment Act examinations of insured depository institutions to ensure that the Enterprises meet their public responsibilities. Instead, the Charter Acts provide for presidentially appointed directors, four out of five of whom must represent key stakeholder groups—other than shareholders—in the Enterprises. Thus, the Charter Acts themselves indicate that the boards of directors of the Enterprises, unlike directors of fully private companies, must be responsible to the public as well as the shareholders. In particular, Congress intended the presidential appointees to be fiduciaries of the ongoing public interest in the Enterprises, even after they became shareholder-owned corporations.

For these reasons, FM Watch strongly supports the concept of a formal corporate governance rule for the Enterprises. We agree with OFHEO that the banking agencies' corporate governance regulations are a good starting point. But the Rule should be strengthened in several ways. We believe that the OFHEO Rule should:

- Incorporate not only the basic structure of the banking agencies' corporate governance rules, but also the banking agencies' operational and managerial standards that ensure that the board and senior management properly monitor the Enterprise's activities.
- Impose an explicit obligation on the presidential appointees to the boards of the Enterprises to ensure that the Enterprises meet their public mission, by creating a mandatory "public mission" committee of each board, consisting of those appointees.
- Include independent-director and conflict-of-interest provisions that reflect the economic and political realities of the environment in which the Enterprises

operate, which is different from that of even a very large fully private entity. These rules should specifically prohibit the Enterprises from targeting specific companies or groups for retaliation.

- Require that compensation be tied to success in accomplishing the public mission of the Enterprises and that employees not be rewarded for activities that detract from that mission by, for example, increasing the already large government subsidy that the Enterprises receive.
- Not apply any particular body of corporate governance law to the Enterprises, because of the significant issues of federalism and undue delegation that would be raised if OFHEO incorporated state law or the Model Business Corporation Act into its regulations. If OFHEO decides to incorporate an outside body of law into the Rule, it should (1) clarify that whatever body of law applies does not in any way expand their permissible activities, and (2) limit the application of that law to the determination of shareholder rights (to the extent consistent with federal law).

Discussion

Responsibilities of the Board of Directors

Responsibilities of All Directors

Proposed Section 1710.20 sets out a basic code of conduct for board members, and Section 1710.21 lists the basic responsibilities of the board. As OFHEO notes, Section 1710.20 reflects state law and the Model Act, and Section 1710.21 describes the board's responsibility to maintain the safety and soundness of the Enterprises. But the board of an Enterprise also has unique responsibilities. The board must ensure that the Enterprise fulfills the public mission for which Congress chartered it. In addition, in sharp contrast to other major modern corporations, whose charters allow them to engage in any legal business, the board of an Enterprise must ensure that the Enterprise does not go beyond the activities and powers authorized by their Charter Acts. Therefore, both of these provisions should include a specific reference to the obligation to ensure that the activities of each Enterprise are consistent with, and do not go beyond, their statutory authority as stated in the Charter Acts. This issue relates directly to the quality of each Enterprise's internal controls. Because the courts could refuse to

recognize an act that exceeded an Enterprise's powers, this is an element that relates directly to safety and soundness.[1]

In some instances, the safety-and-soundness responsibility seemingly conflicts with the public mission in the sense that the Enterprise must forego a profitable business opportunity because it is outside the scope of its public mission. The Proposed Rule states that board members must act "[i]n the best interests of the shareholders and the Enterprise."[2] The Rule should make clear that, as provided in the Charter Acts,[3] acting in the best interests of the Enterprise includes pursuing the public mission even where service to the public mission may not be as lucrative as pursuing other options. The success of each Enterprise's adherence to this Charter Act requirement is heavily dependent on the quality of its internal controls, because of the need to ensure that the public mission of the Enterprises is carried out in a safe and sound manner.

