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Direct Dial
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General Counsel
Office of Federal Housing Enterprise Oversight
1700 G. Street, N. W.
Fourth Floor
Washington, D. C. 20552

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

Dear Mr. Pollard:

In light of my experience in the area of corporate governance and indemnification, Fannie Mae asked me to review the corporate governance regulations proposed by the Office of Federal Housing Enterprise Oversight ("OFHEO") on September 12, 2001. Accordingly, I respectfully submit the following comments.

I currently serve as Chairman of the American Bar Association's ("ABA") Committee on Corporate Governance. I am also a six-year member of the ABA's Committee on Corporate Laws, which writes and revises the Model Business Corporation Act (the "Model Act"). In this capacity, I led the task force that produced the third edition of the Corporate Director's Guidebook, published this year. I have served on four separate Blue Ribbon Commissions of the National Association of Corporate Directors ("NACD"): CEO Succession, Audit Committees, Role of the Board in Strategic Planning, and Board Evaluation. These associations are mentioned for purposes of establishing my credentials; I write to you in my individual capacity, and not on behalf of the ABA or the NACD. In my practice, I counsel corporate boards and board committees on a wide range of issues pertaining to corporate governance, and I have co-authored a book on director and officer indemnification, entitled Director and Officer Liability: Indemnification and Insurance. Earlier this year, I was a member of a five-person ABA delegation that visited South Africa to discuss corporate formation and governance in that country. Our delegation, whose travel was funded by the U.S.

Agency for International Development, met with senior South African government officials, legal groups, and business leaders as part of an assistance program designed to strengthen and increase participation in South African capital markets.

Based on my experience, I have a number of concerns about OFHEO's proposed rules. First, the proposed rules impose vague new standards on officers and directors of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation (the "Enterprises"), inconsistent with state law and the Model Act. The proposal requires each Enterprise to select a body of state law or the Model Act to govern its corporate governance practices, but then, rather than deferring to the selected body of law, the proposed rules enumerate specific duties and responsibilities that are not consistent with state law or the Model Act. Second, the proposal contains significant limitations on indemnification that will expose directors and officers to risk of personal liability, thereby deterring qualified applicants from serving on Enterprise boards. Finally, the proposed rules articulate no justification for subjecting the Enterprises to more stringent corporate governance standards than those applicable to other financial institutions and other businesses.

In short, I believe it would be unwise from a corporate governance perspective to adopt the rules as they are currently proposed. If OFHEO believes that formal corporate governance rules are necessary, it should defer to state law or the Model Act, which provide an established framework for corporate governance. Even deference to state law, however, would require OFHEO to address a number of issues not mentioned in the proposed rules, including state law requirements regarding a corporation's certificate of incorporation. My detailed comments follow.

I. The standards applicable to directors are unclear and inconsistent with established law and practice.

As noted above, proposed section 1710.10 requires each Enterprise to elect to follow and be bound by the corporate governance practices and procedures of a body of state law or the Model Act. Rather than permitting an Enterprise to be governed by the law it elects, however, the proposed rules prescribe a number of additional responsibilities and standards of conduct for Enterprise board members. In my view, the responsibilities and standards enumerated in proposed sections 1710.20 and 1710.21 are unclear and inconsistent with both state corporate law and the Model Act. Moreover, it is unclear what provisions of state law or the Model Act are encompassed by the term "corporate governance practices and procedures."

