Freddie Mac

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By Electronic Mail

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Office of Federal Housing Enterprise Oversight
1700 G Street, NW
Fourth Floor
Washington, DC 20552

Re: **Corporate Governance, Proposed Regulation**
69 *Fed. Reg.* 19126 (April 12, 2004), RIN 2550-AA24

Dear Mr. Pollard:

Freddie Mac appreciates the opportunity to comment on the regulations proposed by the Office of Federal Housing Enterprise Oversight ("OFHEO") concerning corporate governance at Freddie Mac and Fannie Mae (the "Enterprises"). Our views are set forth below.

Freddie Mac is fully committed to meeting or exceeding "best practices" in corporate governance. In addition to meeting all applicable corporate governance requirements set forth in the Sarbanes-Oxley Act,[1] the corporate governance regulations issued by OFHEO[2] and the Securities and Exchange Commission ("SEC"),[3] and the listing standards of the New York Stock Exchange ("NYSE"),[4] Freddie Mac has taken a number of other actions that demonstrate that commitment.

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[1] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-24, 116 Stat. 745-810, codified at 15 U.S.C. §§ 7201 et seq. Most of the provisions of Sarbanes-Oxley will not in fact apply to Freddie Mac until it completes the voluntary registration of its equity securities under the Securities Exchange Act of 1934, which Freddie Mac has publicly committed to do. However, Freddie Mac is already complying voluntarily with the governance-related requirements of the Act.

[2] 12 CFR Part 1710.

[3] *E.g.*, SEC Rel. No. 33-8177 (Jan. 23, 2003) (68 F.R. 5110) (Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002); SEC Rel. No. 33-8183 (Jan. 28, 2003) (68 F.R. 6006) (Strengthening the Commission's Requirements Regarding Auditor Independence); SEC Rel. No. 33-8183 (April 9, 2003) (68 F.R. 18788) (Standards Relating to Listed Company Audit Committees).

[4] New York Stock Exchange Listed Company Manual, § 303A.

Freddie Mac has already taken a series of steps, several of which were called for by the Consent Order to which OFHEO and Freddie Mac agreed on December 9, 2003, that address many of the requirements of the proposed regulations. These include a commitment to separate the positions of Chairman and Chief Executive Officer within a reasonable period of time, adoption of a term limit and retirement age for service on Freddie Mac's Board of Directors, a commitment to hold at least eight Board meetings annually and appointment of a Chief Compliance Officer and a Chief Enterprise Risk Officer.

Freddie Mac has also taken other steps to strengthen the company's corporate governance policies and practices. For example, since the fall of 2003, the Board of Directors and management have been working with Professor Charles M. Elson, an acknowledged expert in the area. In addition to appointment of a Chief Compliance Officer, the Board has strengthened the Codes of Conduct for both employees and members of the Board to ensure that they meet the highest standards of corporate governance and are in full compliance with the applicable requirements of Sarbanes-Oxley and the NYSE corporate governance rules. And, during the second half of 2003, Freddie Mac conducted a newly-designed training program on Sarbanes-Oxley and the Code of Conduct for its employees.

The Board has taken several steps relating to the Audit Committee as well. For example, in addition to undertaking a comprehensive review and revision of the Committee's charter to reflect best practices as well as regulatory requirements, the newly-appointed Chair of the Board's Audit Committee qualifies as an "audit committee financial expert" under SEC standards. The Board also has established a subcommittee of the Audit Committee which meets regularly to oversee the preparation of the financial statements for 2003 and 2004.

I. General Comments

Freddie Mac recognizes the importance of the objectives that OFHEO is seeking to achieve through its corporate governance regulations and the amendments that OFHEO has recently proposed to those regulations. Nonetheless, some of the proposed provisions deprive Freddie Mac of important management flexibility. In Freddie Mac's view, the Enterprises should be permitted to retain the discretion to choose among valid, alternative business models.

In addition, the incorporation by reference of requirements from Sarbanes-Oxley, the SEC's implementing regulations and/or the NYSE corporate governance listing standards raises several concerns that cut across a number of provisions of the proposed regulations. First, Freddie Mac believes that any such provision of OFHEO's regulations should expressly be made co-extensive with the underlying statutory or regulatory requirement that is incorporated, as that requirement may be changed and/or interpreted from time to time by the body that issued and/or enforces it (*i.e.*, Congress, the SEC or the NYSE, respectively). The Enterprises will in any event be subject to the underlying statutory provisions and SEC and NYSE requirements, and the SEC and NYSE already have the responsibility to interpret and implement those requirements for all companies to which they apply. The Enterprises should not also be required to look to OFHEO for a potentially different, and possibly conflicting, interpretation of the same requirements.

A further issue related to the incorporation by reference of provisions of Sarbanes-Oxley and related SEC regulations arises from the fact that many of those provisions will not apply to

Freddie Mac until it has completed the voluntary registration of its securities under the Securities Exchange Act of 1934. Freddie Mac already is meeting most of those Sarbanes-Oxley and related SEC requirements, and Freddie Mac supports OFHEO's overall objective of making them mandatory for Freddie Mac even before it completes the registration process (or in the highly unlikely event that Freddie Mac somehow "deregistered" in the future). However, in the case of certain Sarbanes-Oxley requirements that relate to certification of Freddie Mac's financial disclosures and to possible disgorgement in the event of a restatement, OFHEO's regulations should make clear that Freddie Mac is not required to comply with those requirements before it returns to timely issuance of its financial statements and completes the voluntary registration process, at which time those provisions will become applicable to Freddie Mac by their own terms. As discussed in the detailed comments below, Freddie Mac believes that this issue can best be dealt with by addressing separately, in each individual substantive requirement of the proposed regulations, whether the provision will apply prior to completion of the voluntary registration process. Proposed § 1710.19(c)(1) would then appropriately be revised to apply only to the application of those provisions in the unlikely event that Freddie Mac ever sought to "deregister" its securities, a situation for which there is no need to distinguish among the various Sarbanes-Oxley provisions.[5]

II. Comments on Specific Proposed Provisions

Proposed regulatory provisions as to which Freddie Mac has specific comments are set forth below, in bold-faced type. They are reproduced as they would appear in the context of the current regulations, with underscoring used to indicate new language as proposed by OFHEO. Freddie Mac's comments with respect to each such provision are set forth immediately below the provision.

