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BY ELECTRONIC MAIL AND COURIER

Alfred M. Pollard, Esq.
General Counsel
Office of Federal Housing Enterprise Oversight
Fourth Floor
1700 G Street, N.W.
Washington, D.C. 20552

Re: *Proposed Corporate Governance Regulation, RIN 2550-AA24*

Dear Mr. Pollard:

On April 12, 2004, the Office of Federal Housing Enterprise Oversight ("OFHEO") issued for public comment proposed corporate governance regulations. Fannie Mae shares with OFHEO the core goal of excellence in corporate governance and we appreciate the opportunity to comment on these proposals.

Fannie Mae is committed to the corporate governance principles of openness, integrity, responsibility, and accountability. We continually strive to attain the highest quality corporate governance and transparency. As a Securities and Exchange Commission ("SEC") registrant, Fannie Mae is required to (and does) comply with the SEC's corporate governance requirements and with the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley").[1] As a company listed on the New York Stock Exchange ("NYSE"), Fannie Mae complies with, and in many cases exceeds, the corporate governance requirements of the NYSE. OFHEO's proposal recognizes Fannie Mae's obligation to meet both sets of requirements.[2] In addition, pursuant to OFHEO's existing corporate governance rule, Fannie Mae is subject to, and complies with, the corporate governance practices and procedures of Delaware General Corporate law.

We commend OFHEO's continued leadership in the corporate governance area. Fannie Mae currently meets most of the newly proposed requirements. A majority of the seated members of Fannie Mae's Board are independent, as defined by the NYSE; the non-management board members regularly meet in executive session; a quorum of the Board is at least a majority of the seated directors and proxy voting is prohibited, adequate information is provided to the

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[1] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 746 (codified at scattered sections of 15 U.S.C.).

[2] 69 Fed. Reg. 19126, 19127 (Apr. 12, 2004).

Board to enable them to perform their duties; and the Board reviews its duties at least annually. In addition, Fannie Mae has audit, compensation and nominating and corporate governance committees that meet the requirements of Sarbanes-Oxley and the NYSE rules, and the company has established Codes of Conduct that are reviewed at least annually. Fannie Mae's Board complies with the Board conduct and responsibility provisions proposed, and prohibits extensions of credit, as provided by Sarbanes-Oxley and reiterated by the proposed rule; Fannie Mae's CEO and CFO execute certifications of disclosures, as required by Sarbanes-Oxley and reiterated by the proposed rule; the company's outside auditor is required to rotate its responsible partner every five years, as required by Sarbanes-Oxley and reiterated by the proposed rule; and the company has both an established compliance program and a risk management program. Finally, Fannie Mae does not envision a circumstance in which its common stock would no longer be registered with the SEC, thereby making Sarbanes-Oxley inapplicable to it.

Our comments are limited to several provisions of the proposed rule,[3] which, while intended to support the safety and soundness of the companies, may have unintended consequences.[4]

Fannie Mae's Corporate Governance Record

Fannie Mae's dedication to excellence in corporate governance is well established. Our Board of Directors adopted corporate governance guidelines in 1995. These guidelines addressed many of the topics currently under consideration in the proposed rule, such as term limits and retirement age for directors, director independence and conflicts of interest, frequency of meetings, content of committee and Board materials, and the independence of the audit function. Moreover, these principles had been an important part of the company's practices for many years before the Board formally adopted them.

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[3] In addition to the comments in this letter, Fannie Mae incorporates by reference its comment letter, dated December 13, 2001, on OFHEO's first proposed corporate governance rule.

[4] As a significant regulatory action, the proposal must be based on "the best reasonably obtainable scientific, technical, economic or other information concerning the need for, and consequences of, the intended regulation." Executive Order 12866, 58 Fed. Reg. 51735 (Sept. 30, 1993), as supplemented by OMB's Circular A-4 (Sept. 17, 2003). OFHEO's proposal must assess alternative forms of regulation and must, to the extent feasible, specify "performance objectives rather than specifying the behavior or manner of compliance that regulated entities must adopt." *Id.* at Section 1(b)(8). OFHEO is required to "avoid regulations that are inconsistent, incompatible, or duplicative with its other regulations or those of other Federal agencies." *Id.* at Section 1(b)(10). The proposed regulatory action must also contain a detailed description of the need for the regulation and an explanation of how the action will meet that need. *Id.* at Section 6(a)(3)(B).

