March 27, 2001

BY ELECTRONIC MAIL AND COURIER

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General Counsel
Office of Federal Housing Enterprise Oversight
1700 G Street, NW, 4th Floor
Washington, DC 20552

Re: Comments on Proposed Regulation Regarding Executive Compensation, RIN 2550-AA13

Dear Mr. Pollard:

Fannie Mae respectfully submits this response to the Office of Federal Housing Enterprise Oversight's ("OFHEO") notice of proposed rulemaking regarding executive compensation. The proposed regulation would formalize what has previously been a more flexible, cooperative process of Fannie Mae's submission of information to permit OFHEO to perform its executive compensation oversight responsibilities. We understand that the proposed rule is intended to mirror current processes used by OFHEO.[1]

Statutory Framework

In converting Fannie Mae from a government agency to a shareholder-owned company, Congress envisioned a financial services institution that, like other such private institutions, would be controlled by a shareholder-elected Board of Directors responsible for the hiring and compensation of the company's employees, including its senior management. In the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (the "1992 Act"), Congress amended § 309 of Fannie Mae's Charter to provide the Board of Directors with the power to select officers and fix the compensation for their services as the Board determines is "reasonable and comparable with compensation for employment in other similar businesses (including other publicly held financial institutions or major financial services companies) involving similar duties and responsibilities, except that a significant portion of potential compensation shall be based on the performance of" Fannie Mae.[2] Congress recognized that, in order to fulfill its mission successfully, Fannie Mae, and its sister organization, Freddie Mac would have to pay "marketplace compensation" to attract and retain talented individuals.[3]

[1] 65 Fed. Reg. 81771 (Dec. 27, 2000).
[2] 12 U.S.C. 1723a(d)(2).
[3] H. Rep. 102-206, 102d Cong., 1st Sess. 54 (1991).

In the 1992 Act, Congress gave OFHEO – created principally as Fannie Mae and Freddie Mac's safety and soundness regulator – a narrow and precisely defined role in reviewing the Board of Directors' decisions with regard to executive compensation. First, the Director of OFHEO is authorized to "prohibit[] the payment of excessive compensation by [Fannie Mae] to any executive officer of the [company]."[4] This provision was not designed to insert OFHEO into the business decisions of the company regarding executive pay structures or levels, but rather solely to prevent compensation for the company's most senior executives that would be out of line with the industry generally.[5]

Second, the 1992 Act gives OFHEO a role in the termination agreements Fannie Mae may enter into with its executive officers upon the termination of their employment with the company. The Director of OFHEO must approve in advance any agreement with an executive officer that provides for a payment in connection with the officer's termination of employment.[6] The agreement is subject to approval if the benefits provided are comparable to benefits under similar contracts for officers of other public and private entities involved in financial services and housing interests who have comparable duties and responsibilities.

As set forth below, Fannie Mae believes that several provisions of the proposed rule are inconsistent with Congress' intent in the 1992 Act and Fannie Mae's Charter Act. Further the provisions would create an unnecessary burden on Fannie Mae and Freddie Mac, and might even make full implementation of the regulations more difficult. Accordingly, we offer the following comments to ensure that the regulations accurately reflect their authorizing statutory basis, and help make them more understandable and effective.

I. Definition of Executive Officer

In setting forth the proposed procedures regarding executive compensation, OFHEO defines the term "executive officer" as follows:

(1) The chairman of the board of directors, chief executive officer, chief financial officer, chief operating officer, president, vice chairman, any executive vice president, and any individual who performs functions similar to such positions whether or not the individual has an official title; and
(2) Any senior vice president (SVP) or other individual with similar responsibilities, without regard to title:
(i) Who is in charge of a principal business unit, division or function, or
(ii) who reports directly to the Enterprise's Chair, Vice Chair, Chief Operating Officer or President.[7]

[4] 12 U.S.C. § 4513(b)(8).
[5] See H. Rep. 102-206 at 52; S. Rep. 104-282 at 44. *See* 12 U.S.C. § 1318(b) (preventing Director from setting "a specific level or range of compensation).
[6] 12 U.S.C. 1723a(d)(3)(B).
[7] Proposed 12 CFR §1770.3(g).