Although the Proposed Rule mirrors the general requirements imposed on bank directors by the financial institution regulators, it does not include the specific standards adopted by the federal banking agencies to address key responsibilities of the board and senior management. These standards allow bank examiners to evaluate the board's performance on an array of issues that face the typical financial institution. For example, the banking agencies' Interagency Policy Statement on the Internal-Audit Function and Its Outsourcing states:

> "Effective internal control . . . is a foundation for the safe and sound operation of a banking institution

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[1] *See REW Enterprises, Inc.* ex rel. *Federal Land Bank of Jackson v. Premier Bank, N.A.*, 49 F.3d 163, 171 (5th Cir. 1995), *reh. and reh. en banc denied mem.*, 53 F.3d 1283 (5th Cir. 1995) (*ultra vires* act of federally-chartered federal land bank is "null and void").

[2] *See* Proposed Rule § 1710.20(3), 66 Fed. Reg. at 47562.

[3] *See, e.g.*, the Fannie Mae Charter, which requires Fannie Mae to:

> "[P]rovide ongoing assistance to the secondary market for residential mortgages (including activities relating to mortgages on housing for low- and moderate-income families *involving a reasonable economic return that may be less than the return earned on other activities*) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing."

12 U.S.C. § 1717(c) (emphasis added). *See also* 12 U.S.C. § 4501 (noting public mission of both Fannie Mae and Freddie Mac).

> or savings association (hereafter referred to as institution). The board of directors and senior managers of an institution are responsible for ensuring that the system of internal control operates effectively. Their responsibility cannot be delegated to others within the institution or to outside parties."[4]

The Rule should take a similar approach, perhaps by incorporating the banking standards by reference. OFHEO should require review by the board of directors and senior management of subjects such as:

- Internal controls and information systems;[5]
- Internal audits;[6]
- External audits;[7]
- Credit underwriting policies and procedures;[8]
- Asset quality and asset growth;[9] and
- Privacy and security safeguards.[10]

Responsibilities of Presidential Appointees

As noted, the structure of the Charter Acts makes it clear that the presidential appointees have responsibilities to the public mission of the Enterprises that go

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[4] Board of Governors of the Federal Reserve System ("FRB"), Federal Deposit Insurance Corporation ("FDIC"), Office of the Comptroller of the Currency ("OCC"), and Office of Thrift Supervision ("OTS"), *Interagency Policy Statement on the Internal-Audit Function*, FRB Doc. No. SR-97-35 (Dec. 22, 1997).

[5] *Interagency Guidelines Establishing Standards for Safety and Soundness*, 12 C.F.R. Part 208 app. D-1 (FRB version).

[6] *See* note 4 above.

[7] Federal Financial Institutions Examination Council, *Interagency Policy Statement on External-Auditing Programs of Banks and Savings Associations*, FRB Doc. No. SR-99-33 (Sept. 28, 1999).

[8] *Interagency Guidelines Establishing Standards for Safety and Soundness*, 12 C.F.R. Part 208 app. D-1 (FRB version).

[9] *Interagency Guidelines Establishing Standards for Safety and Soundness*, 12 C.F.R. Part 208 app. D-1 (FRB version).

[10] *Interagency Guidelines Establishing Standards for Safeguarding Customer Information*, 12 C.F.R. Part 208 app. D-2 (FRB version).

beyond the normal director's duty to comply with applicable laws and regulations. As one commentator has noted:

> "Requiring presidentially appointed directors would be pointless, especially in [government-sponsored enterprises] in which the government owns no shares, unless the government's directors represented the national interest in some way."[11]

Because the presidential appointees are a minority of the Board, there is a risk that they will not fulfill their additional responsibilities unless the Rule explicitly requires them to do so and protects their independence from the shareholder-elected majority. The same commentator described the problem as follows:

> "[E]ven if government directors are expected to use their votes and influence to promote the public interest, their influence may not be equal to the task when they are in the minority. (Suppose, for example, that the corporation is considering trade-offs between profit maximization and nonpecuniary social interests such as environmental quality or compliance with current government policy.)[12]

Another commentator described the problems faced by the government-appointed directors of the government-subsidized Union Pacific Railroad in the nineteenth century:

> "They claimed that they were treated as spies and antagonists, and were kept in the dark about many things. Often they were not invited to directors' and committee meetings; and they were rarely heeded or consulted with respect to pending or even past actions, including such major policy decisions as mergers, dividend declarations, and debt refunding."[13]

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[11] A. Michael Froomkin, *Reinventing the Government Corporation*, 1995 U. Ill. L. Rev. 543, 588.