§ 1710.11 Board of Directors.

(a) Membership. (1) Chairperson and chief executive officer. Effective January 1, 2007, the chairperson of the board of directors of an Enterprise may not also serve as the chief executive officer of the Enterprise.

Freddie Mac has committed to OFHEO, and announced to the public, that it will separate the positions of Chairman and CEO, and Freddie Mac intends to honor that commitment. However, it is possible that as a result of future changes in circumstances, for at least some period of time, Freddie Mac's Board might determine that having a single person serve as Freddie Mac's Chairman and CEO would further the interests of safety and soundness or otherwise be more effective for the Company than having two separate individuals occupy those positions. For example, a situation (such as that currently facing Freddie Mac) in which the company needs to undergo substantial change may make it advisable that a single

[5] Freddie Mac also believes that certain aspects of the proposed amendments, as well as aspects of the current regulations, exceed OFHEO's statutory authority. With respect to both the current regulations and the proposed amendments, Freddie Mac incorporates by reference and preserves the arguments concerning OFHEO's statutory authority that it presented in its comments concerning the existing regulations as proposed by OFHEO in 2001, particularly regarding the scope of OFHEO's safety and soundness authority. Comments of Freddie Mac in RIN 2550-AA20, submitted December 13, 2001, http://www.ofheo.gov/Media/Archive/docs/regs/cgfreddie.pdf ("2001 Comments"), at pp. 2-4. Additional comments relevant to specific aspects of OFHEO's current proposal are set forth below.

individual occupy both leadership positions in order to accomplish that objective. The regulations therefore should include a mechanism for an Enterprise to seek, and for OFHEO to grant, a waiver from this requirement under appropriate circumstances for an appropriate period of time.

(a)(2) Limits on service of board members. No director of an Enterprise may serve on the board of directors for more than 10 years or past the age of 72, whichever comes first.

Freddie Mac's Board of Directors has adopted Corporate Governance Guidelines ("Guidelines") that contain the 10-year term limit and retirement age of 72 proposed in the regulations.

However, it is important that reasonable transition provisions, such as those that the Board included in Freddie Mac's Guidelines, be included to avoid potentially harmful disruption to the Board. OFHEO itself noted in its December 2003 Report of Special Examination that a transition period may be necessary to permit an orderly turnover of Directors.[6]

Freddie Mac recognizes the objectives that OFHEO seeks to achieve through its proposed term limit and retirement age, as demonstrated by the Board's adoption of the same limits in Freddie Mac's Guidelines. However, it also is important, particularly in a business as complex as that of Freddie Mac, that the Board have (i) highly qualified Directors, and (ii) adequate continuity, and the benefit of the knowledge and experience concerning prior business operations, regulatory requirements, and Board deliberations that result from such continuity. The imposition of the proposed term limits without a transition period would deprive the Board of that important continuity and experience with Freddie Mac's operations and would exacerbate an already difficult recruiting challenge faced by the Board.[7] Application of the proposed term limits and retirement age without any transition provisions therefore could significantly threaten the Board's ability to oversee Freddie Mac's business effectively, and thus have a result contrary to OFHEO's objective. To avoid such a result, the regulations should include a mechanism for an Enterprise to seek, and for OFHEO to grant, a

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[6] See OFHEO Report of the Special Examination of Freddie Mac (December 2003), at 166, n. 487.

[7] By operation of Freddie Mac's Guidelines and other developments, including changes in the Board that took place at its stockholders' meeting on March 31, 2004, and additional changes that are anticipated to occur at the next stockholders' meeting expected later this year, the Board expects that it will need to fill four elected positions on the Board at the next shareholders' meeting later this year. (Ms. Donoghue and Mr. Ledman are serving as Directors on an interim basis, pending identification by the Board of suitable outside candidates. In addition, two of the Board's remaining original Directors will be required by the Guidelines to leave the Board as of the next shareholders' meeting.) If the proposed regulations were adopted later this year without providing for a transition period, three additional positions – or a total of seven positions -- would have to be filled when the regulations become effective. Even if qualified Directors to fill all of those seats could be identified and recruited, fifteen of the eighteen Directors who were on the Board as of June 1, 2003, would have left the Board by the end of this year if the proposed regulations were to go into effect by that time without a transition period. (Eleven elected Directors would have left, as well as four of the five Presidential appointees; the Office of Counsel to the President has informed Freddie Mac that the President does not intend to reappoint any of his current appointees, but Ms. Engler was elected to the Board by the stockholders on March 31, 2004.) Thus, only three Directors who would be serving as of the end of the year would have served as long as eighteen months on the Board.

limited waiver providing for an appropriate transition schedule for replacement of those Directors who would become subject to the term limit provision when the regulations become effective.

Freddie Mac also believes that there should be some ongoing flexibility with respect to the term limit and retirement age requirements. For example, a Director who would otherwise be required to leave the Board might be playing a critical role, perhaps as a Committee chair, in an important Board activity that is in process and that would suffer if that Director could not remain on the Board for an additional term to see that activity through to completion. Alternatively, the unexpected departure of one Director from the Board could make it important to temporarily extend the tenure of another Director with similar expertise who might otherwise be scheduled to leave the Board under the term limit or retirement age provisions. The waiver mechanism discussed above therefore also should permit an Enterprise to seek, and OFHEO to grant, an extension of up to one term for a Director when justified by special circumstances.

(3) Independence of board members. A majority of seated members of the board of directors of an Enterprise shall be independent board members, as defined under rules set forth by the NYSE.