Fannie Mae believes that OFHEO's definition of "executive officer" goes beyond the statutory definition in the 1992 Act, and, therefore, should be modified.

The 1992 Act defines "executive officer" as "the chairman of the board of directors, chief executive officer, chief financial officer, president, vice chairman, any executive vice president, and any senior vice president in charge of a principal business unit, division, or function."[8] Fannie Mae believes that the treatment of the most senior company officers in proposed § 1770.3(g)(1) is consistent with the 1992 Act.[9] However, with regard to which senior vice presidents should be considered executive officers,[10] Fannie Mae disagrees with OFHEO's apparent interpretation of the 1992 Act. In the preamble of the proposed rule, OFHEO incorrectly states that "[a] reading of the statute joined with an analysis of the job functions at the Enterprises could lead to a reasonable determination that all current senior vice presidents are subject to the [executive compensation provisions]."[11] Such a determination would not be reasonable and it would be inconsistent with the 1992 Act.[12] The 1992 Act considers only those "senior vice president[s] in charge of a principal business unit, division, or function" to be "executive officers." By including this qualification, Congress clearly expressed its intention that not all senior vice presidents would be automatically subject to this rule. Nor did Congress intend to include individuals who perform "similar responsibilities, without regard to title." To find otherwise is contrary to the plain language and intent of the statute.[13]

The 1992 Act's grant of authority over executive compensation extends only to a subset of those individuals carrying the title of "senior vice president" – only those senior vice presidents who are "in charge of a principal business unit, division, or function." This language requires a functional analysis of the job responsibilities of individual senior vice presidents. The most obvious reading of the phrase "in charge" limits the definition to a senior vice president who has direct and substantial management and policy-making authority over, and responsibility for, the strategic direction and activities of a "principal business unit, division, or function." Such management and policy-making authority and responsibility is inherent in any reasonable interpretation of the phrase "in charge."

In determining which senior vice presidents were "in charge of a *principal business* unit, division, or function," Fannie Mae reviewed various possible criteria including head count, budget, and committee membership, among others, and determined that none of them can be

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[8] 12 U.S.C. 4502(7).
[9] We note that under this definition the President of eBusiness is an executive officer.
[10] Proposed 12 C.F.R. § 1770.3(g)(2).
[11] 65 Fed. Reg. 81772 (Dec. 27, 2000).
[12] We also note that it is inconsistent with the definition of executive officer OFHEO has consistently used in the past.
[13] *See* 12 U.S.C. 4502(7). Moreover, including all senior vice presidents in the definition of executive officer would result in the designation of 43 individuals in a public company with only approximately 4000 employees. This is grossly out of line with the reporting of other financial institutions of comparable size and sophistication. In constructing a statutory executive compensation framework expressly based on comparability, Congress could not have intended to sweep in a large number of individuals completely inconsistent with other comparable companies. *See* 12 U.S.C. 4518(a).

used as a proxy for the plain language of the statute. The ordinary definition of "principal" is "first, highest, or foremost in importance."[14] The best indicators of Fannie Mae's principal business units, divisions or functions are our reportable business segments, the accounting equivalent of "principal business" under the 1992 Act.

Fannie Mae discloses annually in our Information Statement our reportable business segments pursuant to FASB's Financial Accounting Standard ("FAS") No. 131, Disclosures about Segments of an Enterprise and Related Information.[15] By utilizing the Financial Accounting Standards Board's ("FASB") concept of reportable business segments, the accounting equivalent of "principal business," Fannie Mae identified two lines of business in its financial statements as reportable business segments – its portfolio investment business and its credit guaranty business. These two reportable business segments account for virtually all of the revenue of the company.

