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**BY ELECTRONIC MAIL AND COURIER**

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

Re: *Proposed Corporate Governance Regulation, RIN 2550-AA20*

Dear Mr. Pollard:

Fannie Mae respectfully submits the following comments in response to the corporate governance regulation proposed by the Office of Federal Housing Enterprise Oversight ("OFHEO") on September 12, 2001. Fannie Mae has many serious concerns about the proposed regulation and urges OFHEO to withdraw it entirely.

First and foremost, the proposal inexplicably rejects the most basic principles of corporate law developed through years of debate by state legislatures, courts, other regulators and legal experts. While these authorities have approached corporate governance issues from different perspectives and in different ways, each has come to the same fundamental conclusion: good corporate governance is not fostered by detailed, prescriptive, and rigid rules. Instead, state legislatures (particularly Delaware) and courts have focused on broad standards of care, loyalty and good faith, recognizing that flexibility is a key component of any successful corporate governance regime. When they have identified specific areas of potential abuse, such as director conflict-of-interest transactions, they have addressed those areas in greater detail – all the while adhering to the notion that broad, process-oriented guidance is more appropriate and effective than substance-oriented proscriptions. The courts and legislatures have deferred in large part to the good-faith business judgments of well-informed directors, a deference reflected in every state's corporate law and the

Model Business Corporation Act (the "Model Act").[1] The Delaware Court of Chancery notes that "[b]ecause businessmen and women are correctly viewed as possessing skills, information and judgment not possessed by reviewing courts and because there is great social utility in encouraging the allocation of assets and the evaluation and assumption of economic risk by those with such skill and information, courts have long been reluctant to second-guess decisions when they appear to have been made in good faith."[2] As a result, U.S. companies have reaped the benefits of intelligent, informed risk-taking by corporate directors while still holding directors to demanding standards of care, loyalty and good faith.

In contrast, the regulation proposed by OFHEO is inflexible and unworkable conceptually and in practice. It imposes an exhaustive list of specific, minimum director responsibilities and standards of conduct, leaving little to the good-faith business judgment of Fannie Mae's Board. In this way, the proposal disregards 200 years of corporate governance scholarship and jurisprudence in favor of a confusion of rules drawn in part from state law, corporate governance commentary, banking guidelines, New York Stock Exchange ("NYSE") rules, and current OFHEO supervisory practices. And, most troubling, it codifies them into a formal regulation to be enforced against the company's directors entirely at OFHEO's discretion. As explained in more detail below, adoption of the proposed regulation in its current form would not lead to better corporate governance practice. On the contrary, it would hamstring legitimate Board activities and discourage Fannie Mae directors from taking even reasonable, well thought out business risks, because of their concern that they may be second-guessed by OFHEO and exposed to personal liability if a decision does not produce anticipated results. The proposal appears to be an attempt to create a structure under which the directors owe certain duties to a regulator as opposed to the corporation and its shareholders – this is completely unprecedented in corporate governance practice.

Second, the proposal is unnecessary in light of Fannie Mae's current corporate governance practices. OFHEO regularly examines Fannie Mae's corporate governance practices under its continuous, on-site examination program,[3] and the company has consistently exceeded the standards established by

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[1] The Model Business Corporation Act is prepared by the Committee on Corporate Laws of the American Bar Association.

[2] In Re J.P. Stevens & Co. Shareholders Litigation, 542 A.2d 770, 780 (Del. Ch. 1988).

[3] OFHEO's examination includes an evaluation of the Board's engagement in the development of Fannie Mae's strategic direction and in ensuring that management appropriately defines the operating parameters and risk tolerances of the company in a manner consistent with strategic direction, legal standards, and ethical standards. OFHEO evaluates the Board's process for hiring and maintaining a quality executive management team and holding this team accountable for achieving the company's defined goals and objectives. OFHEO also determines whether the Board is appropriately informed on the condition, activities, and operation of the company and whether the Board has sufficient time to carry out its responsibilities.

OFHEO.[4] Most other large, private corporations are not subject to government examinations of their corporate governance practices; OFHEO has already put in place a mechanism to address problems at Fannie Mae should they arise. In addition, Fannie Mae already meets corporate governance "best practices" set forth in the *Corporate Director's Guidebook* (published by the same American Bar Association committee that writes and revises the Model Act) and The Business Roundtable's *Statement on Corporate Governance* and other authoritative commentaries on corporate governance. Fannie Mae has standing audit, compensation, nominating and corporate governance, executive, technology, and assets and liabilities policy committees, each of which has specific oversight responsibilities defined in written committee charters or in the bylaws. Furthermore, the company's audit, compensation, and nominating and corporate governance committees are limited to independent directors. The Fannie Mae Board years ago adopted director term limits and a mandatory director retirement age – policies on the cutting edge of corporate governance best practices. Finally, the company complies with NYSE corporate governance requirements regarding, among other things, independent directors, audit committees, quorums, voting rights, and shareholder approvals. OFHEO's proposal would require radical changes to Fannie Mae's corporate governance practices, which OFHEO itself has acknowledged are working well. Given the company's strong existing corporate governance policies, this new layer of regulation is wholly unwarranted.

As stated in Executive Order 12866, OFHEO bears the burden of demonstrating that the proposed regulation is required by law, necessary to interpret the law[5], or made necessary by a compelling public need.[6] OFHEO has not met this burden. Accordingly, the proposed regulation, which is unnecessarily intrusive and inconsistent with established corporate governance standards, should be withdrawn.

Third, the proposed regulation places unprecedented restraints on indemnification of directors and officers. Both Delaware law and the Model Act permit indemnification of directors and officers in

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[4] *See* OFHEO's 1999, 2000, and 2001 Annual Reports to Congress. OFHEO reported to Congress in 1999, 2000, and 2001 that Fannie Mae's internal controls, audit controls, Board governance, and management information framework "exceeded safety and soundness standards." (relevant excerpts attached as an Appendix A).

[5] Neither Federal Housing Enterprises Financial Safety and Soundness Act of 1992 nor its legislative history contains any grant of authority to OFHEO in the area of corporate governance. Given that the 1992 Act provides OFHEO with exclusive authority over very specialized areas, such as ensuring that the companies maintain adequate capital levels, we must respectfully question OFHEO's legal authority to issue a corporate governance proposal. At a minimum, there is no authority in the statute for the proposed highly intrusive regulatory regime. *See, e.g.*, The Business Roundtable v. SEC, 905 F.2d 406 (1990).