Freddie Mac supports this provision. Freddie Mac's Guidelines go beyond the requirements of the provision and of the corresponding provision of the NYSE listing standards, by requiring that a "substantial majority" of Freddie Mac's Directors be independent. For the reasons discussed in its "general comments" above, Freddie Mac believes that this provision should expressly be made co-extensive with the corresponding NYSE rule that is incorporated by reference, as that rule may be interpreted or changed from time to time by the NYSE.[8]

(b) Meetings, quorum and proxies, information, and annual review.

(1) Frequency of meetings. The board of directors of an Enterprise shall meet at least twice a quarter to carry out its obligations and duties under applicable laws, rules, regulations, and guidelines.

Freddie Mac supports the objective of this proposed provision. Freddie Mac's Guidelines require that the Board meet at least eight times per year, the same minimum number of meetings that OFHEO's proposed provision would generate, and Freddie Mac anticipates that the Board will generally meet more than eight times each year. However, there may be circumstances under which holding two meetings within a single quarter could be unnecessary in light of current needs or logistically difficult. Freddie Mac believes that OFHEO's objective could be effectively accomplished by requiring a minimum of eight meetings per years with at least one meeting in each calendar quarter, and OFHEO could express its expectation that two meetings would normally be held in each quarter.

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[8] For example, the provision could be revised in the following manner: "A majority of seated members of the board of directors of an Enterprise shall be independent board members, in accordance with the applicable rules of the NYSE, as such rules may be interpreted and amended from time to time by the NYSE." Similar changes could be made to other proposed provisions incorporating rules issued by the NYSE and/or the SEC.

(4) Information. Management of an Enterprise shall provide a board member of the Enterprise with such adequate and appropriate information that a reasonable board member would find important to the fulfillment of his or her fiduciary duties and obligations.

Freddie Mac supports the objective of this proposed provision. However, in order to ensure that there is a body of law to which Freddie Mac can look for guidance in complying with this provision, and to ensure consistency with its election under § 1710(b) to follow the corporate governance practices and procedures of the Commonwealth of Virginia, Freddie Mac believes that this provision should be clarified by adding the phrase "consistent with the requirements of the state corporate governance law selected by the Enterprise pursuant to section 1710.10(b)" at the end of the provision.

(c) Required committees. An Enterprise shall provide for the establishment of, however styled, the following committees of the board of directors, which committees shall be in compliance with the charter, independence, composition, expertise, duties, responsibilities, and other requirements set forth under section 301 of the Sarbanes-Oxley Act of 2002, Public Law 107-204 (Jul. 30, 2002), as from time to time amended (SOA), with respect to the audit committee, and under rules issued by the NYSE, as from time to time amended (NYSE rules): (1) Audit committee; (2) Compensation committee; and (3) Nominating/corporate governance committee.

For the reasons discussed in its "general comments" above, Freddie Mac believes that this provision should expressly be made co-extensive with the corresponding NYSE rules issued pursuant to Sarbanes-Oxley, which are incorporated by reference, as those rules may be interpreted or changed from time to time by the responsible bodies.

§ 1710.13 Compensation of board members, executive officers, and employees.

(a) General. Compensation of board members, executive officers, and employees of an Enterprise shall not be in excess of that which is reasonable and appropriate, shall be commensurate with the duties and responsibilities of such persons, shall be consistent with the long-term goals of the Enterprise, shall not focus solely on earnings performance, but shall take into account operational stability and legal and regulatory compliance as well, and shall be undertaken in a manner that complies with applicable laws, rules, and regulations.

This proposed provision should be modified to follow more closely the text of the applicable statutory provisions.[9] Those provisions specify that Freddie Mac compensation that is

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[9] Freddie Mac notes that it believes the proposed provision, as currently worded, as well as the existing regulatory provision, exceed OFHEO's statutory authority to regulate compensation in several respects, including the following:

- Neither Freddie Mac's Charter Act (the "Charter Act") nor OFHEO's authorizing statute, the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, Pub. L. No. 102-550, 106 Stat. 3941-4012, codified at 12 U.S.C. §§ 4501 et seq. ("the 1992 Act"), impose restrictions on Board compensation or give OFHEO enforcement authority with respect to such compensation. 12 USC § 1452(c)(9); 12 USC § 4518.

subject to regulation shall be "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."[10] OFHEO also might identify in the regulations certain factors that it would consider in evaluating compensation, as long as those factors are not inconsistent with the statutory provisions.[11]

(b) Disgorgement. If an Enterprise is required to prepare an accounting restatement due to the material noncompliance of the Enterprise, as a result of misconduct, with any financial reporting requirement under law or regulation, the chief executive officer and chief financial officer of the Enterprise shall reimburse the Enterprise as provided under section 304 of the SOA.

Freddie Mac believes that this provision should not be included in the proposed regulations. Unlike the other Sarbanes-Oxley provisions incorporated in the proposed regulations,[12] § 304 does not impose any standard of conduct or other affirmative obligation on companies subject to it. Instead, § 304 provides only a remedy that was designed to be implemented by the SEC (and includes a provision, not expressly included in proposed § 1710.13(b), permitting the SEC to waive that remedy).

Proposed § 1710.13(b) similarly would not impose any standard of conduct or obligation on Freddie Mac or its personnel but instead would only impose a particular remedy to be implemented by OFHEO. OFHEO already has broad remedial and civil monetary penalty

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- The 1992 Act does not give OFHEO enforcement authority with respect to employees other than executive officers. 12 USC § 4518.
- The current and proposed regulatory standards for compensation differ from the standard specified in both the Charter Act and the 1992 Act. 12 USC § 1452(c)(9); 12 USC § 4518.