Proposed section 1710.20 requires each Enterprise board member to devote "sufficient time and attention" to his or her responsibilities, and to act "on a fully informed, impartial, objective, and independent basis; in good faith and with due diligence, care, and loyalty; in the best interests of the shareholders and the Enterprise; and in compliance with the chartering act of the Enterprise and other applicable laws, rules, and regulations." None of these terms is defined, and while some, such as the duty of care, are based on state law principles, the formulation is a mixture of elements from many sources and, as such, has no established meaning in the governance context. Proposed section 1710.21 goes on to provide a list of "minimum" board responsibilities, among them: (1) overseeing corporate strategy and performance; (2) hiring and retaining senior officers; (3) ensuring that compensation plans comply with applicable laws; (4) ensuring the integrity of accounting and financial reporting systems; (5) remaining informed of the condition of the Enterprise; (6) overseeing reporting and disclosure processes; and (7) ensuring the responsiveness of officers to federal regulators. This rigid list of responsibilities fails to take into account the fluid nature of the modern corporation. The proposed rules make the enumerated duties concrete and binding on Enterprise directors, rather than allowing board responsibilities to adjust to changing circumstances. Use of such a term as "ensure" is particularly inappropriate because no director or board can reasonably be expected to "ensure" conduct to any standard. Boards must necessarily make judgments based on expert advice, the work of board committees, management reports, and other relevant information. They are not insurers of corporate compliance but rather overseers.

Proposed sections 1710.20 and 1710.21 appear to be an attempt to codify the general duties of care and loyalty developed by state courts and the Model Act. Under section 8.30 of the Model Act, for example, a director is required to act in good faith and in a manner the director reasonably believes to be in the best interests of the corporation.[1] In addition, directors are expected to discharge their duties "with the care that a person in a like position would reasonably believe appropriate under similar circumstances."[2] The Model Act, as well as Delaware law, appropriately focuses on the manner in which directors perform their duties – not on the ultimate correctness of the decisions made. In contrast, OFHEO's proposed regulations eliminate the element of reasonable belief and employ a subjective, results-oriented analysis. Proposed section 1710.20 requires directors to act "in the best interests of shareholders and the Enterprise," without any reference to the directors' reasonable belief or good faith. As noted above, proposed section 1710.21 also unrealistically requires directors to "ensure" that a number of conditions and responsibilities are met. No such requirements can be found in state law or the Model Act. The proposed rules would permit OFHEO to second-guess directors' good faith actions in hindsight. This would

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[1] *See* Revised Model Business Corporation Act §8.30(a) (1999 ed.).

[2] Revised Model Business Corporation Act §8.30(b) (1999 ed.).

leave directors vulnerable when their informed actions – even those undertaken in good faith and reasonably believed to be in the company's best interests – subsequently prove unsuccessful. The proposed rules thus contradict the widely accepted notion that directors should be encouraged to be innovative and take business risks that they reasonably believe to be in the best interests of the corporations they serve.

The proposed rules also ignore the long-accepted business judgment rule, developed by state courts through years of experience and deliberation to encourage such decision-making. The business judgment rule presumes that in making or approving a business decision, a 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.[3] Accordingly, a director's business decisions "will not be disturbed if they can be attributed to any rational business purpose. A court under such circumstances will not substitute its own notions of what is or is not sound business judgment."[4] The rationale for the business judgment rule is that corporate law should encourage and protect informed business judgments, regardless of whether subsequent events prove those judgments right or wrong.[5] Delaware courts applying the business judgment rule have often stated that it affords a presumption that directors acted on an informed basis and in good faith.[6] OFHEO's proposed rules reflect no such presumption. In fact, the rules permit no deference whatsoever to the business judgment of the board in discharging its duties.

Similarly, the proposed rules fail to recognize the distinction the Model Act makes between standards of conduct and standards of liability for directors. As noted above, section 8.30 of the Model Act defines general standards of conduct for directors. Section 8.30 does not, however, deal directly with the liability of directors. Instead, standards of liability for directors are addressed in Model Act section 8.31. As the official comment to section 8.31 explains, "the fact that a director's performance fails to reach [the level of conduct set forth in section 8.30] does not automatically establish personal liability for damages that the corporation may have suffered as a

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3 *See* Aronson v. Lewis, 473 A.2d 805, 811-812 (Del. 1984). *See also* ABA Committee on Corporate Laws, *Corporate Director's Guidebook* 13 (3d ed. 2001).

4 Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971).