[6] The Executive Order states, "Federal agencies should promulgate only such regulations as are required by law, are necessary to interpret the law, or are made necessary by a compelling public need…" *See* Executive Order 12866, §1(a).

all but the most egregious cases, and both explicitly provide for the advancement of legal expenses. Furthermore, both Delaware law and the Model Act provide for *mandatory* indemnification when the officer or director to be indemnified has been successful on the merits or otherwise. In contrast, the proposed regulation makes no clear statement with respect to the advancement of expenses and places substantial limits on director and officer indemnification – even when the individual seeking indemnification acted in good faith and with Fannie Mae's best interests in mind. As you know, Fannie Mae currently recruits outstanding, well-respected candidates to serve on its Board. These distinguished men and women are in high demand and can choose to serve on other corporate boards not subject to the unusual constraints set forth in OFHEO's proposal. The proposed limits on indemnification, particularly when combined with detailed, inflexible standards of director conduct and responsibility, would expose Fannie Mae directors to an unacceptable and unfamiliar level of potential personal financial liability. This will almost certainly deter qualified, thoughtful candidates from serving on Fannie Mae's Board.[7]

The release accompanying the proposed regulation states that the corporate practices and procedures set forth by OFHEO are "substantively similar to those required by federal banking agencies with respect to the regulated financial institutions."[8] Fannie Mae respectfully disagrees with this assertion. The director responsibilities and standards of conduct that OFHEO proposes to codify in an enforceable regulation are drawn from informal guidance issued by the Federal banking agencies – not from formal banking regulations. The prohibitions on indemnification added to the Federal Deposit Insurance Act ("FDI Act") in 1990 grew out of Congress' concerns that the boards of troubled thrifts, who often had direct approval authority over the transactions that spurred the thrift crisis, were acting in their own personal interest rather than the best interests of the companies. Moreover, indemnification of thrift directors utilized federally insured funds. No such situation exists with respect to Fannie Mae and Freddie Mac, and Congress clearly chose in 1992 not to mirror the indemnification prohibitions of the FDI Act. In fact, the banking regulators administer a completely different statutory scheme than OFHEO, especially in the area of indemnification.

Fourth, proposed section 1710.31 (prohibiting indemnification payments in certain administrative actions) in particular clearly exceeds the authority granted to OFHEO by the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (the "1992 Act"). We have been advised by counsel that these provisions would not be upheld upon judicial review.

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[7] The potential negative impact on the recruitment and retention of senior management is of equal concern.

[8] 66 Fed. Reg. 47557.

Fifth, the proposed regulation bars Fannie Mae's Board from delegating any of its responsibilities to board committees. This prohibition, which is inconsistent with both the Model Act and Delaware law, will make it difficult for the Board to operate in an efficient and effective manner.

Sixth, the proposed regulation imposes detailed rules governing board quorums, conflict-of-interest standards, proxy voting, and Board audit and compensation committees. Such requirements are inconsistent with Delaware law and the Model Act and are unnecessary and confusing.

Seventh, the proposed regulation is internally inconsistent. Proposed section 1710.10 would require Fannie Mae to elect to "follow and be bound by the corporate governance practices and procedures" of the law of the District of Columbia, Delaware law or the Model Act.[9] Proposed sections 1710.20 and 1710.21, however, impose detailed director responsibilities and standards of conduct that conflict with the broad standards of care, loyalty and good faith envisioned by state corporate law and the Model Act and judicial decisions that have interpreted and applied those standards.[10] If adopted, this contradictory regime would create confusion as to which standards and requirements apply to Fannie Mae and its officers and directors.

Eighth, several provisions of the proposed regulation raise serious, additional legal questions. Proposed section 1710.12, which requires compensation of directors and employees of Fannie Mae to be "reasonable and commensurate" with duties, is contrary to express provisions in the 1992 Act and conflicts with OFHEO's recently adopted rules on executive compensation. Also, proposed sections 1710.11(b)(2), 1710.12, 1710.20(a) and 1710.21(a)(4) require the Board to ensure compliance with applicable laws, rules, and regulations generally. These provisions could be interpreted to authorize OFHEO to take enforcement action against one of the companies or its individual directors for conduct inconsistent with any Federal, state, or local law or regulation – including laws and regulations wholly unrelated to OFHEO's mission.

Taken together, our enumerated concerns demonstrate that OFHEO's regulation is contrary to hundreds of years of well-established corporate governance principles and the approach of other regulators, is unnecessary, will create confusion, will deter highly qualified directors from serving on Fannie Mae's Board, may negatively impact the company's ability to attract and retain superior senior officers, and is contrary to law in several key respects. If adopted, the proposal will violate the express will of Congress that OFHEO ensure the sound operation of Fannie Mae without unduly interfering in the day-to-day management of a private company. The legislative history of the 1992 Act could not be clearer:

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[9] Proposed §1710.10; 66 Fed. Reg. 47561.

[10] We note that the proposal contains many other provisions that conflict with this "choice of law" requirement.

> The Committee does not mean for the Director or HUD Secretary to impose his or her business judgment on, or interfere with, the normal management prerogatives of an enterprise that has sound financial controls, and is adequately capitalized, and profitable. Congress created the enterprises under private ownership and management to bring the entrepreneurial skills and judgments of the private sector to bear on accomplishment of public purposes relating to housing. The Committee does not mean to upset this unique structure or to encourage any government official to second guess decisions of enterprise management arrived at through the exercise of honest, unbiased judgement of what is in the best interests of the enterprise.[11]

It is therefore difficult to justify the proposed rule, which would, in effect, replace the honest, unbiased business judgment and normal management prerogatives of Fannie Mae's Board with that of a government agency.

For the reasons summarized above, Fannie Mae strongly urges OFHEO to withdraw the proposed regulation. Fannie Mae's detailed comments follow.

*I. The detailed director responsibilities and standards of conduct set forth in proposed sections 1710.20 and 1710.21 are inconsistent with established corporate law and will undermine prudent Board operation.*

In contrast to well-developed principles of corporate law which focus on broad standards of care and loyalty for directors, the proposed regulation imposes an exhaustive list of specific, minimum director responsibilities and standards of conduct. This approach leaves little to the good-faith business judgment of Fannie Mae's Board, and rejects the approach of both the Model Act and Delaware statutory and case law. Moreover, many of the terms OFHEO proposes to codify are undefined and leave OFHEO with inappropriate discretion to determine when the standards have been violated in a way that triggers an enforcement action.

Proposed section 1710.20 states that each director, in conducting the business of Fannie Mae, must act: (1) on a fully informed, impartial, objective, and independent basis; (2) in good faith and with due diligence, care, and loyalty; (3) in the best interests of the shareholders and Fannie Mae; and (4) in compliance with Fannie Mae's chartering act and other applicable laws, rules, and regulations. In addition, each Fannie Mae director must devote "sufficient time and attention" to his or her responsibilities in conducting the business of Fannie Mae.[12] Proposed section 1710.21 sets forth a

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[11] S.Rep. No. 102-282, 102d Cong. 2d Sess. 25 (1992).

[12] Proposed § 1710.20(b); 66 Fed. Reg. 47562.

number of specific director responsibilities, including, at a minimum: (1) monitoring corporate performance and reviewing and overseeing corporate strategy, major plans of action, and risk policy; (2) hiring and retaining qualified senior executive officers and overseeing succession planning for such officers; (3) ensuring that compensation plans for officers and employees comply with applicable laws, rules, and regulations and approving the compensation of directors and senior executive officers; (4) ensuring the integrity of the accounting and financial reporting systems of Fannie Mae; (5) remaining informed of the condition, activities, and operations of Fannie Mae; (6) overseeing the process and adequacy of reporting, disclosures, and communications to shareholders, investors, and potential investors; and (7) ensuring the responsiveness of executive officers in providing reports to Federal regulators and in addressing the supervisory concerns of Federal regulators in a timely and appropriate manner.