Fannie Mae strongly believes that a company dedicated to "best practices" in the corporate governance area must constantly engage in self examination, as well as benchmarking against broader trends, practices and experiences. Accordingly, in 2002, Fannie Mae's Nominating and Corporate Governance Committee undertook a thorough review of Fannie Mae's corporate governance practices. After rigorous examination, the Committee designed, and recommended to the Board a revised set of Corporate Governance Guidelines, updated charters for key Board Committees, and adopted an expanded Code of Business Conduct and Ethics and Conflict of Interest Policies for Members of the Board of Directors. The Board reviewed the governance guidelines again earlier this year and adopted additional enhancements. The Nominating and Corporate Governance Committee intends to conduct such governance reviews on an annual basis and will continue to provide leadership in the area of corporate governance.

Fannie Mae complies with all SEC and NYSE corporate governance requirements. These include, among other things, a Board with a majority of independent directors, only independent directors on the audit, compensation, and nominating and corporate governance committees, quorums, voting rights, and required shareholder approvals. In fact, Fannie Mae exceeds a number of important NYSE requirements:

- Fannie Mae exceeds the requirement of a majority of independent directors; nine of its thirteen directors are independent.[6]

- Fannie Mae's independence standards are stricter than those required by the NYSE. The company has a five-year look-back period for possible relationships that could affect independence, rather than the required three-year look-back period.[7]

- The company applies the prohibition against direct compensation to all Board members, not just audit committee members.[8]

- The company applies a bright line standard with respect to conflicts of interest created by a director's association with a charitable organization receiving donations from Fannie Mae or the Fannie Mae Foundation.

- The company has a stricter test on the compensation committee interlock and deems that a director is not independent if he or she is an employee, not just an executive, of

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[6] *Compare* NYSE Listed Company Manual Section 303A.01 *with* Fannie Mae Corporate Governance Guidelines at 2-3.

[7] *Compare* NYSE Listed Company Manual Section 303A.02(b) *with* Fannie Mae Corporate Governance Guidelines at 5-7.

[8] *Compare* Rule 10A-3(b)(ii) of the Securities Exchange Act of 1934, as amended, *with* Fannie Mae Corporate Governance Guidelines at 6.

a company where a Fannie Mae executive sits on the company's compensation committee.[9]

Fannie Mae's corporate governance policies have received high ratings from independent organizations that rate corporations' effectiveness in this area.[10] Standard & Poor's assigned Fannie Mae a corporate governance score of 9.0 on a 10-point scale, reflecting "governance practices that are consistently strong or very strong across each of [S&P's] areas of analysis." Institutional Shareholder Services stated that, as of June 1, 2004, Fannie Mae outperformed 95.3% of the S&P 500 and 99.3% of banks. Finally, The Corporate Library, an independent research firm that rates corporate governance practices, gave Fannie Mae a "B" grade, which is in the top 5%, and recognized Fannie Mae's Board in 2003 as "Best Stakeholder Board."

We understand that OFHEO's proposed rule seeks to build on the comprehensive study and work Fannie Mae's Board has done to enhance the company's corporate governance.[11]

Key Concerns

A. Auditor Rotation

Proposed section 1710.18(b) requires Fannie Mae to change its auditor on or before January 1, 2006, and at least every ten years thereafter.[12] OFHEO has proposed mandatory auditor rotation "given the importance of having the most impartial oversight and review of accounting and other matters." Fannie Mae agrees with OFHEO on the importance of an independent outside auditor in public company governance.[13] In finalizing its proposal, Fannie Mae respectfully requests that OFHEO consider the following information.

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9 *Compare* NYSE Listed Company Manual Section 303A.02(b)(iv) *with* Fannie Mae Corporate Governance Guidelines at 6.

10 Standard & Poor's Corporate Governance Score (Jan. 30, 2003); The Corporate Library, Board Effectiveness Ratings 2003. Moody's stated in its corporate governance assessment of Fannie Mae that there is a "[c]lear commitment by board and CEO to adopting governance 'best practices' that go beyond minimum regulatory requirements." Moody's Corporate Governance Assessment (Mar. 2004).