5 *See* The American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations*, Volume I, Part IV, 135 (American Law Institute Publishers 1992).

6 *See, e.g.,* Grobow v. Perot, 539 A.2d 180, 187 (Del. 1988).

consequence." Rather than imposing a results-oriented liability analysis, section 8.31 places the burden on the party challenging a director's action to prove: (1) that the challenged action was not 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. In contrast, the proposed rules specify no standard of liability and convey no clear burden of proof. Under the proposed rules, Enterprise directors will have no way of knowing when they can be held personally liable for perceived violations.

In short, I am concerned that the standards of conduct and responsibility in the proposed rules will impose new burdens on directors without recognizing established protections and presumptions of due care. If OFHEO's proposed standards are codified in formal regulations, they will be mandatory on Enterprise boards and will be enforced through OFHEO administrative proceedings and the possible imposition of civil monetary penalties.[7] It is contrary to accepted standards of corporate governance to bring proceedings based on such undefined standards. OFHEO should not subject directors to administrative penalties simply because, in hindsight, their informed, reasonable, good faith decisions are deemed unwise by OFHEO.

II. Indemnification of officers and directors is unduly restricted.

The indemnification provisions of the proposed rules are inconsistent with the approach to indemnification set forth in Delaware law and the Model Act and fail 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. All 50 states have statutory provisions covering 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, and for the expenses related to defending themselves. Indemnification provides officers and directors with reasonable protection from exposure to personal 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 Enterprise value. Each of the above policy considerations, however, must be balanced against the concern that indemnification might protect or encourage improper or wrongful conduct by corporate officers and/or directors. As pointed out in the introductory comment to the

[7] *See* 12 U.S.C.S. §4513(b)(5).

Model Act, "the goal of indemnification is to 'seek the middle ground between encouraging fiduciaries to violate their trust, and discouraging them from serving at all.'"[8] After lengthy deliberations and numerous drafts and amendments, both Delaware law and the Model Act strike a careful balance between these concerns. In contrast, the proposed rules do not adequately balance these concerns.

Proposed section 1710.30 provides that in OFHEO proceedings, an Enterprise may indemnify its officers and directors for legal expenses (presumably including advances to pay such expenses, although the proposed rules are not explicit on this point) if the board determines: (1) that the officer or director in question acted in good faith and in a manner he or she believed to be in the best interest of the corporation; and (2) that the indemnification payment will not materially adversely affect the Enterprise's safety and soundness. With regard to non-OFHEO civil actions or administrative proceedings, the proposed rules state only that an Enterprise may provide indemnification for legal expenses (again, presumably including advances) so long as such payments are in accordance with applicable law and will not have a material adverse affect on the Enterprise's safety and soundness. Such an approach undermines the purposes of indemnification. First, tying indemnification to the undefined "safety and soundness" concept creates a vague and uncertain standard. An Enterprise's officers and directors will be unable to determine in advance whether they will be protected by indemnification. Instead, OFHEO regulators will have wide latitude to determine, after the fact, what does and does not affect the safety and soundness of an Enterprise. Second, the proposed rules do not plainly state whether an Enterprise may provide advancement and indemnification to its officers and directors for the costs of investigations. Finally, the proposal does not clearly address whether indemnification for damage awards, fines, and amounts paid in settlement of non-OFHEO suits is permitted. By contrast, state statutes not only authorize indemnification for a wide range of damage awards against directors and officers but also permit corporate charters to limit or eliminate monetary liability of directors (and, in some cases, officers) for breaches of the duty of care.