Senior vice presidents who are "in charge" of the business units, divisions or functions related to the company's portfolio investment and credit guaranty business or who play a key role in the management and policy-making decisions that affect these principal lines of business are "executive officers." Using these criteria, eight senior vice presidents of the 33 individuals who hold the title are executive officers for purposes of the 1992 Act. These officers are the senior vice presidents for multifamily lending and investment, portfolio management, portfolio strategy, investor channel, single-family mortgage business, and administration, the Treasurer, and the General Counsel. Under Fannie Mae's current business model and division of management responsibilities, these are senior vice presidents who are primarily responsible for business units that generate significant revenue for the company or are integral to the effectuation of, and decision-making regarding, the business of all these units.[16]

There are 24 other officers in the company who hold the title "senior vice president" who are <u>not</u> "in charge of a principal business unit, division, or function," under the terms of the statute. These officers are senior vice presidents who function in support and administrative operations that assist the principal business units in their activities or who report to another senior vice president who is an "executive officer." They do not exercise broad independent

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[14] Webster's II New College Dictionary 879 (1995).

[15] Under FAS No. 131, a segment is defined as a component of an enterprise:

1. that engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same enterprise);
2. whose operating results are regularly reviewed by the enterprise's chief operating decision maker to make decisions about resources to be allocated to the segment and to assess its performance; and
3. for which discrete financial information is available.

[16] The senior vice presidents for portfolio management and portfolio strategy direct and manage Fannie Mae's portfolio investment business. The Treasurer plays a critical role in Fannie Mae's portfolio investment business by participating in the policy-making decisions regarding issuance of debt and mortgage derivative securities, the principal funding source for portfolio activities. The senior vice presidents for multifamily, single family and investor channel direct and manage the company's credit guaranty business. Although arguably not included under the statute's definition of executive officer, because of the key role the General Counsel and the Senior Vice President - Administration play in Fannie Mae's portfolio investment and the credit guaranty business units by providing decision determinative advice and guidance that directly affects the business activities in these units, the Board of Directors resolved to include them within the Company's formal designation of its executive officers.

policy-making authority on principal business issues. While each of the 24 senior vice presidents exercises a certain measure of discretion in performing assigned duties, the basic role of each is to implement business decisions made by the Office of the Chairman and the executive vice presidents (or another senior vice president who is an executive officer), rather than to make such decisions for Fannie Mae.

The relationship of a senior vice president's operating entity to Fannie Mae's principal business activities supports distinction among the senior vice presidents. If a senior vice president works in a department that only supports a revenue-generating activity (such as information services or credit), that senior vice president is not "in charge of a principal business unit, division, or function" and, therefore, should not be designated as an executive officer. Only senior vice presidents who are in charge of revenue-generating business units, divisions, or functions and those who play a key role in policy-making decisions that affect Fannie Mae's primary lines of business are executive officers. This distinction between senior vice presidents gives meaning to the qualification language and the intent of the statute.

Fannie Mae believes that OFHEO should defer to the company's determination of which officers are "executive officers" for these purposes because it is in the best position to know and understand the precise duties and responsibilities of its officers, which may change from time to time. To provide clarity and consistency on this point, Fannie Mae's Board of Directors passed a resolution designating which officers are "executive officers" for purposes of the 1992 Act and public disclosure statements. In the resolution, the Board certified the members of the Office of Chairman, all executive vice presidents, the President of eBusiness, the senior vice presidents for multifamily lending and investment, portfolio management, portfolio strategy, investor channel, single-family mortgage business, and administration, the Treasurer, and the General Counsel as "executive officers" of the company.[17] This designation will be reflected in public documents listing the company's "executive officers," including the proxy and Information Statement. Pursuant to the resolution, the Board will designate the appropriate executive officers annually. OFHEO can and should rely upon these formally approved Board designations.

The 1992 Act is clear: only senior vice presidents in charge "of a principal business unit, division or function" are covered in the definition of "executive officer." OFHEO's inclusion of: (a) senior vice presidents who are in charge of units that are not "principal business unit[s], division[s], or function[s];" (b) all senior vice presidents who report directly to the Chair, the Vice Chair, the COO or President, without regard to their duties;[18] and (c) any person who performs similar functions, regardless of title, are all extensions of OFHEO's authority without support in the statute. These provisions should be dropped from any final rule.

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[17] Notably, the Board's resolution is consistent with the provisions of other financial institutions of comparable financial size and sophistication such as Citigroup, Wells Fargo, Chase Manhattan and American Express who in recent years have designated no more than 17 individuals as executive officers, even though these entities have broader lines of business and many more employees than Fannie Mae.