These requirements, which OFHEO proposes to codify in an enforceable regulation, do not reflect the approach uniformly followed by state corporate law and the Model Act, which instead set forth broad standards of conduct. As the Delaware Supreme Court recently stated, it would not enforce specific "aspirational goals of ideal corporate governance practices."[13] Such goals, though helpful as informal guidance to directors, "are not required by the corporation law and do not define standards of liability."[14] Similarly, the Model Act recognizes that "the nature and extent of [a director's] responsibilities will vary, depending on such factors as the size, complexity, urgency, and location of activities carried on" by the corporation.[15]

This flexible approach, rather than a checklist, to board responsibility is essential. It encourages directors to exercise their informed business judgment in overseeing the management of a corporation—the very reason for a board of directors. The best boards are comprised of a diverse group of experienced men and women with different backgrounds and life experiences. The standards of care, loyalty and good faith, as articulated in the Delaware law and Model Act, not only hold these directors to high standards, but also encourage the thoughtful innovation and intelligent risk-taking that are essential to business success. The proposed regulation fails to encourage such innovation and risk-taking. In fact, it may encourage directors to escape these responsibilities by relying instead on a checklist of duties instead of using their own best judgment to determine which issues should receive boardroom focus and how best to address them under the circumstances.

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[13] *Brehm v. Eisner*, 746 A.2d 244, 256 (Del. 2000).

[14] *Id.*

[15] Official comment to Model Act §8.30(b).

The Delaware law and the Model Act, unlike the proposed regulation, also do not require directors to "ensure" that particular results are achieved.[16] No board of directors, no matter how diligent and faithful, can reasonably be expected to "ensure" a result or consequence. In fact, the concept of "substantive due care" reflected in the proposed regulation is totally foreign to Delaware law. In Delaware, "due care in the decision-making context is *process* due care only."[17] Where proposed sections 1710.20 and 1710.21 would allow OFHEO to second-guess a director's substantive decisions *de novo*, Delaware law, in sharp contrast, would presume that the director acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the corporation.[18] Likewise, the Model Act's "desired level of director performance, with its objectively based standards of conduct" does not carry with it a results-oriented liability analysis.[19] The Model Act recognizes that "although some decisions turn out to be unwise or the result of a mistake of judgment, it is not reasonable to re-examine an unsuccessful decision with the benefit of hindsight."[20] This flexible, yet demanding, standard is what state legislatures and courts have found best fosters thoughtful decision-making by boards of directors.

In contrast, proposed section 1710.20(a)(3) would permit OFHEO to determine, after-the-fact, whether a particular Board decision was "in the best interests" of Fannie Mae and its shareholders. The term "best interests" is not defined. As the drafters of the Model Act realized, a director considering a corporation's best interests should have "wide discretion in deciding how to weigh near-term opportunities versus long-term benefits as well as in making judgments where the interests of various groups within the shareholder body or having other cognizable interests in the enterprise may differ."[21] The proposed regulation permits no such discretion. In addition, the proposed regulation does not require OFHEO to consider whether a director *reasonably believed* that his or her decision was in the company's best interests. The element of reasonable belief, which

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[16] *See* proposed §1710.21(a)(3), §1710.21(a)(4), and §1710.21(a)(7), which require Fannie Mae directors to "ensure" that compensation plans comply with applicable laws and regulations, "ensure" the integrity of the company's accounting and financial reporting systems, and "ensure" the responsiveness of officers to Federal regulators.

[17] *Brehm v. Eisner*, 746 A.2d 244, 264 (Del. 2000) (emphasis added).

[18] *See Aronson v. Lewis*, 473 A.2d 805, 811-812 (Del. 1984).

[19] Official comment to Model Act §8.31.

[20] *Id.*

[21] Official comment to Model Act §8.30(a).

is clearly reflected in Delaware law and the Model Act,[22] is conspicuously absent in the proposed regulation.

Proposed section 1710.20 requires each Fannie Mae director to "devote sufficient time and attention" to his or her responsibilities and to act on a "fully informed" basis.[23] The terms "sufficient time and attention" and "fully informed" are not defined, and the proposed regulation provides no guidance on how OFHEO will interpret them. Without such guidance, section 1710.20 could be interpreted to require Fannie Mae directors to be involved in the detailed day-to-day administration of the company and to be aware of every possible fact relating to corporate operations. In contrast, Delaware law and the Model Act do not require directors to devote time and attention to the minute details of corporate operations. The Model Act explicitly rejects such a test.[24] Similarly, Delaware law does not require directors to be informed about the nuances of corporate operations; instead, a board is responsible for considering only material facts that are reasonably available.[25] These key concepts of good corporate governance, which allow corporate boards the discretion to allocate their time efficiently and effectively to those matters which they, in their business judgment, determine are most important to the corporation at a given time, are not reflected in the proposed regulation.

The proposed regulation also fails to recognize a distinction between standards of director conduct and standards of director liability. In fact, the proposal makes no mention whatsoever of what standard will be applied to determine director liability. One must assume, then, that a Fannie Mae director could be held personally liable for perceived violations of *any* of the specified responsibilities or standards of conduct. In contrast, both Delaware law and the Model Act make sharp distinctions between desired levels of director conduct and the imposition of personal liability. According to the Model Act, "a director whose performance fails to reach [the desired level of conduct] does not automatically establish personal liability for damages that the corporation may have suffered as a consequence."[26] Instead, section 8.31 of the Model Act places the burden on the party challenging a director's action to prove: (1) that the challenged action was not

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[22] *See, e.g., Grobow v. Perot*, 539 A.2d 180 (Del. 1988); Model Act §8.30(a).

[23] Proposed §1710.20(b) and §1710.20(a)(1); 66 Fed. Reg. 47562.

[24] The official comment to Model Act §8.30(b) provides that the "measure of care that [a director] might determine to be appropriate, in a given instance, would normally involve a selection from the range of options and any choice within the realm of reason would be an appropriate decision under [this] standard of care."

[25] *See Brehm v. Eisner*, 746 A.2d 244, 259 (Del. 2000).

[26] Official comment to Model Act §8.31.

undertaken in good faith, or that the director was not informed, did not reasonably believe the action to be in the best interests of the corporation, lacked objectivity, failed to devote attention to the affairs of the corporation, or received an improper financial benefit; and (2) that the director's conduct caused harm to the corporation or its shareholders. Likewise, Delaware's business judgment rule "is not a description of a duty or standard used to determine whether a breach of duty has occurred; rather, it is a standard of judicial review used in analyzing director conduct to determine whether a board decision can be successfully challenged or a director should be held personally liable."[27] In failing to make any distinction between standards of conduct and standards of liability, the proposed regulation provides Fannie Mae directors with no way to know when they can be held personally liable for alleged violations. As a result, they will almost certainly begin to focus unnecessarily on the minor details of corporate operations – at the expense of larger, more significant corporate objectives.