[10] 12 USC § 1452(c)(9); 12 USC § 4518. Neither Freddie Mac's Charter Act nor the 1992 Act authorizes OFHEO to regulate compensation by reference to what is "appropriate" (whatever that term may be deemed to mean) or "commensurate with the duties and responsibilities" of the individuals whose compensation OFHEO purports to regulate. Moreover, the term "appropriate" is undefined and subjective and therefore inappropriate for use in a mandatory standard of conduct set forth in a regulation. The proposed requirements that compensation "shall be consistent with the long-term goals of the Enterprise, shall not focus solely on earnings performance, but shall take into account operational stability and legal and regulatory compliance as well" also are nowhere authorized by statute.

[11] For example, OFHEO might require that the compensation of individuals subject to such regulation "shall not be in excess of that which is reasonable and comparable with compensation for employment in other similar businesses (including other publicly held financial institutions or major financial services companies), taking account of the nature and scope of their duties and responsibilities and of the performance of the enterprise." OFHEO should not require that compensation "be undertaken in a manner that complies with applicable laws, rules, and regulations." As Freddie Mac discussed in its 2001 comments, such a provision would improperly make any potential violation of any statute having to do with compensation (*e.g.*, tax or employment laws, including at the state or local level) a violation of OFHEO's regulations.

[12] § 301 imposes requirements on audit committees, § 302 requires certification of financial statements, § 402 prohibits certain extensions of credit, and § 406 requires specific provisions in a company's code of ethics.

powers under the 1992 Act,[13] on which it is currently relying to seek similar remedies against certain former Freddie Mac officers. And, ultimately, introduction of the new remedial provision proposed in § 1710.13(b) could create unnecessary confusion and uncertainty as to the scope of OFHEO's remedial authority under the 1992 Act.

If such a provision is to be included in OFHEO's regulations, it should not apply to Freddie Mac until Freddie Mac has returned to the timely filing of financial statements, remediated the operational weaknesses disclosed in its 2002 Annual Report, and completed the process of voluntarily registering its securities, at which time the corresponding provisions of § 304 of Sarbanes-Oxley will become applicable by their own terms, without any action by OFHEO. Freddie Mac is in the process of revising its accounting systems to implement the revised accounting policies adopted in connection with its recent restatement, as well as new accounting guidance applicable for 2003, so that those accounting systems can fully support the preparation of consolidated financial statements in accordance with GAAP. Although Freddie Mac's top priority is the issuance of timely and accurate financial statements, there is no good regulatory reason why Freddie Mac's senior officers should or need to be subject to the threat of a substantial monetary sanction under proposed § 1710.13(b) until Freddie Mac is able to fully implement its plans to address the operational weaknesses that are contributing to its current inability to release financial results on a timely basis.[14]

§ 1710.14 Code of conduct and ethics.

(a) General. An Enterprise shall establish and administer a written code of conduct and ethics that is reasonably designed to assure the ability of board members, executive officers, and employees of the Enterprise to discharge their duties and responsibilities, on behalf of the Enterprise, in an objective and impartial manner, and that includes standards required under section 406 of the SOA.

For the reasons discussed in its "general comments" above, Freddie Mac believes that the last portion of this provision should expressly be made co-extensive with the corresponding regulations issued by the SEC pursuant to section 406 of Sarbanes-Oxley, which is incorporated by reference, as those rules may be interpreted or changed from time to time.

(b) Review. Not less than once every three years, an Enterprise shall review the adequacy of its code of conduct and ethics to ensure that it is consistent with best practices.

Freddie Mac supports the objective of this provision. However, it is not feasible for Freddie Mac to "ensure" the consistency of its code of conduct with any set of external standards, and

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[13] 12 USC § 4631; 12 USC § 4636.

[14] Also, if such a provision is to be included, OFHEO should make clear that the provision includes all aspects of § 304 of Sarbanes-Oxley, both by (i) expressly incorporating the itemization in § 304(a)(1) and (2) of the specific types of compensation that are potentially subject to forfeiture, and (ii) expressly providing that OFHEO has the same authority that was given to the SEC to exempt any person from the forfeiture provision as necessary and appropriate.

particularly not with "best practices." Moreover, although the meaning of the term "best practices" is commonly understood in general terms, it is impossible to determine with specificity what practices are, in fact, "best practices," as would be necessary for that term to be used to define a mandatory standard of conduct in a regulatory provision. Freddie Mac believes that it would be appropriate instead for such a provision to require that it "review the adequacy of its code of conduct in light of best practices."

§ 1710.15 Conduct and responsibilities of board of directors....

(b) Conduct and responsibilities. The board of directors is responsible for directing the conduct and affairs of the Enterprise in furtherance of the safe and sound operation of the Enterprise and shall remain reasonably informed of the condition, activities, and operations of the Enterprise. The responsibilities of the board of directors include having in place adequate policies and procedures to assure its oversight of, among other matters, the following: (1) Corporate strategy, major plans of action, risk policy, programs for legal and regulatory compliance and corporate performance...(6) Extensions of credit to board members and executive officers;

As OFHEO has proposed to revise clause (1) of § 1710.15(b), that provision would require policies and procedures to assure Board oversight of legal and regulatory compliance programs. This revised provision therefore would encompass the Board's obligation to oversee compliance with the prohibition on extensions of credit to Directors and executive officers in § 402 of Sarbanes-Oxley and the parallel provision that OFHEO proposes to add to its corporate governance regulations, in § 1710.16. Because this specific oversight requirement relates to a far more narrow substantive obligation than the other oversight requirements in § 1710.15(b) and is otherwise addressed by clause (1), Freddie Mac recommends that clause (6) not be included in § 1710.15(b).

§ 1710.16 Prohibition of extensions of credit to board members and executive officers.

An Enterprise may not directly or indirectly, including through any subsidiary, extend or maintain credit, arrange for the extension of credit, or renew an extension of credit, in the form of a personal loan to or for any board member or executive officer of the Enterprise, as provided by section 402 of the SOA

For the reasons discussed in its "general comments" above, Freddie Mac believes that this provision should expressly be made co-extensive with the corresponding provision of Sarbanes-Oxley, which is incorporated by reference, as that rule may be changed or interpreted by the SEC from time to time.

