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Sent via email to RegComments@OFHEO
and hand delivery

June 7, 2004

Alfred M. Pollard
General Counsel
Attention: Comments/RIN 2550-AA24
Office of Federal Housing Enterprise Oversight
Fourth Floor
1700 G Street, NW
Washington, DC 20552

Re: RIN 2550-AA24, Department of Housing and Urban Development, Office of Federal Housing Enterprise Oversight, Proposed Amendments to the Rules on Corporate Governance

Dear Mr. Pollard,

Thank you for the opportunity to comment on the Office of Federal Housing Enterprise Oversight's (OFHEO) proposed corporate governance rules applicable to the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). While Ernst & Young does not serve as the independent auditor of either affected entity, the proposed rules raise issues we find worthy of comment.

First, we wish to congratulate OFHEO on its focus on enhanced corporate governance. Your proposed regulations promote a higher level of transparency and enhanced corporate governance by subjecting Fannie Mae and Freddie Mac to the requirements of the Sarbanes-Oxley Act of 2002 and implementing rules and regulations of the Securities and Exchange Commission (SEC), whether or not they are registered with the SEC. We also are fully supportive of the proposed rules on requirements and responsibilities of the board of directors and board committees. Among other things, your proposed rules would require that the committees of the board of directors comply with the applicable New York Stock Exchange (NYSE) rules. The NYSE rules address the independence of the audit committee members, the audit committee's responsibility to select and oversee the issuer's independent accountant, and a requirement that there be a procedure for handling complaints regarding the issuer's accounting practices. We believe strongly that enhancing the role of audit committees, as required under the Sarbanes-Oxley Act and the NYSE rules, yields many benefits not the least of which is overseeing the work and independence of the external auditor.

The proposed regulation, however, would add a new requirement for mandatory audit firm rotation, which was not part of the Sarbanes-Oxley Act of 2002, and which was a reform considered, and later rejected, by Congress. We do not believe that laws or rules mandating the periodic rotation of audit firms are in the public interest. Rather, we believe the audit committee should be charged on a continual basis with reviewing the work and independence of the audit firm as part of its decision to hire and fire a firm. For the reasons set forth below, OFHEO may find that, at this time, mandatory audit firm rotation may not be a necessary or appropriate reform for Freddie Mac and Fannie Mae in light of the other reforms that are being implemented in your proposed regulations.

The GAO Study found that mandatory audit firm rotation might not be the most effective way to strengthen auditor independence

The Sarbanes-Oxley Act of 2002 included reforms to strengthen auditor independence and improve audit quality. Mandatory audit firm rotation was considered as a reform to enhance auditor independence but was rejected by Congress as unnecessary. Instead Congress mandated more rigorous audit partner rotation requirements and combined this reform with enhanced oversight, strict independence rules and increased scrutiny by the audit committee. Congress also asked the GAO to study and report on the potential effects of mandatory audit firm rotation. GAO completed its report in November 2003 (GAO-04-216).

GAO conducted extensive surveys and interviews of the CFOs and audit committee chairs of Fortune 1000 publicly-traded companies, institutional investors, stock market regulators, bankers, accountants, and consumer advocacy groups. GAO broke its questions into three groups:

1. Is the independence of a public accounting firm auditing a company's financial statements adversely affected by a firm's long-term relationship with the client and the desire to retain the client?

2. Do the Sarbanes-Oxley Act's requirements for reform accomplish the intended benefits of mandatory audit firm rotation?

3. Would the intended benefits of mandatory audit firm rotation outweigh the costs and loss of company-specific knowledge gained by an audit firm through years of experience auditing the client?

A substantial majority of the interviewees believed that the costs of mandatory audit firm rotation are likely to exceed the benefits. The interviewees felt that the current requirements for audit partner rotation, auditor independence, and other reforms when fully implemented will sufficiently achieve the intended benefits of mandatory audit firm rotation. The GAO concluded:

> "*GAO believes that mandatory audit firm rotation may not be the most efficient way to strengthen auditor independence and improve audit quality considering the additional financial costs and the loss of institutional knowledge of the public*

company's previous auditor of record, as well as the current reforms being implemented…GAO believes audit committees, with their increased responsibilities under the act, can also play an important role in ensuring auditor independence."

Other Items to Consider - Company-specific Experience Benefits the Quality of an Audit

1. The auditor's knowledge of the client enhances audit quality

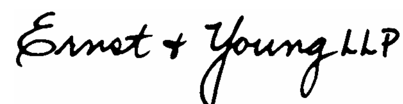
The auditor must understand the client's business to audit it effectively. Given the complexity of today's global business environment, it is imperative for the auditor to be highly knowledgeable of the client's business and industry. Knowledge is cumulative and is built up over a number of years, and must be leveraged for the benefit of the investors. Audit partner rotation balances the need for a fresh look with the need to always have a competent and knowledgeable team of auditors. The current rules provide a fresh look by limiting both the lead and concurring partners to a maximum of five consecutive years of service in those roles and then requiring them to rotate off for at least five years, and by limiting other audit partners to a maximum of seven consecutive years of service with at least a two year break in service.

2. Studies have found that audit failures occurs more often when the auditor is performing a first or second audit of a company

A study of U.S. public companies between l987 and l997 found that audit failures were much more likely to occur during the last year of the outgoing auditor and in the first few years of the incoming auditor. AICPA research into 406 cases of audit deficiencies involving member firms between l979 and l991 found that alleged audit failures occurred almost three times as often when the auditor was performing a first or second audit of a company. (Statement of Position Regarding Mandatory Rotation of Audit Firms of Publicly Held Companies by the AICPA from their l992 Quality Control Inquiry Committee of the SEC Practice Section).

Our firm will continue to champion reform that enhances quality audits and transparency. We again applaud your proposed regulations to enhance corporate governance within Fannie Mae and Freddie Mac. However, we ask you to reconsider your proposal on mandatory audit firm rotation because studies and experience have shown that such a requirement may not be in the public interest. If you have any questions, please contact Randy Fletchall at (212) 773-4043.

Sincerely,



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