[12] *Id.* at 588-89 (footnote omitted), *citing, inter alia*, Herman Schwartz, *Governmentally Appointed Directors in a Private Corporation: The Communications Satellite Act of 1962*, 79 Harv. L. Rev. 350, 353-54, 358-59 (1965).

[13] Herman Schwartz, *supra* note 12, at 359-60 (footnotes omitted).

In light of these questions about the role and effectiveness of presidential appointees, the Rule should address their additional responsibilities. FM Watch proposes two ways that the Rule could help ensure that these board members properly carry out their responsibilities to the public. First, the Rule should explicitly state that presidential appointees have a special responsibility to serve the public interest and to ensure that the Enterprise fulfills its public mission in a manner consistent with safety and soundness.

Second, the Rule should require each Enterprise to create a Public Mission Committee composed of the presidential appointees, with independence and resources equivalent to that of the audit and compensation committees. The shareholder-elected members of the board should be required to cooperate with the Public Mission Committee, and the Committee should issue periodic public reports on the degree to which the Enterprise is fulfilling its public mission in a safe and sound manner while staying within the statutory confines of its Charter Act. Creating this specific responsibility structure would not be a new or radical step. Rather, it would merely specifically implement, in the context of this Rule, the corporate governance structure contemplated by the Charter Acts.

Definition of "Independent" Director and Conflicts of Interest

Proposed Section 1710.11 would require each Enterprise to establish audit and compensation committees consisting of "independent" directors. An "independent" board member would be defined in Section 1710.2(m) as a director who "meets the criteria for independence under the [New York Stock Exchange ("NYSE")] rules for audit committee members." FM Watch strongly supports the requirement to establish independent audit and compensation committees. As discussed, these requirements are particularly important for the Enterprises because of the lack of market or regulatory mechanisms that apply to fully private companies.

We believe, however, that the definition of an "independent" director should be clarified to ensure that the members of these important committees are truly independent. The NYSE rules generally prohibit "a partner, controlling shareholder, or executive officer of an organization that has a business relationship with the company," or a board member who has a direct business relationship with the company, from serving on the audit committee.[14] But the

[14] *See* Securities and Exchange Commission, Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the New York Stock Exchange, Inc. Amending Audit Committee Requirements of Listed Companies, 64 Fed. Reg. 55514, 55515 (October 13, 1999). The prohibition continues for three years after the relationship that triggers it ends. *Id.*

individual can serve on the audit committee if "the company's Board of Directors determines in its business judgment that the relationship does not interfere with the director's exercise of independent judgment."[15]

It may be reasonable to permit an ordinary public company to allow a board member who has a business relationship with the company to be considered independent, if the board of directors determines that the individual can exercise independent judgment. It is not appropriate to allow one of the Enterprises to do so. Because of the overwhelming power that the Enterprises can exert over even the largest fully private players in the mortgage industry, they should not be permitted to waive this restriction regardless of the nature of the relationship.

OFHEO should also clarify that political relationships can also constitute "business relationships" that disqualify an individual from being treated as independent. For example, the Enterprises have worked closely with state and local officials in establishing affordable housing programs around the country, and a former official (or the spouse or relative of a current official) whose jurisdiction has been the recipient of such largesse would have difficulty in viewing the Enterprise's activities with the requisite independent judgment.