Finally, the release accompanying the proposed regulation states that the corporate practices and procedures proposed to be prescribed in such detail by OFHEO are "substantively similar to those required by federal banking agencies with respect to the regulated financial institutions."[28] This is misleading. In fact, the detailed standards of conduct OFHEO proposes to put into an enforceable regulation are drawn from informal guidance issued by the Federal banking agencies, the breach of which cannot by itself result in administrative action against a board member. This difference alone is significant enough to result in an OFHEO regulation that is <u>not</u> substantively similar to banking precedent. Moreover, the Office of the Comptroller of the Currency ("OCC") abandoned an attempt to put specific standards of board conduct into formal regulation, acknowledging "the limitations inherent in crafting a regulation in this complex area that is not overly detailed yet provides directors with clear and useful guidance as to their responsibilities."[29]

In summary, OFHEO's proposed codification of standards of conduct and director responsibilities inexplicably rejects the approach taken by Delaware law, the Model Act and the banking regulators. In fact, OFHEO's approach has been consistently rejected. Codification of standards and responsibilities of directors will undermine innovation and informed risk-taking that are in the best interests of the company and its shareholders in favor of micromanagement and undue attention to meeting OFHEO's requirements. The OFHEO proposal would punish directors for actions taken in accordance with sound business judgment and put the personal assets of such directors at risk merely for doing their jobs. This is not the model upon which modern principles of corporate governance is based – directors should be accountable to the company and its shareholders. The

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[27] American Bar Association Committee on Corporate Laws, *Corporate Director's Guidebook*, 13 (3d ed. 2001).

[28] 66 Fed. Reg. 46557.

[29] 61 Fed. Reg. 4856 (1995).

OFHEO proposal would establish an unfortunate precedent in corporate America under which a government agency would apparently assume the authority to enforce a director's duty to a company and its shareholders.

*II. The restraints on indemnification set forth in proposed sections 1710.30 and 1710.31 are contrary to established corporate law and will deter qualified candidates from serving on the Fannie Mae's Board.*

The proposed regulation places unprecedented constraints on indemnification of Fannie Mae directors and officers. The limitations set forth in proposed sections 1710.30 and 1710.31 are inconsistent with Delaware law and the Model Act, and they will discourage the highly qualified candidates Fannie Mae strives to attract from serving on the company's Board or as senior management. These provisions should be withdrawn.

Fannie Mae's shareholder-approved indemnification policy incorporates the standards of indemnification in the Delaware law. The Delaware statute was chosen because it represents a widely followed formulation of corporate indemnity powers and has been used as a model by other jurisdictions. Fannie Mae currently provides indemnification for officers and directors except: (1) when the individual seeking indemnification is found to have breached his or her duty of loyalty, to have acted not in good faith or in a manner involving intentional misconduct, to have had reasonable cause to believe his or her conduct was unlawful, or to have derived an improper benefit; or (2) when the individual seeking indemnification is fined, and Fannie Mae is prohibited by law from reimbursing him or her.

OFHEO's proposal would remove a significant part of the indemnification protection currently provided to officers and directors of Fannie Mae and would put the personal financial assets of these officers and directors at risk. As a result, Fannie Mae officers and directors would have far less protection and much greater personal financial exposure than directors and officers of other large corporations. OFHEO makes no attempt to explain its proposal to override shareholder judgment as to appropriate indemnification. And, indeed, there is no justification for this dramatic change.

Proposed section 1710.30 permits Fannie Mae to indemnify a director or officer with respect to an OFHEO-initiated proceeding only if: (1) the Board determines that the director or officer seeking indemnification acted in good faith and in a manner he or she believed to be in the best interests of the company, and the indemnification payment will not materially adversely affect the safety and soundness of the company; and (2) the director or officer agrees in writing to reimburse the company for any portion of an indemnification payment that subsequently becomes prohibited under proposed section 1710.31. Proposed section 1710.31 prohibits the company from making any

payment to indemnify a director or executive officer for any legal expense incurred in connection with an OFHEO administrative proceeding that results in a final order or settlement pursuant to which the director or officer is assessed a civil monetary penalty or is required to cease and desist from or take any affirmative action with respect to the company.[30] This prohibition is subject to two narrow exceptions. First, the company could purchase insurance to cover legal expenses and the amount of any restitution owed by the director or officer to the company. This insurance, however, could not be used to indemnify a director or officer for any civil monetary penalty assessed in an OFHEO proceeding.[31] Second, Fannie Mae would be permitted to indemnify a director or officer for legal expenses specifically attributable to particular charges for which there has been an adjudication or finding that the individual to be indemnified did not violate the law, breach a fiduciary duty, or engage in certain unsafe or unsound practices.[32] In non-OFHEO actions, proposed section 1710.30(b) would permit the company to make indemnification payments in accordance with applicable law, provided that any such payments would not materially adversely affect the safety and soundness of the company.

In striking contrast to OFHEO's proposal, both Delaware law and the Model Act permit indemnification of directors and officers in all but the most egregious cases. Section 145 of the Delaware law provides that a corporation may indemnify an officer, director, or employee if the person to be indemnified acted in good faith and in a manner the person reasonably believed to be in (or not opposed to) the best interests of the corporation.[33] Furthermore, the Delaware law states that a corporation *must* indemnify an officer or director who has been "successful on the merits or otherwise" in defense of any action, suit, or proceeding related to his or her corporate duties, or in defense of any claim, issue, or matter therein.[34] Similarly, the Model Act permits a corporation to indemnify an officer or director if he or she acted in good faith and reasonably believed that his or her conduct was in (or was not opposed to) the best interests of the corporation.[35] The Model Act also provides for *mandatory* indemnification of officers and directors who have been "wholly

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[30] *See* proposed §1710.31(a); 66 Fed. Reg. 47563.

[31] *See* proposed §1710.31(b)(1); 66 Fed. Reg. 47563.

[32] *See* proposed §1710.31(b)(2); 66 Fed. Reg. 47563.

[33] *See* Delaware General Corporate Law ("DGCL") §145(a).

[34] *See* DGCL §145(c).

[35] *See* Model Act §8.51 and §8.56.

successful, on the merits or otherwise," in the defense of any proceeding related to their corporate duties.[36]

In addition to deviating from the mainstream of corporate law with respect to indemnification generally, the proposed regulation is troubling in other, more specific respects. First, the proposed regulation contains no provision for mandatory indemnification. Second, even the seemingly permissive indemnification provisions set forth in proposed section 1710.30 are unusually restrictive. In OFHEO initiated actions, section 1710.30 would require the Board to determine that any requested indemnification payment would not "materially adversely affect the safety and soundness" of the company.[37] With respect to non-OFHEO initiated actions, the proposal apparently gives OFHEO the discretion to determine whether the indemnification would materially adversely affect safety and soundness. This concept, which is neither defined in the regulation nor reflected in state corporate law, would create an unfortunate uncertainty as to whether a Fannie Mae officer, director, or employee would receive any indemnification, and how much could be paid, for legal expenses if indemnification were deemed to adversely affect Fannie Mae's bottom line – even if the person requesting indemnification acted in good faith, pursued Fannie Mae's best interests, and was wholly successful on the merits of the case.