11 *See* Executive Order 12866, section 6(a)(3)(B), requiring an agency proposing a significant regulatory action to demonstrate a need for regulation and how the proposal meets such need.

12 12 C.F.R § 1710.18(b) (proposed).

13 Our Audit Committee (the members of which meet the independence, qualification and expertise requirements of the NYSE listing standards as well as Fannie Mae's corporate governance standards, and two members of which have been designated "audit committee financial experts" under SEC rules) is responsible for overseeing our outside auditor's qualifications and independence. The Committee carries out this responsibility by reviewing the audit scope and plans and the results of audit examinations; reviewing and approving all audit and audit-related engagements of the outside auditor; conducting due

First, Sarbanes-Oxley imposes strict requirements for auditor independence that are overseen by the SEC and the Public Company Accounting Oversight Board, and Fannie Mae and our independent auditor are subject to them, as are all other SEC registrants and their auditors. These requirements include, among other things, mandatory rotation of certain partners on the audit engagement team every five years, limitations on hiring personnel from the audit firm, prohibition against providing certain non-audit services, and mandatory pre-approval of audit and non-audit engagements. Fannie Mae meets all of these requirements. In addition, the Audit Committee oversees the rotation of audit partners, which last occurred in 2004. The Audit Committee adopted guidelines for the hiring of personnel from our independent auditors in January 2003 that are more restrictive than the Sarbanes-Oxley Act and SEC implementing regulations.

Second, Congress considered and decided not to require mandatory auditor rotation in its debates concluding in passage of Sarbanes-Oxley, and instead directed the General Accounting Office ("GAO") to study the question.[14] The GAO concluded that the issue is not yet ripe for decision, stating in its November 2003 comprehensive study on mandatory audit firm rotation that:

> [M]andatory audit firm rotation may not be the most efficient way to strengthen auditor independence and improve 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. The potential benefits of mandatory audit firm rotation are harder to predict and quantify, though GAO is fairly certain that there will be additional costs.
>
> Several years' experience with implementation of the Sarbanes-Oxley Act's reforms is needed, GAO believes, before the full effect of the act's requirements can be assessed. GAO therefore believes that the most prudent course of action at this time is for the Securities and Exchange Commission and the Public Company Accounting Oversight Board to monitor and evaluate the effectiveness of existing requirements for enhancing auditor independence and audit quality. [15]

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diligence regarding the outside auditor's independence from Fannie Mae and its management, the auditor's prior performance, and the qualifications and expertise of the audit firm and members of the engagement team; and reviewing and approving the rendering of non-audit services to Fannie Mae by the outside auditor, and the compatibility of such services with the auditor's independence. These actions are taken in Audit Committee meetings held frequently throughout the year; in 2003, the Audit Committee met nine times. The Committee meets with the independent auditors without management present regularly.

[14] Sarbanes-Oxley Act of 2002, Section 207, 15 U.S.C. § 7232.

[15] United States General Accounting Office, *Report to the Senate Committee on Banking, Housing and Urban Affairs and the House Committee on Financial Services, Public Accounting Firms: Required Study on the Potential Effects of Mandatory Audit Firm Rotation,* (November 2003).

Moreover, in promulgating the auditor independence requirements of the Sarbanes-Oxley Act, the SEC considered the issue of mandatory audit firm rotation and concluded that mandatory auditor rotation required further study and would not be included in the final rule.[16]

Third, other studies provide support for concluding that the current rules regarding auditors do not lead to increased probability of fraud or errors. For example, researchers analyzed whether longer auditor tenure reduced earnings quality and found that it generally leads to higher earnings quality. The study concluded that the longer auditors are engaged by the company, the greater constraints auditors put on management's financial reporting decisions.[17] Other studies conclude that fraudulent financial reporting is more likely when auditor tenure is three years or less, and financial fraud is no more likely when auditor tenure is nine years or longer.[18]

Fourth, there are important practical reasons not to require auditor rotation. Fannie Mae retains a "Big Four" accounting firm as its independent auditor and, from time to time, engages one or more of the remaining "Big Four" firms to perform certain non-audit services. This has been recognized as a best practice, since an auditor is simply precluded from providing certain non-audit services. Freddie Mac also retains one of the "Big Four" firms as its independent auditor. The availability of only four large accounting firms makes it difficult to comply with mandatory rotation rules. The NYSE has recognized that mandatory auditor rotation would be highly disruptive as companies would be required to alter many, if not all, of these engagements. In its June 2002 report, the NYSE Corporate Accountability and Listing Standards Committee stated: "We do not mandate periodic rotation of auditors because we believe that mandatory rotation may undercut the effectiveness of the independent auditor and quality of the audit. The transitions between auditors could disrupt the audit process, deprive auditors of 'institutional memory' and make the new auditors more dependent on management for information." [19]

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16 SEC Release No. 33-8183 (Jan. 28, 2003).