§ 1710.17 Certification of disclosures by chief executive officer and chief financial officer.

The chief executive officer and the chief financial officer of an Enterprise shall read each quarterly report and annual report issued by the Enterprise and such reports shall include certifications by such officers as required by section 302 of the SOA

As noted above, Freddie Mac is in the process of revising its accounting systems to implement the revised accounting policies adopted in connection with its recent restatement,

as well as new accounting guidance applicable for 2003, so that those accounting systems can fully support the preparation of consolidated financial statements in accordance with GAAP. Until Freddie Mac is able to fully implement its plans to address the operational weaknesses that are contributing to its current inability to release financial results on a timely basis,[15] Freddie Mac will not be able to complete the process of voluntarily registering its equity securities under the Securities Exchange Act of 1934 – at which time Freddie Mac will become subject to the certification requirement of § 302 of Sarbanes-Oxley – nor should OFHEO's regulations require the CEO and CFO to provide such certifications prior to that time. Freddie Mac requests that OFHEO make clear in its final rule, as appears to be OFHEO's intent, that this proposed provision would not require Freddie Mac's CEO or CFO to submit the type of certifications that registrants are required to submit by § 302 until Freddie Mac completes the voluntary registration process and becomes subject to that certification requirement.

In addition, for the reasons discussed in its "general comments" above, Freddie Mac believes that this provision should expressly be made co-extensive with the corresponding provision of Sarbanes-Oxley, which is incorporated by reference, and the SEC's implementing regulations, as those statutory and regulatory provisions may be changed by Congress or the SEC, respectively, or interpreted by the SEC from time to time.

§ 1710.18 Change of external audit partner and audit firm.

(a) Change of external audit partner. An Enterprise may not accept audit services from an external auditor if either the lead (or coordinating) external audit partner who has primary responsibility for the external audit of the Enterprise or the external audit partner who has primary responsibility for reviewing the external audit has performed audit services for the Enterprise in each of the five previous fiscal years.

For the reasons discussed in its "general comments" above, Freddie Mac believes that this proposed regulatory provision should expressly be made co-extensive with the corresponding provision of Sarbanes-Oxley on which the proposed regulatory provision is based, as that statutory provision may be changed by Congress or interpreted by the SEC from time to time.

(b) Change of external audit firm. The Federal National Mortgage Association shall change its external auditor no later than January 1, 2006, and thereafter no less frequently than every ten years; and the Federal Home Loan Mortgage Corporation shall change its external auditor no later than January 1, 2009, and thereafter no less frequently than every ten years.

During the last two years, mandatory rotation of external auditors has been considered by Congress, the General Accounting Office, the SEC and the New York Stock Exchange, and each of them determined that mandating rotation of external auditors is unnecessary and/or inappropriate. OFHEO should likewise defer action on a mandatory audit firm rotation requirement.

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[15] *See* Freddie Mac's 2002 Annual Report, at pp. 71-73 (Management's Discussion and Analysis of Financial Condition and Results of Operations – Risk Management – Operation Risk – Internal Control Weaknesses") (http://www.freddiemac.com/investors/ar/pdf/2002annualrpt.pdf)

In passing Sarbanes-Oxley, Congress heard testimony on the issue of mandatory audit firm rotation but determined that it would not include such a requirement in Sarbanes-Oxley.[16] Instead, in Section 207 of the Sarbanes-Oxley Act, Congress commissioned a study by the General Accounting Office to examine the potential effects of requiring mandatory audit firm rotation.

The GAO concluded in its study that reforms currently being implemented may provide the intended benefits of mandatory audit firm rotation and that the SEC and the Public Company Accounting Oversight Board should gain more experience with those reforms before considering whether further rulemaking – including the possibility of mandatory audit firm rotation – is needed to enhance auditor independence and audit quality. The GAO found that mandatory audit firm rotation may not be the most efficient means of enhancing auditor independence and audit quality in light of the loss of institutional knowledge possessed by the previous external auditor. The GAO also found that, while additional costs seem fairly certain in the event that audit firm rotation is required, the potential benefits are harder to predict and quantify.

When the SEC adopted its final rules regarding auditor independence in January 2003, it noted that mandatory audit firm rotation had been debated for many years, with some groups suggesting that mandatory rotation will help ensure a "fresh look" and others arguing that the loss of continuity and audit competence created by mandatory rotation creates a greater risk to audit quality, and that the costs involved in requiring rotation exceed the benefits. The SEC noted that it would continue to monitor the issue and that, as directed by Congress, firm rotation would be the subject of further study but would not be made the subject of a mandatory requirement.[17]

Finally, the New York Stock Exchange examined the issue of mandatory audit firm rotation in connection with its recent corporate governance reforms. The NYSE concluded that it did not make sense to mandate audit firm rotation because "mandatory rotation may undercut the effectiveness of the independent auditor and the quality of the audit" while at the same time the "transitions between auditors could disrupt the audit process, deprive auditors of 'institutional memory,' and make the new auditors dependent on management for information."[18]

One of the principal concerns with mandatory audit firm rotation is that it would decrease the quality of audits by depriving auditors of experience with a particular client and its business,

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[16] See GAO Report to the Senate Committee on Banking, Housing and Urban Affairs and the House Committee on Financial Services; Required Study on the Potential Effects of Mandatory Audit Firm Rotation (November 2003) (the "GAO Report"), at 2.

[17] SEC Rel. No. 33-8183 (Jan. 28, 2003) (68 F.R. 6006).