Conflicts of Interest

We commend OFHEO for requiring the Enterprises, in Section 1710.14, to institute conflict-of-interest standards to:

> "[P]rovide reasonable assurance that the board members, executive officers, employees, and agents of the Enterprise discharge their responsibilities in an objective and impartial manner."

Because of the advantages that Congress has granted the Enterprises, including a protected duopoly, it is essential that the Enterprises act objectively and impartially. A company is ordinarily free, absent antitrust concerns, to refuse to deal with any other company or individual. But the Enterprises are in a position to exert significant pressure against individuals and companies in the mortgage industry who criticize them publicly. There have been widely reported allegations that the Enterprises have threatened severe consequences against individuals and companies that disagreed with the Enterprises' policy positions, even when the critics are among the leading players in the mortgage industry. Without respect to whether these allegations were true, the strong response of the Enterprises to them

[15] *Id.*

indicated that the Enterprises themselves understand that they must use their government-granted advantages in a reasonable and impartial manner. The quality of public policy suffers when major participants in the industry are unable to comment freely on their vision of an appropriate industry structure.

For these reasons, we recommend that OFHEO expand the conflict of interest provision in Section 1710.14 by including a "free speech" provision that specifically prohibits the Enterprises from retaliating in any manner against an individual or entity that advocates a public policy position adverse to that of the Enterprise.

Revolving Door

The ability of Congress to effectively oversee the Enterprises has been hampered because of a "revolving door" between the staffs of the committees with jurisdiction and the Enterprises. Staff members of executive branch agencies whose policies affect the Enterprises have also found employment with the Enterprises. The Enterprises have also employed spouses and relatives of current congressional and executive-branch employees. The availability of future employment, or current employment of a spouse or close relative, with one of the Enterprises can have an obvious impact on a staff member's objectivity and willingness to be aggressive in overseeing the Enterprises.

Thus, the "revolving door" problem is another area where conflicts of interest can have an adverse impact on the Enterprises' safety and soundness and their ability to fulfill their public mission in conformity with the Charter Acts. As a first step toward addressing this issue, OFHEO should include in the rule a requirement that the Enterprises disclose, at least annually, a list of all employees—

- Whose total annual compensation exceeds $100,000; and
- Who have been employed, or whose spouse or immediate family member has been employed, by Congress or the federal government in the last five years.

<u>Compensation</u>

Section 1710.12 requires that compensation of board members, executive officers, and employees be reasonable and commensurate with their responsibilities and comply with applicable laws and regulations. Although FM Watch supports this requirement as essential to safety and soundness, it is also important to ensure that compensation plans do not provide an incentive for board members, executives, or employees to engage in activities that conflict with the Enterprise's public mission. As noted, the public mission is not always compatible with the profit-maximizing model of a fully private company, and this tension must be resolved

by a regulation that emphasizes that the public mission must always be the Enterprise's overriding concern. In addition, the Enterprises receive massive public subsidies in the form of favorable access to funding and tax and regulatory exemptions. It would be natural for the Enterprises to seek to reward officers and employees who are successful in increasing these subsidies or preserving unjustified existing subsidies, but such activities are contrary to the public interest.

For these reasons, the Rule should explicitly require the Enterprises to—

- Consider the extent to which an executive officer or employee contributed to the fulfillment of the Enterprise's public mission; and
- Develop a compensation structure in which profits or revenues attributable to maintaining or increasing public subsidies are not considered in determining compensation.

Governing Corporate Law

Under Section 1710.10, each Enterprise would be required to choose, in its bylaws, to be subject to the corporate law of "the jurisdiction in which its principal office is located, Delaware General Corporation Law, or the Model Business Corporation Act." It would then be subject to that law to the extent that the law did not conflict with federal law or regulations, including the Rule.

We understand OFHEO's desire to provide legal certainty as to the details of corporate governance procedures, which are not spelled out in the Charter Acts. But incorporating state law or the Model Business Corporation Act ("Model Act") raises difficult issues of federalism and undue delegation and could be misinterpreted as a grant of additional powers to the Enterprises beyond those provided by federal law. These unintended side effects could run counter to the goals of improving the Enterprises' safety and soundness and their ability to fulfill their public mission. Therefore, we recommend that OFHEO not adopt this portion of the proposal.

