CONSUMER MORTGAGE COALITION

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:

The Consumer Mortgage Coalition ("CMC"), a trade association of national residential mortgage lenders and servicers, appreciates the opportunity to submit its views concerning the proposed regulation (the "Proposed Rule" or "Rule") of the Office of Federal Housing Enterprise Oversight ("OFHEO"), published in the *Federal Register* on September 12, 2001, which would establish minimum requirements for corporate governance practices and procedures of the Federal National Mortgage Association and the Federal Home Loan Marketing Corporation (the "Enterprises").

We agree with OFHEO that the Enterprises need to meet minimum standards of good corporate governance, and that these standards need to be based on explicit practices and procedures. We commend OFHEO for pointing out that :

> [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. Strong controls mandated by explicit rules of corporate governance are an essential tool for preventing questionable decisions from being made and keeping the Enterprises focused on achieving the purposes for which Congress intended them.

The Proposed Rule is an important step towards establishing such explicit controls. Our purpose in submitting this comment is to point out some instances in which those controls might be made more explicit, and therefore more effective, than they would be under the Proposed Rule as published. Notably, we think OFHEO should: (1) reconsider the governing law provisions of the Proposed Rule; (2) impose certain additional requirements on the Enterprises' directors, including presidential appointees; and (3) impose certain additional requirements on senior managers of the Enterprises.

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Governing Law

Under Section 1710.10 of the Proposed Rule, 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 agree with OFHEO that it is important to provide as much legal certainty as possible concerning the details of corporate governance procedures not spelled out in the Acts of Congress chartering the Enterprises (each a "Charter Act"). Regrettably, we think that incorporating state law or the Model Business Corporation Act (the "Model Act") actually raises more questions than it resolves. The Enterprises are unique federal corporations with unique rights and unique responsibilities, and they cannot and should not be treated as fundamentally similar to private corporations.

The Proposed Rule would delegate the federal government's fundamental responsibility for establishing the legal underpinnings of the Enterprises to the bodies that have drafted and would continue to modify the corporate law chosen by the Enterprises. Depending on the Enterprises' choices, the legislature of Delaware, Virginia or the District of Columbia, or the private organizations that drafted the Model Act, would be responsible for establishing the rules that governed the Enterprises' internal decision-making, standards of responsibility for those decisions, and liabilities for violations of those standards of responsibility. These bodies of law address the needs of traditional private companies, and, as such, are not fully appropriate for guiding the governance of national institutions such as the Enterprises, with national public purposes. Even though Section 1710.10 of the Proposed Rule specifies that the chosen body of corporate law applies only "to the extent such procedures are not inconsistent with safety and soundness and applicable Federal law," aspects of that outside body of law that are arguably not inconsistent with safety and soundness and not literally inconsistent with federal law may still be completely incompatible with the goals of the Charter Acts.

The controversy over Freddie Mac's provision of a line of credit to Lending Tree provides a good example of the kind of mischief that wholesale application of state corporate law to the Enterprises' activities could cause. It has been reported that OFHEO and the Department of Housing and Urban Development are 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. If such a situation were to arise after the Proposed Rule became final, Freddie Mac might cite the applicable corporate law as authority to provide the Lending Tree line of credit, because any of the possible applicable corporate laws give corporations in general unlimited authority to lend money, or, for that matter, to engage in virtually any lawful pursuit.[1] Such a result would be

[1] 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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> ". . . .

clearly inconsistent with OFHEO's stated intent to assert its authority to enforce Charter Act limitations on permissible activities.[2]

We also note that the delegation of authority contained in the Proposed Rule would continue regardless of subsequent changes to the corporate laws that applied to the Enterprises. Thus, the success of the Proposed Rule could be affected by decisions made by state legislatures or the private organization that drafts the Model Business Corporation Act. Changes in the governing corporate laws might be inconsistent with OFHEO's goals, but having delegated its authority, OFHEO would find it difficult to take that power back.

Rather than delegating away from the federal government the authority to determine the underlying corporate law applicable to the Enterprises, we think OFHEO should clearly state that the Charter Acts and other applicable federal are the sole source of the powers of the Enterprises. To the degree that OFHEO thinks federal common law is not adequate to fill in the legal interstices left by the Charter Acts, OFHEO should establish the necessary rules itself, in part by following the model of the banking agencies' Interagency Guidelines Establishing Standards for Safety and Soundness (the "Interagency Guidelines").[3] The Interagency Guidelines are 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.

Responsibilities of Directors

General Responsibilities of the Board

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. Although the Proposed Rule generally follows the banking regulators in the general requirements it imposes on directors, it does not impose the banking agencies' specific standards addressing the key responsibilities of the board and senior management. Explicit standards are crucial, however, to allow examiners to evaluate directors' actual performance on the issues that any financial institution typically faces. As the

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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).