Equally troublesome, the proposed regulation makes no clear statement on the question of whether Fannie Mae directors and officers may be advanced the expenses of defending themselves. Both the Model Act and the Delaware law explicitly provide for advancement.[38] In this regard, the FDIC's regulations specifically provide that the "institution or holding company may advance legal and other professional expenses…" in certain circumstances.[39] If advancement is not permitted, Fannie Mae officers and directors might be required to pay all legal expenses out-of-pocket – with no reasonable assurance that such expenses would be reimbursed. This uncertainty alone would likely deter thoughtful, qualified candidates from serving on Fannie Mae's Board or accepting positions as senior officers.

The substantial limits on indemnification proposed by OFHEO seem to be based on statutory and regulatory prohibitions applicable to federally insured banks and thrifts – prohibitions enacted by Congress in response to devastating bank and thrift failures and resulting federal insurance

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[36] Model Act §8.52 and §8.56(c).

[37] Proposed §1710.30(a)(i) and §1710.30(b); 66 Fed. Reg. 47562-47563.

[38] Model Act §§ 8.53 and 8.56; DGCL § 145(e)

[39] 12 CFR 359.0 (Emphasis added.)

obligations.[40] The prohibitions on indemnification added to the FDI Act in 1990 grew out of Congress' concerns that the boards of floundering thrifts, who often had direct approval authority over the transactions that spurred the thrift crisis, were acting in their own personal interest rather than the best interests of the companies. Moreover, indemnification of thrift directors utilized federally insured funds. Fannie Mae and Freddie Mac are in strong financial condition, as OFHEO's own examiners have reported, and do not accept consumer deposits. There is no basis for OFHEO to look to the banking laws or regulations, which are very different from structure established by the 1992 Act, as a model for indemnification practices.

OFHEO's proposed regulation fails to recognize the significance of meaningful indemnification rights for corporate officers and directors. The legislatures, courts, and business and legal communities of this country have long acknowledged the importance of indemnification to good corporate governance. All 50 states have statutory provisions addressing the authority or obligation of a corporation to indemnify its officers and directors for claims made against them and damage awards that may be made in connection with their corporate activities. Indemnification provides officers and directors with reasonable protection from exposure to personal financial liability. It also makes possible the recruitment and retention of qualified officers and directors. Moreover, indemnification permits officers and directors to engage in prudent and healthy risk-taking to enhance corporate performance and shareholder value. Each of these policy considerations, however, must be balanced against the concern that indemnification might protect or encourage improper conduct by corporate officers or directors. Corporate governance experts agree that the proper goal of indemnification should be to "'seek the middle ground between encouraging fiduciaries to violate their trust, and discouraging them from serving at all.'"[41] Both Delaware law and the Model Act strike a careful balance between these concerns. The proposed regulation, which unduly restricts permissible indemnification, provides for no mandatory indemnification, is unclear on advancement of expenses, and relies on misplaced provisions of federal banking law, does not reach this middle ground.

In summary, the proposed limits on indemnification – particularly when combined with the detailed standards of director conduct and responsibility put forth by OFHEO – could expose Fannie Mae's directors to an unprecedented level of potential personal financial liability – a level of exposure dramatically different from that in place on other large corporate boards. This provision could have an especially damaging financial impact on the presidential appointees to the Board – as they would be less likely to be covered by "umbrella" insurance policies than other Board members. These

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[40] *See* Public Law 101-647 (1990), which imposed new limits on indemnification of directors of federally insured banks and thrifts.

[41] Introductory comment to Model Act §§8.50-8.59 (*quoting* Johnston, *Corporate Indemnification and Liability Insurance for Directors and Officers*, 33 Bus. Law 1993, 1994 (1978)).

prohibitions are not rooted in Delaware law or case law and are not found in the Model Act. OFHEO provides no justification for its rejection of these widely followed models on indemnification or for a radical change in the way Fannie Mae has indemnified its directors and officers for years. OFHEO's apparent reliance on bank precedent is entirely misplaced. Accordingly, these provisions should be withdrawn.

*III. The proposed restraints on indemnification exceed OFHEO's statutory authority.*

Proposed section 1710.31, which prohibits indemnification in certain administrative actions, goes beyond the clearly stated authority granted to OFHEO by Congress in the 1992 Act. This broad indemnification prohibition violates both the letter and spirit of the 1992 Act. It unlawfully exceeds the narrow prohibition on indemnification prescribed by the statute and disserves OFHEO's stated goal of enabling Fannie Mae to attract and retain the highest caliber of Board members and executive officers. Not only does expanding the existing statutory prohibition against indemnification of "Tier III" conduct to encompass penalties imposed under "Tier II," or legal expenses associated with "Tiers II and III," and other payments "materially adversely" affecting safety and soundness render meaningless the precise language chosen by Congress in the 1992 Act regarding indemnification; it also negates the plain consequence of Congress's choice to prohibit indemnification in only one situation.[42]

Section 1376 of the 1992 Act defines the prohibited conduct for which OFHEO may impose a civil money penalty and establishes three tiers of penalties that vary in severity according to the nature of the misconduct. Tier I misconduct punishes the company for violations of the Charter or agreements or orders between Fannie Mae and OFHEO, in an amount up to $5,000 per day. Tier II misconduct is punishable by an amount up to $10,000 per day for an individual (up to $25,000 per day for the company) and requires a finding that the misconduct "is part of a pattern of misconduct" or "involved recklessness and caused or would be likely to cause a material loss to the enterprise." Tier III misconduct is punishable by an amount up to $100,000 per day for an individual (up to $1,000,000 per day for the company) and requires a finding that the misconduct "was knowing and caused or would be likely to cause a material loss to the enterprise."

Section 1376(g) of the 1992 Act states that "[a]n enterprise may not reimburse or indemnify any individual for any penalty imposed under [Tier III]." When reading this provision in the context of the penalty scheme, this provision specifies the *complete and exclusive* range of penalties or expenses for which indemnification is prohibited. By singling out third-tier misconduct in section 1376(g), Congress chose to reserve especially harsh punishment for individuals whose misconduct

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[42] Appendix B to this letter contains a detailed legal analysis of proposed section 1710.31.

was *intentional*. OFHEO may not dilute this Congressional choice by exposing individuals to liability if their misconduct was *unintentional*. Moreover, unlike the banking laws that apparently provided the model for the indemnification restrictions in the proposed regulation, the 1992 Act contains no express grant of authority to OFHEO to restrict any indemnification payments – much less to expand the statutory indemnification restriction to additional types of violations.[43] OFHEO may enforce section 1376(g) of the 1992 Act; it may not expand the statutory language.