[18] Although in the past OFHEO, as a matter of convenience, has identified senior vice presidents who report directly to the Chair, the Vice Chair, the COO or President, without regard to their duties, as "executive officers" this distinction would not necessarily include senior vice presidents who are covered by a functional interpretation of the statute.

II. Safety and Soundness

While Fannie Mae recognizes that the 1992 Act provides OFHEO with exclusive authority to prohibit the company from engaging in excessive compensation practices, this authority is separate and distinct from OFHEO's authority regarding safety and soundness matters.[19] OFHEO has inappropriately intertwined these issues in the proposed regulation. OFHEO's proposal states that any violation of the proposed executive compensation regulations (including failure to make timely information submissions) would constitute an "unsafe and unsound" practice and thus warrant "corrective or remedial action." See 65 Fed. Reg. at 81,773; proposed 12 C.F.R. § 1770.5(c). This is contrary to the established judicial understanding of the term "unsafe and unsound practices," which is limited to actions that threaten the very financial integrity or stability of the regulated entity.[20] As currently drafted, the rule could be interpreted to enable OFHEO to take far more drastic measures in response to a violation of the executive compensation regulations than simply preventing the compensation from occurring – even if those violations do not threaten a company's safety and soundness. We believe that regulatory action to correct excessive executive compensation should be narrowly tailored to address the alleged problem – and not be needlessly broad. That is, we believe that under the 1992 Act, OFHEO does not have broad authority to take the same types of remedial and corrective actions that are appropriate when there is a serious risk that a company may become insolvent, whenever it believes that a particular executive compensation action is contrary to its regulations. For these reasons, Fannie Mae recommends that OFHEO delete proposed Section 1770.5(c) of the proposed rule and revise proposed Section 1770.5(d) to exclude the reference to "corrective and remedial action."

III. Submission Requirements

Under proposed section 1770.4(b)(2), Fannie Mae and Freddie Mac would be required to submit the portions of the minutes of the Board meetings relating to executive compensation and supporting materials of the Committee responsible for compensation within a week of the date when the meeting was held. Fannie Mae would not be able to meet these timing requirements because the minutes of a particular Board meeting are prepared after that meeting and adopted at the next Board meeting. Thus, OFHEO should amend the rule to allow the portion of the minutes of Board of Directors relating to executive compensation and supporting materials of the Committee responsible for compensation to be submitted within a week following the adoption of the minutes of the Board meeting. In addition, based on our current practice, we would like to confirm our understanding that "supporting materials" means copies of compensation documents referenced in the minutes or incorporated by reference into the Board or Committee resolutions.

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[19] *See* 12 U.S.C. 4513(b)(5).

[20] See, e.g., Johnson v. OTS, 81 F.3d 195, 204 (D.C. Cir. 1996) (citations omitted) (the "weight of case law hold[s] that '[t]he unsafe or unsound practice provision . . . refers only to practices that threaten the financial integrity of the association"); Seidman v. OTS, 37 F.3d 911, 926 (3d Cir. 1994) (holding that "[t]he imprudent act must pose an abnormal risk to the financial stability of the banking institution. This is the standard that the case law and legislative history indicate we should apply in judging whether an unsafe or unsound practice has occurred"); Hoffman v. FDIC, 912 F.2d 1172, 1174 (9th Cir. 1990) (describing FDIC's authority under 12 U.S.C. § 1818(b)(1) to issue a cease-and-desist order based on unsafe and unsound practice and citing definition used in Gulf Fed. Sav. & Loan Ass'n v. FHLBB, 651 F.2d 259, 264 (5th Cir. 1981) *cert. denied* 458 U.S. 1121 (1982)).

Fannie Mae also urges OFHEO to clarify section 1770.4(b)(8), which requires the submission of "[i]nformation regarding the hiring of and payment of compensation to an executive officer for whom a contract remains under negotiation." Fannie Mae interprets this requirement to apply to a situation where an executive officer has been hired, but portions of the executive compensation benefits continue to be negotiated. Under such circumstances, Fannie Mae would notify OFHEO of the hiring of the individual and submit information regarding the portions of the compensation that were completed. Information regarding portions of the compensation under negotiation would not be submitted until finalized.