The proposed limitations on indemnification also go well beyond any limitations found in Delaware lawand the Model Act. Section 1710.31 would prohibit an Enterprise from making indemnification payments for any legal expense incurred in an OFHEO administrative proceeding that results in a final order or settlement requiring the officer or director to pay a civil money penalty or cease and desist from or take any affirmative

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[8] Revised Model Business Corporation Act §§8.50–8.59, Introductory Comment at 8-84 (1999 ed.) (citing Johnston, *Corporate Indemnification and Liability Insurance for Directors and Officers,* 33 Bus. Law 1993, 1994 (1978)).

action. This broad prohibition is subject to two very narrow exceptions. First, the Enterprise would be permitted to purchase insurance covering legal expenses and the amount of any restitution owed to the Enterprise by an officer or director. Second, the Enterprise would be permitted to pay partial indemnification for legal expenses attributable to particular charges for which there has been a finding that the officer or director did not violate the law, engage in unsafe or unsound practices, or breach a fiduciary duty. This may mean that the officer or director could not recover the costs of such a successful defense until the proceeding reached the point of adjudication; the language is unclear as to advancement of the costs of defense in an OFHEO administrative proceeding. Any limitation on advances puts officers and directors at an unreasonable risk of funding defense costs in an OFHEO action out of pocket, even if they are ultimately successful (partially or wholly) and ultimately can receive reimbursement.

Section 145 of the Delaware General Corporation Law ("DGCL") and sections 8.50-8.59 of the Model Act, which address officer and director indemnification, contain none of these limitations. Section 145(a) of the DGCL and section 8.51 of the Model Act, which cover suits by third parties, permit indemnification of expenses, judgments, fines, and amounts paid in settlement if the persons to be indemnified acted in good faith and with a reasonable belief that their conduct was in, or not opposed to, the best interest of the corporation. Section 145(b) of the DGCL, which relates to derivative suits, permits indemnification for expenses; such expenses can be indemnified with judicial approval even if the person seeking indemnification has been found liable to the corporation. Section 8.51 of the Model Act contains a similar provision regarding the indemnification of officer and director expenses relating to derivative suits. Thus, unlike the proposed rules, neither the DGCL nor the Model Act imposes anything like a safety and soundness test before a corporation may authorize indemnification, even for derivative claims.

Furthermore, unlike the proposed rules, both the DGCL and the Model Act grant some absolute rights to indemnification. Section 145(c) of the DGCL provides for mandatory indemnification of expenses where the person to be indemnified has been "successful on the merits or otherwise." Section 8.52 of the Model Act likewise provides for mandatory indemnification of expenses where the person to be indemnified has been "wholly successful, on the merits or otherwise." These mandatory indemnification provisions are in stark contrast to the entirely permissive provisions in the proposed rules. Moreover, while the proposal is ambiguous regarding the advancement of expenses (as noted above), both section 145(e) of the DGCL and section 8.53(a) of the Model Act explicitly provide for advancement. Finally, recognizing that a certain degree of flexibility is necessary, both the DGCL and the Model Act contain a non-exclusivity provision. Section 145(f) of the DGCL expressly contemplates agreements that provide greater protection to officers, directors, and other persons than does the statute itself.

The Model Act, too, "does not preclude provisions in articles of incorporation, bylaws, resolutions, or contracts designed to provide procedural machinery in addition to (but not inconsistent with)" specific Model Act provisions.[9] Such a non-exclusivity provision is entirely absent in the proposed rules.

Although OFHEO indicates that it modeled the indemnification portion of the proposed rules on federal banking regulations, it does not explain why it did so. The provisions applicable to banks were enacted by Congress, and further developed by bank regulators, in response to devastating bank and thrift failures and resulting federal obligations to pay account holders for their losses. These circumstances are not applicable to the Enterprises. As noted above, unlike the FDIC regulations, for example, the proposed rules are unclear as to the advancement of expenses. Thus, without articulating any justification as to why the Enterprises should be subject to the restrictive standards of indemnification applicable to the banking industry, OFHEO has proposed what may be an even stricter regime for the Enterprises' officers and directors. The result can only be, as discussed below, to discourage qualified men and women from serving the Enterprises.