Fannie Mae's interpretation of the 1992 Act is consistent with well-established principles of statutory interpretation. If the narrow statutory indemnification prohibition could be expanded by regulation to encompass Tier II penalties, as well as legal expenses associated with Tier II and III penalties, and other payments "materially adversely" affecting safety and soundness, then the language of section 1376(g) would be superfluous. Congress singled out only Tier III penalties to constitute the limit of penalties and expenses for which indemnification is prohibited. Thus, OFHEO's interpretation of section 1376(g) violates "the elementary canon of construction that a statute should be interpreted so as not to render one part inoperative."[44] Moreover, given the precise nature with which Congress delineated the indemnification prohibition (Tier III only), OFHEO does not have a "broad license . . . to change basic decisions made by Congress."[45]

OFHEO's proposal also contravenes the common-sense interpretive rule that "[w]hen a statute limits a thing to be done in a particular mode, it includes a negative of any other mode."[46] Under this principle, known as *expressio unius est exclusio alterius*, Congress's explicit prohibition of indemnification for only one type of penalty reflects its intention that indemnification be allowed for other penalties.[47] Application of this maxim is especially compelling in this situation for four reasons.

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[43] Compare 12 U.S.C. 1828(k) ("The [FDIC] may prohibit, by regulation or order, any . . . indemnification payment") with 12 U.S.C. 4636(g) ("An enterprise may not reimburse or indemnify any individual for any penalty imposed under subsection (b)(3) of this section.").

[44] *Colautti v. Franklin*, 439 U.S. 379, 392 (1979).

[45] *American Bankers Association v. Securities and Exchange Commission*, 804 F. 2d 739 (1986).

[46] *Raleigh & Gaston R. Co. v. Reid*, 13 Wall. 269, 270 (1872).

[47] *See Tennessee Valley Auth. v. Hill*, 437 U.S. 153 (1978) (holding that "under the maxim *expressio unius est exclusio alterius*," one must presume that if Congress includes certain exceptions in a statute, those are the *only* exceptions that Congress intended); *Halverson v. Slater*, 129 F.3d 180, 185-86 (D.C. Cir. 1997) (holding that under the statutory construction principle known as *expressio unius est exclusio alterius*, Congress's statement that certain functions could be delegated to the Coast Guard implied that they could not be delegated to non-Coast Guard officials); *Mich. Citizens*

[Footnote continued on next page]

First, Congress deliberately chose not to mirror the indemnification provisions that were added to the FDI Act in 1990, only two years prior to the enactment of section 1376 of the 1992 Act. Under the FDI Act, the FDIC is authorized to prohibit certain indemnification or severance payments to institution-affiliated parties in virtually any circumstance.[48] OFHEO's authority to limit indemnification payments is much more circumscribed. If Congress intended for OFHEO to have the same authority, it would have granted comparable statutory authority to OFHEO. OFHEO cannot promulgate a regulation, which is virtually identical to a regulation promulgated by the FDIC under the authority of the FDI Act, when it lacks similar underlying statutory authority.

Second, the limits on OFHEO's authority are further evidenced by the fact that the penalties are plainly listed in subsection 1376(b). The 1992 Act leaves no uncertainty as to what violations Congress sought to exclude from indemnification when it chose to place third-tier misconduct – and *only* third-tier misconduct – within the scope of section 1376(g). The intention and purpose behind Congress's choice of language in section 1376(g) is no mystery; Congress sought to prohibit indemnification for penalties arising from intentional but not unintentional misconduct.[49]

Third, section 1376(g) is precise and definite, and it does not contain open-ended language that invites interpretation. Thus, while the *expressio unius* maxim does not apply when the items specified by statute are merely meant to be illustrative of, or included in, a broader set,[50] the "list" found in section 1376(g) of one item, and one item only, was clearly meant to be exhaustive. Section 1376(g) specifically and precisely prohibits indemnification for Tier III penalties. It cannot be reasonably read, as OFHEO's proposal implicitly suggests, as providing a prohibition against indemnification for "all penalt[ies], *including* any penalty imposed under subsection (b)(3)."[51] In short, the specific reference to third-tier penalties in section 1376(g) is not an example of a broader

[Footnote continued from previous page]
*v. Thornburgh*, 868 F.2d 1285, 1292 (D.C. Cir. 1989) (holding that "if Congress banned the importation of apples, oranges and bananas from a particular country, the canon of *expressio unius est exclusio alterius* might well indicate that Congress did not intend to ban the importation of grapefruits. In that event, an agency decision to ban grapefruits would be contrary to Congress' specific intent").

[48] *See* 12 U.S.C. §1828(k) (added to section 1828 by Pub. L. 101-647, §2523(a)).

[49] "[W]here Congress includes particular language in one section of a statute but omits it in another section of the same Act, it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion." *Russello v. United States*, 464 U.S. 16, 23 (1983).

[50] *See* 2A Singer §47:23, at 316.

[51] *Cf. Dong v. Smithsonian Institution*, 125 F.3d 877, 880 (D.C. Cir. 1997) (holding that "the word 'includes' normally does not introduce an exhaustive list but merely sets out examples of some 'general principle.'" (citation omitted)).

category of penalties that section 1376(g) was meant to cover; rather, it is the one and only one circumstance in which Congress meant to ban indemnification.

Fourth, section 1376 is a penal law. Although subsection (g) is not the provision defining the prerequisites for liability, it does define when individuals must bear the full practical consequence of a civil money penalty. The meaning of subsection (g) is thus subject to the well-established "rule of lenity" in the strict construction of penal statutes.[52]

Proposed section 1710.31 exceeds OFHEO's authority under the 1992 Act. This is not an issue of statutory ambiguity; the 1992 Act is clear and specific. Deference to agency interpretation, therefore, would not come into play. Fannie Mae has been advised by counsel that this provision would not be upheld by a federal court. Accordingly, OFHEO should withdraw it.

*IV. The restrictions on committees in proposed sections 1710.11 and 1710.21 are inconsistent with established corporate law and would make it difficult to operate the Board in an efficient and effective manner.*

It is well established in corporate America that effective boards meet many of their responsibilities through the work of board committees.[53] The OFHEO proposal inexplicably places severe restraints on this widely-followed practice. While proposed section 1710.11 expressly permits Fannie Mae to provide in its bylaws that the company may create committees of its Board of Directors, it imposes unworkable restrictions. For example, no committee is permitted to have "the authority of the board of directors to amend bylaws and no committee shall operate to relieve the board of directors or any board member of any responsibility imposed by applicable laws, rules and regulations."[54] Moreover, proposed sections 1710.11(a) and 1710.21 would not appear to permit Board members to delegate any of the director responsibilities set out in section 1710.21 to a highly qualified committee. Thus, for example, no committee of the Board, with members with particular expertise, could focus its exclusive attention on risk management policies or the accounting process. OFHEO should not remove Fannie Mae's flexibility to allocate its Board's responsibilities in a manner that best suits the company's needs. The modern trend toward specialized audit, nominating

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[52] *See United States v. Wiltberger*, 18 U.S. 76, 105 (1820) (holding that "[t]he rule that penal laws are to be construed strictly, is perhaps not much less old than construction itself. It is founded on the tenderness of the law for the rights of individuals; and on the plain principle that the power of punishment is vested in the legislative . . . department."). *See also United States v. One 1973 Rolls Royce*, 43 F.3d 794, 819 (3d Cir. 1994) (applying the rule of lenity to a civil forfeiture statute with a punitive purpose).