IV. Prior Approval of Termination Benefits

Fannie Mae urges OFHEO to clarify the nature of the information relating to termination benefits that is requested under proposed section 1770.4(c)(3)-(5).[21] Fannie Mae interprets this provision to require Fannie Mae to obtain prior approval of changes in a "top hat" plan such as Fannie Mae's Executive Pension Plan, because it is a plan that benefits only executive officers (and, indeed, only a subset of those officers). Consistent with our current practice, we assume that this provision does not apply to benefits available under a general welfare and benefit plan that is available to a wider employee population. Most of our benefit and welfare plans have standard provisions spelling out rights that an employee has upon departure from Fannie Mae, whether by resignation, retirement, death or disability. For administrative and fiduciary reasons, under ERISA and other benefit laws and regulations, we are required to address a participant's rights under the plans under each of these circumstances. We do not believe that the statute requires OFHEO's prior approval for such post-employment benefits because they are part of an executive's compensation package throughout his or her tenure at the company. The purpose of requiring OFHEO's prior approval of termination benefits was aimed at special benefits provided to executives at the time of termination, rather than normal welfare benefit plan termination provisions.[22] Moreover, if OFHEO were to review such post-employment benefits in connection with an executive's termination, it would in essence be reviewing those benefits twice – once in connection with its periodic review of a company's executive compensation practices and once as part of its prior approval of termination benefits. We do not believe that this was the intent of Congress or of OFHEO in drafting the proposed regulation.

We note that in implementing their authority over executive termination benefits, bank regulators have specifically exempted qualified retirement plans, non-qualified "bona fide" deferred compensation plans, nondiscriminatory severance pay plans, other types of common benefits, certain segments required by law and death benefits.[23] Fannie Mae requests that the final rule clarify OFHEO's intent not to exercise prior approval over such benefits.

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[21] Under section 1770.4(c)(3)-(5), all relevant information must be provided to OFHEO when Fannie Mae –

(3) Takes any other action to provide termination benefits to a specific executive officer, regardless of how it is effected;

(4) Makes any changes in post employment benefit programs affecting multiple executive officers; or

(5) Changes the termination provisions of other compensation programs affecting multiple executive officers.

[22] *See* 137 Cong. Rec. H6840 (daily ed. Sept. 25, 1991) (statement of Rep. Schumer).

[23] 12 C.F.R. § 359.0.

Fannie Mae also requests that OFHEO clarify proposed § 1770.4(d). This provision would require Fannie Mae to submit certain specific information and data before entering into an individual termination agreement with an executive officer so the agency can "calculate an executive officer's total termination or severance benefits package."[24] The timing requirement could be interpreted to prevent Fannie Mae from entering into an agreement with a potential officer or departing officer prior to OFHEO approval. This is inconsistent with OFHEO's current practice and proposed §1770.5, which allows Fannie Mae to enter into an agreement containing termination provisions provided the agreement specifies that the provisions are not effective until approved.

V. Confidentiality

Finally, because the compensation information requested by OFHEO in the proposed rule is of a nonpublic nature, Fannie Mae is highly concerned about the possibility that such information could be inadvertently released to the public, and cause Fannie Mae competitive and economic harm. For example, if compensation information about individual executive officers were to become publicly available, other employers and executive search firms could calibrate exactly what it would take to make an attractive compensation proposal to our executives. Because of this concern, we request that, with respect to all compensation information, excluding the information we disclose in the proxy statement and the annual report to Congress, OFHEO follow the procedures adopted by OFHEO examiners who conduct their examinations on site when reviewing highly sensitive information. Of course, this information is exempt under the Freedom of Information Act exemptions that bar release of trade secrets or examination, operating or condition materials.[25]

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As noted above, Fannie Mae supports OFHEO's efforts to promulgate rules that will assist the agency in performing its statutory executive compensation oversight responsibilities. As OFHEO has consistently concluded in the past, we pay our executives fairly – not excessively – and we are committed to continuing this practice in the future in compliance with this rule once promulgated. Thank you for your consideration of our views.

Sincerely,

Ann M. Kappler

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[24] 65 Fed. Reg. 81773.

[25] *See* 12 C.F.R. § 1703.11.