III. The proposed rules will dissuade qualified directors from serving on Enterprise boards.

As noted above, the proposed rules will subject Enterprise directors to heightened standards of care without recognizing the protections available under state law and the Model Act. These new burdens, when combined with the proposed limitations on indemnification, will in all likelihood deter qualified, thoughtful directors from serving on Enterprise boards. The Enterprises currently recruit exceptional, well-respected men and women to serve on their boards; such candidates are in high demand and can choose to serve on other boards not subject to such unusual burdens and limitations. The new standards also may distort board priorities and practices; they seem to assume that directors are in a position to micromanage day-to-day corporate operations in order to "ensure" compliance with multiple standards of conduct. Such an approach misconceives the proper role of directors, casting them as day-to-day managers rather than as strategic thinkers and overseers of corporate management. The result may well be too much attention to the details of corporate compliance and too little attention to overall strategic direction, management evaluation, and oversight.

I believe that it is important to set high goals to motivate corporate directors. At the same time, however, directors should not be subject to an unreasonable fear of

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[9] Revised Model Business Corporation Act § 8.59 & Official Comment at 8-126 (1999 ed.).

liability. The Model Act and other state corporate laws recognize that fairness to those who are willing to serve as directors is a core value of good corporate governance.[10] If directors believe they can be penalized for immaterial corporate failings or for unexpected results, they will not be in a position to exercise good and effective business judgment. Directors in constant fear of being sued or reprimanded will almost always pick the most conservative course of action – even when that course is not necessarily in the best long-term interests of the corporation. In my view, the proposed rules may prompt current Enterprise directors to resign and will almost certainly deter qualified applicants from agreeing to serve on Enterprise boards.

IV. Deference to state law is appropriate; additional regulatory requirements are unnecessary.

The proposed rules impose, without explanation or justification, an additional regulatory regime on top of state law, marketplace requirements, and current practices. I do not believe that additional corporate governance rules are necessary or appropriate for Fannie Mae. Based on my review, Fannie Mae already follows strong practices with respect to corporate governance. Fannie Mae has guidelines covering such areas as board committees, board policies, and conflicts of interest, and the company's shareholder-approved indemnification policy is consistent with Delaware law.

I am advised that Fannie Mae also undergoes annual examinations by OFHEO supervisory personnel. As stated in the OFHEO Examination Handbook (cited in the release accompanying the proposed regulations), OFHEO regulators examine the company's corporate governance practices, including board governance, management processes, audits, and management information. If these practices are judged inadequate or incomplete, OFHEO regulators may communicate with Fannie Mae's management, require corrective action plans, and evaluate the execution and effectiveness of proposed solutions. In addition, Fannie Mae is subject to marketplace discipline. As a New York Stock Exchange (NYSE) listed company, Fannie Mae must comply with NYSE corporate governance requirements regarding, among other things, independent directors, audit committees, quorums, voting rights, and shareholder approval. If the company fails to comply with any of these requirements, its securities may be delisted from the NYSE.

The proposed rules articulate no justification for imposing additional corporate governance requirements. It is not clear why Fannie Mae should be subject to more

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10 *See* The American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations*, Volume I, Part IV, 136 (American Law Institute Publishers 1992).

stringent standards than those applicable to other publicly held financial and other businesses, especially given the level of oversight currently exercised by OFHEO, the NYSE and Fannie Mae shareholders. If OFHEO believes that formal corporate governance rules are necessary in the public interest, I suggest that OFHEO defer to state law or the Model Act, without imposing additional requirements. As noted above, deference to state law would require OFHEO to address a number of issues not currently covered by the proposed rules, including state law requirements regarding a certificate of incorporation. In my opinion, allowing the Enterprises to look to established standards of corporate law would provide a better framework than the confusing mixture of governance regimes represented by the proposed rules.

I appreciate your consideration of my views. I would be happy to meet with you to discuss corporate governance issues in general, or to explain more fully how the proposed rules deviate from current practices. Please contact me with any questions or concerns.

Sincerely,

John F. Olson

JFO/jeb