[53] American Bar Association Committee on Corporate Laws, *Corporate Director's Guidebook,* 31 (3d ed. 2001).

[54] Proposed § 1710.11(a); 66 Fed. Reg. 47561.

and corporate governance committees composed of independent directors is built on the principle of delegation of responsibilities.

OFHEO's proposed prohibitions on delegation are also inconsistent with Delaware law and the Model Act and will make it difficult to operate the Board in an efficient and effective manner. Delaware case law gives directors broad authority to delegate the management of the business and affairs of the corporation unless the duties are not delegable by virtue of statute or the certificate of incorporation.[55] Similarly, Delaware law permits boards to designate one or more committees and delegate to a committee "all the powers and authority of the board of directors in the management of the business and affairs of the corporation."[56]

The Model Act's official comment to section 8.25 points out that the drafters clearly recognized "that appropriate board committee action is not only desirable but also is likely to improve the functioning of larger and more diffuse boards of directors." The drafters of the Model Act, cognizant of the concern that a board not be permitted to delegate authority to the point that it abdicates responsibility, crafted a provision that strikes a balance between allowing a board of directors to delegate enough responsibility that it does not stifle the efficient functioning of the corporation, and allowing the board to delegate so much responsibility that it thereby would abdicate all responsibility.[57] OFHEO's proposed regulation does not strike this balance.

The result of OFHEO's proposal could well be an unworkable situation under which the full Board would be required to micromanage all of the affairs of the company – in direct contravention of Congress' express intent that OFHEO defer to the business judgment of those in the best position to effectively run the company.

*V. The provisions applicable to audit and compensation committees, quorum and proxy provisions and conflict-of-interest standards are unnecessary, confusing and inconsistent with established corporate law.*

The proposed regulations contain a number of provisions related to Board operation that are unnecessary and confusing. In these areas, OFHEO again rejects well established principles of corporate law without providing a rationale for changing the procedures currently in place at Fannie Mae that follow these principles.

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[55] Lehrman v. Cohen, 43 Del. Ch. 222, 235, 222 A.2d 800, 808 (Del. 1966).

[56] DGCL § 141(c)(2).

[57] Official comment to Model Act § 8.25.

Subpart (b) of proposed section 1710.11 requires the company to create an audit committee. The audit committee must comply with the charter of the company and the requirements of the audit committee rules of the NYSE.[58] Subpart (b)(1) is duplicative and unnecessary because Fannie Mae has a listing agreement with the NYSE, which requires compliance with NYSE audit committee rules. If Fannie Mae fails to maintain an audit committee in compliance with NYSE rules, its stock could be delisted.

While the requirement of audit committees has an analogue in Federal banking law, which requires all insured depository institutions with assets over $500 million to have an independent audit committee,[59] the requirement for banks is statutorily mandated. Congress has *not* deemed it necessary to mandate such a committee for Fannie Mae. Moreover, it is noteworthy that the banking regulators are increasingly relying on the rules of self-regulatory organizations to guide the activities of the entities that they regulate, rather than imposing regulations that essentially duplicate those rules. Fannie Mae already follows this model and subjects itself to the NYSE rules.

Additionally, the audit committee provision in the proposed regulation is unclear. It does not state whether Fannie Mae will be obligated to comply with the NYSE audit committee rules in effect at the time the proposed rule is adopted or as the NYSE rules from time to time may be amended. The proposal also does not address how the rules will be enforced. It is unclear whether the companies must comply with the NYSE rules as interpreted and enforced by the NYSE or OFHEO. There is no reason for Fannie Mae and its directors to be held to standards different from other NYSE-listed companies.

Subpart (b) of proposed section 1710.11 also provides that the company must have a compensation committee and that the compensation committee must be "comprised of at least three independent board members, whose duties include ensuring that compensation plans for executive officers and employees comply with applicable laws, rules and regulations and approving the compensation of senior executive officers."[60] A regulation mandating a compensation committee is not necessary for two reasons. First, Fannie Mae already has in place a compensation committee, whose role, among other things, is to administer the policies that govern Fannie Mae's annual compensation and stock ownership plans. The committee is composed entirely of independent directors. The Board of Directors sets, and the compensation committee administers, the policies that govern Fannie Mae's annual compensation and stock ownership plans. After consideration and recommendation by the compensation committee, the Board approves salaries and long-term incentives for all

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[58] Proposed § 1710.11(b)(1); 66 Fed. Reg. 47562.

[59] 12 U.S.C. 1831m(g).

[60] Proposed § 1710.11(b)(2); 66 Fed. Reg. 47562.

officers at the level of executive vice president and above. While Fannie Mae takes appropriate steps to ensure that its compensation plans for executive officers and employees comply with applicable laws, rules and regulations, this could not realistically be the ultimate responsibility of the compensation committee, which must rely on Fannie Mae's legal counsel for such determinations.

Second, neither banking laws nor state corporate laws require a compensation committee. The banking regulators do not require banks or bank holding companies to have a compensation committee, although the policies and other materials that they issue as guidance for bank directors contemplate establishment a compensation committee. Moreover, neither the Model Act nor Delaware law (nor to our knowledge any state statute) specifically requires that a board of directors form a compensation committee. Rather, Delaware law and the Model Act give a board the authority to establish one or more committees, recognizing that requirements for specific committees are likely to change over time and are different for particular companies.

The proposed regulation also requires the companies to amend their bylaws to provide that a quorum of "the board of directors is a majority of the board of directors and that a board member may not vote by proxy."[61] Fannie Mae's bylaws already provide that a majority of the Board members constitutes a quorum and that Board members may not vote by proxy.

Nevertheless, as with other parts of the proposed regulation, OFHEO's quorum requirement for Board meetings is inconsistent with Delaware law and the Model Act. Delaware law gives a corporation the flexibility to require that a quorum consist of either more than or less than a majority of the members of a board of directors, provided that in no event may less than one-third of the directors be considered a quorum.[62] Under the Model Act, a majority of the board of directors constitutes a quorum unless the articles of incorporation or bylaws state otherwise, provided that in no event may the articles of incorporation or bylaws authorize a quorum of a board of directors to consist of fewer than one-third of the total number of members of the board.[63] The reduced quorum option in these statutes provides useful flexibility for corporations with large boards of directors and does not detract from the functioning of boards subject to that option.

While Fannie Mae has no plans to change its bylaws with respect to these matters, it should not be unnecessarily restricted. OFHEO has not provided any rationale as to why the company should not have the flexibility provided by state corporate law in these areas.

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[61] Proposed § 1710.14; 66 Fed. Reg. 47562.

[62] DGCL § 141(b).

[63] Model Act § 8.24.

The proposed regulation also requires that the companies "establish and administer written conflict-of-interest standards that will provide reasonable assurance that the board members, executive officers, employees, and agents of the Enterprise discharge their responsibilities in an objective and impartial manner."[64] While this provision, at first, appears unobjectionable and consistent with Fannie Mae's current practice, Fannie Mae believes that OFHEO should not adopt this provision for two reasons. First, the proposed regulation imposes an unachievable standard on the companies. Although Fannie Mae can and does make conscientious efforts designed to provide reasonable assurance (through, for instance, the adoption and circulation of written conflict of interest standards) that its directors, employees and Board members act in an objective and impartial manner, it is not possible for the companies to "assure" or guarantee the state of mind of such individuals. It is for this reason that thoughtful legal standards require reasonable efforts, but do not require a guaranteed result.