[18] See Report of the New York Stock Exchange Corporate Accountability and Listing Standards Committee. (June 6, 2002), at 14.

thus reducing the auditor's understanding of the business and its operations.[19] This concern is particularly acute in the mortgage finance industry in which Freddie Mac and Fannie Mae are principal participants. Freddie Mac's business requires a complex audit dealing with highly sophisticated issues, and firms other than the four major accounting firms are unlikely to possess the expertise and resources that are necessary to perform such audits. And, for reasons of confidentiality and competition, Freddie Mac and Fannie Mae clearly cannot share the same audit firm or even use a firm that has audited the other in the recent past. In addition, Freddie Mac and Fannie Mae have an ongoing need to retain sophisticated accounting firms other than their external auditors for consulting work.[20]

There are at most four audit firms capable of performing the highly sophisticated audit and non-audit work that Freddie Mac and Fannie Mae require in light of the nature of their businesses. The mathematics is simple – there are barely enough qualified firms available under the current auditor independence rules. Imposition of a mandatory audit firm rotation requirement would create a substantial likelihood that the quality of those audits will suffer. OFHEO should defer imposing any such rotation requirement on Freddie Mac and Fannie Mae when a number of other reputable bodies, which have studied the issue at length, have determined that the case has not yet been made to impose it more broadly – especially with the additional concern in the context of the Enterprises that the shortage of qualified audit firms would be particularly acute.[21]

§ 1710.19 Compliance and risk management programs; compliance with other laws.

(a) Compliance program. An Enterprise shall establish and maintain a compliance program, headed by a person who reports directly to the chief executive officer of the Enterprise, that shall--

Freddie Mac recognizes the importance of the objectives addressed by this proposed provision and has established a compliance program headed by a Chief Compliance Officer. Freddie Mac's Chief Compliance Officer currently reports directly to the CEO, as contemplated by the proposed provision. However, Freddie Mac expects to re-evaluate the Chief Compliance Officer reporting relationship following completion and release of its 2003 financial results and believes that it should be permitted to retain the flexibility to structure

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[19] Other concerns with mandatory rotation include a loss in continuity of support (especially in light of the SEC's shortened reporting periods, rotating external auditors would make timely reporting more difficult at the outset of a rotation as the new auditor learned the company's business) and increased audit costs, as new auditors would need to be educated about a company's business and company management would need to invest time and money on the selection process.

[20] While Sarbanes-Oxley permits certain types of such work to be provided by Freddie Mac's external auditor, the Audit Committee must ensure that such consulting work does not impair the audit firm's independence. Moreover, there is growing pressure from shareholder groups to further limit the amount of such consulting work performed by a company's external auditor. See, e.g., April 15, 2003 letter from Mark Anson, Chief Investment Officer of the California Public Employees' Retirement System ("CalPERS") to companies in the CalPERS U.S. equity portfolio (www.calpers-governance.org/viewpoint/speeches/anson041403.asp).

[21] If such a requirement were to be imposed, the first required rotation date for Freddie Mac should be 2012, ten years after Freddie Mac first retained PricewaterhouseCoopers.

the reporting relationship in the manner that, at any particular point in time, will best achieve the objectives that this provision is designed to achieve.

(1) Ensure that the Enterprise complies with all applicable laws, rules, regulations, and guidelines, and adheres to best practices;

No compliance program, no matter how well designed and implemented, can "ensure" compliance. As the SEC recently recognized, "compliance policies and procedures will not prevent every violation of the securities laws."[22] The regulations should neither require that Freddie Mac's compliance program achieve that result nor provide a basis for an independent regulatory violation on the part of the compliance program if the result is not achieved.

Moreover, even if generally applicable "best practices" could be defined and identified, the composition of an effective compliance program will vary from business to business, depending on its structure and operations, as both the SEC and the Sentencing Commission have recognized.[23] In any event, while the meaning of the term "best practices" is generally understood, it is impossible to determine with specificity precisely which practices are, in fact, "best practices," as would be necessary in order to use that term to define the regulatory obligation of a compliance program. However, Freddie Mac is committed to adopting the best compliance procedures appropriate to its business, and it therefore keeps abreast of developments in compliance techniques within the financial services industry and beyond, and would be pleased to work with OFHEO on an informal basis to identify effective compliance practices on an ongoing basis.

Freddie Mac supports a regulatory provision that is consistent with that commitment and that in fact goes beyond OFHEO's proposal in certain respects, but that takes into account the concerns noted above. Freddie Mac believes that it would be appropriate, for example, for this provision to require establishment and maintenance of a compliance program that "is reasonably designed, taking into account best practices, to (i) promote compliance with all applicable laws, rules, regulations, and guidelines, (ii) prevent violations from occurring, (iii) detect violations that have occurred, and (iv) correct promptly any violations that have occurred."

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[22] Final Rule: Compliance Programs of Investment Companies and Investment Advisers, Release Nos. IA-2204; IC-26299; File No. S7-03-03, at n.16. Similarly, the United States Sentencing Commission, which was charged by Congress in the Sarbanes-Oxley Act with re-examining the basic elements of an effective compliance program, recently affirmed that "The failure to prevent or detect [an] offense does not necessarily mean that the program is not generally effective in preventing and detecting criminal conduct." Sentencing Guidelines for United States Courts, ___ Fed. Reg. ___ (proposed ___ __, 2004) (proposed new §8B2.1(a)) [submitted April 30,2004; www.ussc.gov/FEDREG/05_04_notice.pdf].

[23] Final Rule, Compliance Programs of Investment Companies and Investment Advisers at text following note 14 ("Commenters agreed with our assessment that funds and advisers are too varied in their operations for the rules to impose of a single set of universally applicable required elements."); United States Sentencing Commission, Guidelines Manual, §8A1.2, comment. (n.3(k)) ("The precise actions necessary for an effective program to prevent and detect violations of law will depend upon a number of factors.").

(2) Establish written internal controls and disclosure controls and procedures;

Effective compliance programs generally are designed to support and enforce the responsibility of each corporate business area to establish controls concerning the specific legal and regulatory requirements that affect the business area's activities. The business areas, not the central compliance program, are best able to determine what controls would be most effective in promoting compliance with those specific requirements. Moreover, a compliance program that actually established specific compliance controls for all business areas of an organization subject to numerous and varied statutory and regulatory requirements would necessarily be very large, would substantially duplicate aspects of business area operations, and would likely prove unworkable.[24] For those reasons, compliance programs, including the program established by Freddie Mac, are not generally designed to "establish" internal controls. Instead, consistent with what is widely accepted as an effective compliance model, it would be appropriate for this provision to require that the compliance program "develop, administer and enforce a program to establish controls that are reasonably designed to prevent violations of applicable laws, rules and regulations."