The heart of the problem with the Proposed Rule as drafted is that it would delegate the determination of many of the rules of corporate governance of the Enterprises to the outside body that drafted the applicable corporate law. The outside body would be the state legislature of Delaware if either Enterprise elected to be governed by Delaware law; the legislature of Virginia (for Freddie Mac), or the City Council of the District of Columbia (for Fannie Mae); or the private organizations that drafted the Model Act, which have no legislative authority. Although Section 1710.10 specifies that the applicable corporate law

applies only "to the extent such procedures are not inconsistent with safety and soundness and applicable Federal law," there may be aspects of that outside body of law that are arguably not inconsistent with safety and soundness and not literally inconsistent with federal law and, but are wholly incompatible with the goals of the Charter Acts.

To take one example, the Enterprises could contend that they are entitled to exercise the very broad powers provided by typical state laws because those powers are not literally "inconsistent" with a specific prohibition in the Charter Acts or other applicable law. OFHEO and the Department of Housing and Urban Development are reportedly currently considering a request for an interpretation that Freddie Mac exceeded its powers under the Charter Act when it acted as a commercial lender in providing a line of credit to Lending Tree to support Lending Tree's technology initiatives.

We are concerned that, if the Rule were adopted as proposed, Freddie Mac might cite the applicable outside corporate law as authority to provide the Lending Tree line of credit, because the state laws give corporations unlimited authority to lend money, or, for that matter, to engage in virtually any lawful pursuit.[16] OFHEO

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[16] The Model Act states that:

> "Unless its articles of incorporation provide otherwise, every corporation has perpetual duration and succession in its corporate name and has the same powers as an individual to do all things necessary or convenient to carry out its business and affairs, including without limitation power:
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> ". . . .
>
> > "(8) to lend money, invest and reinvest its funds, and receive and hold real and personal property as security for repayment. . . ."

Model Act § 3.02(8) (1998 ed.). The other state laws that the Enterprises could elect contain identical or similar language. The Virginia Stock Corporation Act (which could apply to Freddie Mac) has exactly the same provision. *See* Va. Code § 13.1-627.1. The Delaware General Corporation Law and District of Columbia Code (which could apply to Fannie Mae) contain very similar provisions. *See* Delaware General Corporation Law § 122(14); D.C. Code § 29-304(9).

has asserted its authority to enforce Charter Act limitations on permissible activities[17] and clearly does not intend this result.

Moreover, even if OFHEO is satisfied with the current corporate laws and the Model Act, they are subject to amendment and, in the case of the state and District laws, interpretation by regulators and the courts. Incorporating these outside bodies of law into the regulation would give the Enterprises an incentive to lobby for changes or interpretations that could be favorable to the Enterprises but inconsistent with OFHEO's goals.

Therefore, as noted, we recommend against adopting this portion of the proposal. If OFHEO decides to do so, it could reduce the possibility of abuse by one of the Enterprises by applying the outside law only to the determination of shareholder rights and not to other aspects of corporate governance. At a minimum, the Rule should make it clear that, notwithstanding any provision of the governing corporate law, the powers of the Enterprises are determined solely by the Charter Acts and other applicable *federal* law.

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FM Watch appreciates the opportunity to comment on the Proposed Rule.

Sincerely,

W. Mike House
Executive Director

[17] *See* OFHEO, Memorandum from Alfred M. Pollard, General Counsel, and David W. Roderer, Deputy General Counsel, to Armando Falcon, Director, regarding Consideration of Freddie Mac/HomeAdvisor Technologies (Sept. 7, 2000), *attached to* Letter from Armando Falcon, Director, OFHEO, to Diane M. Casey, President & Chief Executive Officer, America's Community Bankers (Sept. 7, 2000).