Second, neither Delaware law nor the Model Act adopts an "assurance" standard for conflicts of interest. Instead, Delaware law and the Model Act, unlike the proposed regulation, create reasonable presumptions and offer safe harbor provisions with regard to interested director transactions in order to provide a framework that can be implemented in practice. For example, the obligation of directors under Delaware law to avoid self-dealing arises from their "duty of loyalty." Under Delaware law, a transaction between the corporation and an interested director will be valid if the "entire fairness" of the transaction may be established, which requires a showing of fair dealing and fair price.[65] The Model Act follows the same general approach.[66]

In summary, OFHEO provides no justification for adoption of its proposed process standards. Fannie Mae follows established corporate law and the NYSE listing standards. The standards prescribed by OFHEO will only create confusion and will remove needed flexibility.

*VI. The proposed regulation is confusing and internally inconsistent with respect to the corporate governance practices that Fannie Mae must follow.*

The proposed regulation relies on both state "corporate governance law" and the detailed director responsibilities and standards of conduct set forth in the proposed regulation, thus creating confusion as to how these potentially different standards should apply. Proposed section 1710.10 would require Fannie Mae to elect to "follow and be bound by the corporate governance practices

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[64] Proposed § 1710.14; 66 Fed. Reg. 47562.

[65] *Weinberger v. U.O.P., Inc.*, 457 A.2d 701 (Del. 1983).

[66] Model Act §§ 8.60 to 8.63.

and procedures" of the law of the District of Columbia, the Delaware law, or the Model Act.[67] Proposed sections 1710.20 and 1710.21, however, impose detailed director responsibilities and standards of conduct that conflict with the broad standards of care and loyalty envisioned by state corporate law and the Model Act and judicial decisions that have interpreted and applied those standards. If adopted, this contradictory regime would create confusion as to which standards and requirements apply to Fannie Mae and its officers and directors.

*VII. Provisions on compensation and enforcement of "other laws" raise serious legal questions.*

OFHEO's proposal contains several provisions that are unrelated to corporate governance practices and raise additional legal concerns. Proposed section 1710.12, which limits compensation of officers, directors and employees exceeds OFHEO's statutory authority under the 1992 Act and is inconsistent with recently enacted OFHEO regulations. It mandates that compensation of Fannie Mae directors, officers, and employees "shall not be in excess of that which is reasonable and commensurate with their duties and responsibilities and comply with applicable laws, rules, and regulations."[68] The 1992 Act specifically authorizes OFHEO to prohibit Fannie Mae from providing compensation to any executive officer that is not reasonable and comparable with compensation for employment in other similar businesses (including other publicly held financial institutions and major financial services companies) involving similar duties and responsibilities.[69] The statute clearly limits OFHEO's authority to *executive officers*; it does not mention directors and other employees. The 1992 Act also does not grant OFHEO broad discretion to determine what level of compensation is "reasonable and commensurate," as proposed by section 1710.12. The 1992 Act specifies that OFHEO must exercise its oversight in the context of what is "reasonable and comparable with compensation for employment in other similar businesses" – not what is reasonable and commensurate in general. OFHEO cannot through regulation broaden its express statutory authority.

OFHEO recently finalized its executive compensation regulation for Fannie Mae and Freddie Mac.[70] Adding an overlapping and inconsistent requirement in the instant proposal would be illogical and could lead to conflicting regulatory standards. Fannie Mae particularly objects to the definition of "executive officer" in proposed section 1710.2(l). This definition is inconsistent with

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[67] Proposed §1710.10; 66 Fed. Reg. 47561.

[68] Proposed §1710.12; 66 Fed. Reg. 47562.

[69] *See* 12 U.S.C. 4518.

[70] 66 Fed. Reg. 47550 (Sept. 12, 2001).

both the 1992 Act and the definition adopted in the recently finalized OFHEO rule on executive compensation.

Several of the provisions in the proposed regulation, including sections 1710.11(b)(2), 1710.12, 1710.20(a)(3) and 1710.21(a)(4), would require the Board or a Board committee to ensure compliance with other "applicable laws, rules and regulations." These provisions could be interpreted to authorize OFHEO to take enforcement action against Fannie Mae or an individual director for any conduct inconsistent with any federal, state or local "laws, rules, and regulations" including matters wholly unrelated to OFHEO's mission, such as tax and employment matters. Those unspecified other "laws, rules and regulations" are subject to enforcement authorities determined by Congress or the state government that enacted them. OFHEO's statutory enforcement authority is generally limited to violations of the 1992 Act and Fannie Mae's Charter. Congress neither intended nor authorized OFHEO to be the enforcer of all laws, rules, and regulations applicable to Fannie Mae and/or their directors. OFHEO cannot create authority for itself by issuing a regulation that Fannie Mae and its directors must comply with all such laws, rules and regulations.

Accordingly, the provisions discussed above should be withdrawn.

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In conclusion, we strongly urge OFHEO to withdraw the proposed rule in its entirety. Fannie Mae's existing corporate governance practices are at the forefront of best practices in this area. As the above comments demonstrate, the proposed regulation is unnecessary and far outside the mainstream of widely-followed corporate governance practices. Moreover, the proposed regulation is beyond OFHEO's authority in many respects. Fannie Mae has been fortunate in attracting high caliber directors to its Board and we are concerned that current and future Board members (as well as senior officers) will be deterred by the proposed regulations.

If OFHEO nevertheless determines that some agency action is justified, we strongly suggest that guidance on director conduct and responsibilities, similar to the guidance in the banking area, would be more appropriate. Another approach that could provide the clarity and predictability needed to maintain "best practices" and a well-qualified Board would be to adopt a state law standard. However such an approach needs to be given careful consideration since Fannie Mae does not have articles of incorporation in any state and state law cannot "wholesale" be applied to Fannie Mae. Consequently, for example, it would not be workable to designate all provisions of title 8 of the Delaware law as applicable to Fannie Mae. Any OFHEO rule would need to contain specific provisions designed to permit Fannie Mae to designate the appropriate state corporate governance law that should apply.

Moreover, in considering any such regulation, OFHEO should revise the selection of jurisdictions it permits Fannie Mae and Freddie Mac to choose from. Under the proposal, Fannie Mae and Freddie Mac may chose among the Delaware law, the Model Act or the jurisdiction of its principal office.

We believe that rather than referring to "jurisdiction of its principal office," any regulation should refer to the District of Columbia or Virginia, the two jurisdictions in which the companies have significant operations. Both Fannie Mae and Freddie Mac have offices in the District of Columbia and Virginia and should have the same range of options in selecting the state law which will govern their corporate governance practices.

Thank you for consideration of our views on the proposed regulation. Please do not hesitate to contact us with any questions or to discuss any of these matters further.

Sincerely,

Attachments