17 *See, e.g.*, James Myers, Linda A. Myers & Thomas C. Omer, *Exploring the Term of the Auditor-Client Relationship and the Quality of Earnings: A Case for Mandatory Auditor Rotation?*, 78 The Accounting Review 779 (2003) ("If deteriorating earnings and/or audit quality are the call for mandatory rotation, then our results do not support such an argument."). *See also,* Wanda A. Wallace, *Auditor Rotation: A Bad Governance Idea*, Directors and Boards (Spring 2004).

18 Joseph V. Carcello, *Audit Firm Tenure and Fraudulent Financial Reporting* (January 2004) (unpublished). *See also,* American Institute of Certified Public Accountants, *Statement of Position Regarding Mandatory Rotation of Audit Firms of Publicly Held Companies (1992)*, and studies cited therein, concluding that mandatory audit firm rotation would not be in the public interest because it would increase the likelihood of audit failure and would increase dramatically costs for companies, audit firms, and the public.

19 NYSE Corporate Accountability and Listing Standards Committee Report, June 6, 2002, at 14.

In light of the above, Fannie Mae urges that OFHEO mandate external audit firm partner rotation, consistent with Sarbanes-Oxley, but not require audit firm rotation.

B. Mandated Chairman/CEO Split

OFHEO proposes, by regulation, to require Fannie Mae to separate the Chairman of the Board and CEO positions.[20] Separating the positions of Chairman and CEO may or may not be the best decision for a particular company at a particular time. It is, however, a decision most appropriately made by a company's board. Accordingly, Fannie Mae respectfully requests that OFHEO modify this proposal to require the Board to conduct a thorough study, on a regular basis, of whether the posts of CEO and Chairman should be split given the then-current facts and circumstances.

There is not a current consensus that separation of the Chairman and CEO positions is a best practice that warrants imposing a split by government action.[21] Congress considered, but did not adopt, a requirement for a separate Chairman and CEO for registered companies.[22] No other government regulator—including the other financial safety and soundness regulators, such as the Office of the Comptroller of the Currency (OCC) or the Federal Reserve Board—has concluded that it is appropriate to require a split in the positions of Chairman and CEO, and action by OFHEO thus would set a government-wide precedent that should receive careful analysis and attention.

There is not empirical evidence that American corporations are moving to split the positions of Chairman and CEO. According to The Corporate Library, 377 of the S&P 500 companies combined the positions of CEO and Chairman of the Board.[23] More than half of the companies that divide the posts are chaired by their former CEOs.[24] As noted by The Business Roundtable, most American corporations are well served by a structure in which the CEO also

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[20] 12 C.F.R. § 1710.11(a)(1) (proposed).

[21] *See* Executive Order 12866, at sections 1(b)(7) and 6(a)(3)(B), requiring that proposed regulations be based on the best, reasonably available information concerning the need for regulation and that an agency demonstrate how a proposed regulation meets such need.

[22] *See Accounting and Investor Protection Issues Raised by Enron and Other Public Companies: Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 107th Cong.; 148 Cong. Rec. H4,866 (July 25, 2002).

[23] The Corporate Library, *available at* <http://www.thecorporatelibrary.com/Governance-Research/spotlight-topics/spotlight/boardsanddirectors/SplitChairs2004.html>.

[24] *Id.*

serves as Chairman of the Board.[25] The CEO ensures that management and the Board act together in the best interests of the company.