(3) Provide for periodic meetings of the board of directors to ensure the board is able to assess adherence to and adequacy of current policies and procedures of the Enterprise regarding compliance and adjust such policies and procedures, as required.

The scheduling of Board meetings is a function performed by the Board, in conjunction with the Corporate Secretary. Thus, the chief compliance officer is not in a position to "provide for...meetings of the board of directors." Instead, the obligation of the chief compliance officer should be to report on a regular basis to the Board. Moreover, because the NYSE listing standards require that the Audit Committee assist Board oversight of corporate compliance, [25] the proposed provision should provide flexibility with respect to the Board entity to which such reports are provided.

In addition, neither the chief compliance officer nor any other member of management who reports to the Board can "ensure" that the Board is able to take certain action. Instead, management can provide information on the relevant topic to the Board, for the Board to use in fulfilling its own fiduciary, statutory and regulatory obligations.

For the reasons discussed above, it would be appropriate for this provision to require that the compliance program "provide for regular reporting by the chief compliance officer to the board of directors, or an appropriate committee of the board, regarding adherence to and the adequacy of current policies and procedures of the Enterprise regarding compliance, and regarding any adjustments to such policies and procedures that the chief compliance officer considers to be warranted."

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[24] Even if the alternative model that would apparently be called for by the proposed regulation were feasible, the discretion to choose among alternative models should be left with the company.

[25] NYSE Listed Company Manual, § 303A.07(c)(i)(A)(2).

§ 1710.19(b) Risk management program. An Enterprise shall establish and maintain a risk management program, headed by a person who reports directly to the chief executive officer of the Enterprise, that shall--

Freddie Mac recognizes the importance of the objectives addressed by this proposed provision and has established a risk management program headed by a Chief Enterprise Risk Officer who reports directly to the CEO, as contemplated by the proposed provision. However, as in the case of the compliance program, discussed above, Freddie Mac expects to re-evaluate the Chief Enterprise Risk Officer reporting relationship following completion and release of its 2003 financial results and believes that it should be allowed to retain the flexibility to structure the reporting relationship in the manner that, at any particular point in time, will best achieve the objectives that this provision is designed to achieve.

(1) Manage the overall risk oversight function of the Enterprise;

For consistency with other portions of this proposed subsection, Freddie Mac believes that this provision should be revised to state that the chief risk officer shall: "(1) Oversee the overall risk management function of the Enterprise."

(2) Provide for periodic meetings of the board of directors to ensure the board is able to assess adherence to and adequacy of current policies and procedures of the Enterprise regarding risk management and adjust such policies and procedures, as required.

Like the chief compliance officer, the chief risk officer should be required to report on a regular basis to the Board, rather than to "provide for...meetings of the board of directors." Moreover, because the NYSE listing standards require that the Audit Committee discuss policies with respect to risk assessment and risk management, the proposed provision should provide flexibility with respect to the Board entity to which such reports are provided.[26] Also, like the chief compliance officer, the chief risk officer should be required to provide relevant information to the Board but not to "ensure" that the Board is able to take certain actions based on that information.

For the reasons discussed above, it would be appropriate for this provision to require that the risk management program "provide for regular reporting by the chief risk officer to the board of directors, or an appropriate committee of the board, regarding adherence to and the adequacy of current policies and procedures of the Enterprise regarding risk management, and regarding any adjustments to such policies and procedures that the chief risk officer considers to be warranted."

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[26] NYSE Listed Company Manual, § 303A.07(c)(iii)(D).

§ 1710.19(c) Compliance with other laws.

(1) If an Enterprise deregisters or does not register its common stock with the U.S. Securities and Exchange Commission (Commission) under the Securities Exchange Act of 1934, the Enterprise shall continue to comply with sections 301, 302, 304, 402, and 406 of the SOA, subject to such requirements as provided by Sec. 1710.30 of this part.

(2) An Enterprise that has its common stock registered with the Commission shall maintain such registered status, unless it provides 60 days prior written notice to the Director stating its intent to deregister and its understanding that it will remain subject to the requirements of sections 301, 302, 304, 402, and 406 of the SOA, subject to such requirements as provided by Sec. 1710.30 of this part.

There is little likelihood that Freddie Mac will ever seek to "deregister" its stock, given the applicable statutory and regulatory restrictions, the provisions in its Bylaws requiring unanimous Board of Directors support for such action, and the likely investor response to any proposal by Freddie Mac to do so. Nevertheless, Freddie Mac recognizes OFHEO's objective in ensuring that such action, if it ever were taken, would not permit Freddie Mac to cease complying with important provisions of Sarbanes-Oxley.

However, as noted in the "general comments" above, the proposed regulations should be clarified to confirm that they do would not make certain provisions of Sarbanes-Oxley applicable to Freddie Mac before it has returned to the timely filing of financial statements and completed the voluntary registration process, and before those Sarbanes-Oxley provisions therefore would apply on their own terms. As discussed, Freddie Mac is already complying voluntarily with several of those provisions – in particular, § 301 (audit committee requirements), § 402 (prohibition on extensions of credit) and § 406 (code of ethics) – and does not oppose OFHEO regulatory provisions making such compliance mandatory. However, Freddie Mac should not be required to comply with Sarbanes-Oxley provisions relating to certification of its financial disclosures (§ 302) and possible disgorgement in the event of a restatement (§ 304) until Freddie Mac has completed the actions necessary to return to the timely filing of financial statements and to voluntarily register its securities. Thus, Freddie Mac believes that § 1710.19(c)(1) – like § 1710.19(c)(2) – should be revised to apply only to a situation in which an Enterprises' securities are deregistered. At the same time, the applicability of the enumerated Sarbanes-Oxley provisions prior to the completion of Freddie Mac's initial voluntary registration should be clarified, as appropriate to each particular requirement, in the individual sections of the proposed regulations that deal with each of those requirements.