[2] *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).

[3] 12 C.F.R. Part 208 app. D-1 (Board version).

banking agencies have noted, "[t] he 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] OFHEO may wish to take an approach similar to that of the banking agencies, perhaps incorporating the banking standards by reference. At the least, OFHEO should require review by the board of directors and senior management of subjects such as: internal controls and information systems; audits (both internal and external); credit underwriting policies and procedures; asset quality and asset growth; and privacy and security safeguards.[5]

Special Responsibilities of Presidential Appointees

It is clear from the structure of the Charter Acts that the presidential appointees to the Enterprises' boards have responsibilities to the public purposes of the Enterprises that go beyond the normal duties of a director to advance the interests of the corporation while complying with applicable laws and regulations. Scholars of publicly-chartered corporations, however, have noted that there is a risk that government appointees in such a situation will not be able to fulfill their duties to the public unless their independence is protected from the shareholder-elected majority.[6]

The CMC, therefore, believes that the Rule should explicitly state that presidential appointees to an Enterprise's board have a special responsibility to ensure that the Enterprise fulfills its public mission, as specified in its Charter Act. In addition, the Rule should require each Enterprise to constitute the presidential appointees as a separate committee of the board, with resources and independence comparable to that of each Enterprise's audit or compensation committees, and with the responsibility to publish periodic reports on the Enterprise's fulfillment of its public purposes. The committee would also be expected to comment on whether the Enterprise is abiding by the limitations imposed by its Charter Act. This power of publicity would help ensure that the presidential appointees fulfill their unique role in the governance of the Enterprises.

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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 *See Interagency Policy Statement on the Internal-Audit Function*, FRB Doc. No. SR-97-35 (Dec. 22, 1997); *Interagency Policy Statement on External-Auditing Programs of Banks and Savings Associations*, FRB Doc. No. SR-99-33 (Sept. 28, 1999); *Interagency Guidelines Establishing Standards for Safety and Soundness*, 12 C.F.R. Part 208 app. D-1 (FRB version); *Interagency Guidelines Establishing Standards for Safeguarding Customer Information*, 12 C.F.R. Part 208 app. D-2 (FRB version).

6 "[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." A. Michael Froomkin, *Reinventing the Government Corporation*, 1995 U. Ill. L. Rev. 543, 588-89, *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).

Definition of "Independent" Directors

Another issue relating to the board of directors has to do with which of the directors can be said to be "independent." Proposed Section 1710.11 would require each Enterprise to establish audit and compensation committees consisting of "independent" directors. Proposed Section 1710.2(m) defines an "independent" board member as a director who "meets the criteria for independence under the [New York Stock Exchange ("NYSE")] rules for audit committee members." While the CMC strongly supports the requirement to establish independent audit and compensation committees, we believe that the members of these important committees need to be truly independent.

The NYSE rules, while they may ensure directorial independence for ordinary private corporations, are inadequate in these circumstances. The NYSE rules 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.[7] But the NYSE rules permit an otherwise conflicted individual to 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."[8] This is not appropriate for the Enterprises. 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.

Given this problem, we think that OFHEO should not simply adopt the NYSE's rules on independent directors, but should establish rules specifically adapted to the special circumstances of the Enterprises.

Scrutiny of Senior Managers

The special circumstances of the Enterprises extend to their senior management as well as their Boards of Directors. 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. The CMC agrees with this general proposition, but we also think it important to ensure that compensation plans not provide incentives for board members, executives, or employees to engage in activities that conflict with the public purposes of the Enterprises. Public purposes are not always compatible with the profit-maximizing model of a fully private company. OFHEO can address this issue by stating clearly that the public purposes enshrined in the Enterprises' Charter Acts must always be the overriding concern of senior management. OFHEO can also impose the concrete requirement that an Enterprise's compensation structure consider the extent to which the individual officer or employee contributes to the fulfillment of the Enterprise's public purpose.

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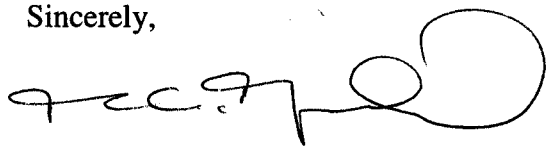
[7] *See* Securities and Exchange Commission, Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the New York Stock Exchange, Inc. Amending Audit Committee Requirements of Listed Companies, 64 Fed. Reg. 55514, 55515 (October 13, 1999). The prohibition continues for three years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

[8] *Id.*

Again, we commend OFHEO for addressing the question of what corporate governance rules should apply to the Enterprises. The CMC appreciates the opportunity to comment on the Proposed Rule.

Sincerely,



Anne C. Canfield
Executive Director