In addition, for the reasons discussed below with respect to proposed § 1710.30, Freddie Mac believes that proposed § 1710.30, in its current form, should not be incorporated in proposed § 1710.19(c).

Subpart D--Modification of Certain Provisions

§ 1710.30 Modification of certain provisions.

In connection with standards of Federal or state law (including the Revised Model Corporation Act) or NYSE rules that are made applicable to an Enterprise by

§§ 1710.10, 1710.11, 1710.12, 1710.17, and 1710.19 of this part, the Director, in his or her sole discretion, may modify such standards upon written notice to the Enterprise.

This provision could be read to provide for the modification of any of the Sarbanes-Oxley or NYSE rules that are incorporated by reference in the above provisions – with notice, but without a formal rulemaking or otherwise providing both notice and opportunity to comment. Freddie Mac assumes, however, that OFHEO intends the provision to comply fully with the Administrative Procedure Act ("APA"),[27] to which the agency is subject.[28] Accordingly, Freddie Mac believes the provision should be clarified to state that the standards incorporated from other bodies of law or regulations may be modified or interpreted, for purposes of the OFHEO corporate governance regulations, in accordance with the applicable provisions of the APA, including the notice exceptions set forth in the APA.[29]

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[27] 5 U.S.C. §§ 551 *et seq.* The "written notice to the Enterprise" required by proposed section 1710.30 would not be sufficient to satisfy the notice-and-comment requirements required by the APA and the 1992 Act. The APA specifically requires that (1) the proposed rule be published in the Federal Register, (2) interested persons be afforded "an opportunity to participate in the rule making through submission of written data, views or arguments," (3) "after consideration of the relevant matter presented, the agency [] incorporate in the rules adopted a concise general statement of their basis and purpose," and (4) the final rule become effective no earlier than 30 days following publication. 5 U.S.C. § 553(b)-(d).

[28] The 1992 Act generally requires OFHEO to adhere to the notice-and-comment procedures of Section 553 of the APA. Specifically, Section 1313(a) of the 1992 Act charges OFHEO with "ensur[ing] that the enterprises are adequately capitalized and operating safely, in accordance with this chapter," and Section 1313(b)(1) authorizes OFHEO to issue regulations in furtherance of its safety and soundness mandate. *See* 12 U.S.C. § 4513(a)-(b). The 1992 Act further provides that such regulations "shall be issued after notice and opportunity for public comment pursuant to the provisions of section 553 of [the APA]." 1992 Act § 1319G(b), 12 U.S.C. § 4526(b).

It is well established that an agency may not exempt itself from the APA's notice-and-comment rulemaking requirements. The D.C. Circuit affirmed this principle in a case in which the National Park Service interpreted an open-ended clause ("clause 13") in one of its rules "as granting [the agency] the authority to impose new substantive restrictions uniformly [on regulated entities] without engaging in notice and comment procedures." *United States v. Picciotto*, 875 F.2d 345, 346 (D.C. Cir. 1989). The Park Service argued that "since clause 13 went through notice and comment, the new restrictions do not need to." *Id.* The court of appeals rejected the agency's argument, observing that "[i]n essence, the Park Service is claiming that an agency can grant itself a valid exemption to the APA for all future regulations, and be free of APA's troublesome rulemaking procedures forever after, simply by announcing its independence in a general rule." *Id.* at 346-47. The court said simply: "That is not the law." *Id.* The court held that the agency "cannot construct its own veto of Congressional directions," and therefore must follow notice and comment procedures unless the rule falls within one of the express exceptions to those requirements set out in the APA. *Id.* at 347.

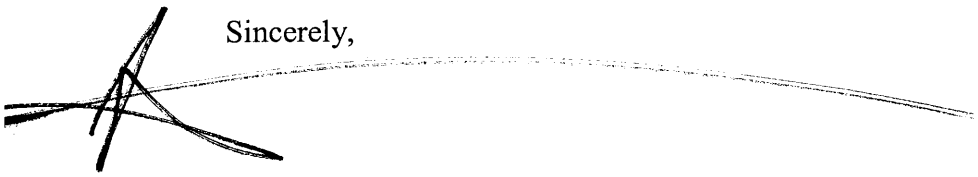
[29] 5 U.S.C. § 553(b). Clarification would also be useful with respect to the language in proposed § 1710.30 that "the Director, **in his or her sole discretion**, may modify" standards applicable to the Enterprises under the corporate governance rule. This "sole discretion" language, without more, would not insulate the Director's actions from judicial review or reduce the degree of judicial scrutiny that would otherwise apply. The APA provides that a court may review agency action for "abuse of discretion," 5 U.S.C. § 706(2)(A), but it also provides that a court may not review "agency action [that] is committed to agency discretion by law." 5 U.S.C. § 701(a)(2). The "committed to agency discretion by law" exception to judicial review applies where **Congress** has committed a decision to agency discretion in a **statute**. *See Webster v. Doe*, 486 U.S. 592, 599-600 (1988) (emphasis added; internal quotations and citations omitted).

Conclusion

Freddie Mac recognizes the importance of the objectives that OFHEO is seeking to achieve through its corporate governance regulations and its proposed amendments to those regulations. Freddie Mac is committed to meeting or exceeding "best practices" in corporate governance, through both compliance with OFHEO's regulations and other requirements and voluntary actions that go beyond those requirements. Freddie Mac urges OFHEO to modify its proposed amendments in the manner discussed above to help ensure that they achieve OFHEO's objectives and do not have any unintended and undesirable results.

Thank you for the opportunity to comment.

Sincerely,



Ralph F. Boyd, Jr.