Experts in the field of corporate governance disagree whether a split in the positions of Chairman and CEO is in the best interests of a corporation. SEC Chairman William Donaldson, in comments at a Business Roundtable forum on Corporate Governance stated: "The issue of CEO, lead director, chief executive, this is an issue I believe requires great discussion...I believe there is not one suit that fits all. I believe that the issue of leadership of the board depends upon the company, the industry it's in, the nature of the people that are there, and that shifts and changes."[26] Academic Robert E. Mittelstaed concludes in an article published by Wharton that "experience shows that it is difficult to make the argument that dividing the roles will result in better performance in all cases. There is no one black and white answer to fit all situations."[27]

Nor is an imposed regulatory requirement to split the positions necessary to achieve the objective of a Board independent of management. The NYSE rules address such independence concerns by requiring non-executive sessions of the Board and by requiring that the primary Board Committees be comprised solely of independent directors.[28] OFHEO's proposed rules adopt this approach as well. The Wharton article discussed above notes that the Chair/CEO split issue "can be accomplished in other ways such as directors holding meetings without the CEO being present."[29]

Our view is that each company should be allowed to make its own determination of what leadership structure is most effective given the company's present and anticipated circumstances.[30] Corporate structure should be dynamic and adaptable to changing markets and changing demands.[31] As one expert notes: "[n]o one structure is right for. . .any one corporation

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25 The Business Roundtable, *Principles of Corporate Governance* 13 (May 2002).

26 Remarks of William Donaldson, *The Business Roundtable Corporate Governance Forum, "Taking Stock and Looking Ahead,"* September 10, 2003.

27 Wharton School, "Splitting Up the Roles of CEO and Chairman: Reform or Red Herring?" available at http://www.bettermanagement.com/Library/Library.aspx?LibraryID=9680

28 NYSE Listed Company Manual Sections 303A.03, .04, .05, and .07.

29 As noted above, Fannie Mae's non-management directors regularly meet in executive session.

30 *See* The Business Roundtable, Principles of Corporate Governance 13 (May 2002); Jay Dahya & Nickolaos G. Travlos, *Does the One Man Show Pay? Theory and Evidence on the Dual CEO Revisited*, European Financial Management 85 (2000); Wharton School, University of Pennsylvania, *Re-Examining the Role of the Chairman of the Board, available at* <http://www.bluesteps.com/mlibrary/ml_aesc2.asp?mldid=124&cat=5>.

31 The legislative history of the 1992 Act is clear: "The Committee does not mean for the Director or HUD Secretary to impose his or her business judgment on, or interfere with, the normal management

during different stages of its development, and the question of the appropriate structure must be constantly re-evaluated and fine-tuned."[32]

Fannie Mae's Board has carefully considered whether a split in the position of Chairman and CEO is currently in the best interest of the company and concluded that it is not appropriate at this time. While we urge that this provision be modified as discussed above, if OFHEO adopts the proposal we believe the final rule should provide enough flexibility to ensure a smooth transition that does not interfere with existing contracts or succession plans.

C. A Significant Administrative Procedure Act Concern

Proposed section 1710.30 provides that "the Director, in his or her sole discretion, may modify" the standards of federal or state law or NYSE rules made applicable to the enterprises under the regulation simply "upon written notice" to the enterprises. It appears that the intent behind this provision is to provide OFHEO flexibility "to provide additional guidance concerning general or specific circumstances, if necessary in light of the special characteristics of the two" enterprises.[33]

Proposed section 1710.30 appears to permit the imposition of new requirements on the enterprises simply upon the written direction of the Director. If interpreted in this manner, the provision would authorize OFHEO effectively to amend the rule without the notice-and-comment procedures required by the Administrative Procedure Act ("APA").[34]

We have attached to this comment letter a memorandum from the law firm of Kirkland & Ellis, concluding that this portion of OFHEO's proposal is inconsistent with established law.

Fannie Mae understands that OFHEO believes that this provision is required to allow OFHEO to quickly respond to any situation considered by OFHEO to be a corporate governance crisis at an enterprise. However, we note that OFHEO already has statutory authority, and has provided for additional authority by regulation, to take a number of actions to respond to such a

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prerogatives of an enterprise that has sound financial controls, and is adequately capitalized, and profitable. Congress created the enterprises under private ownership and management to bring the entrepreneurial skills and judgments of the private sector to bear on accomplishment of public purposes relating to housing. The Committee does not mean to upset this unique structure or to encourage any government official to second guess decisions of enterprise management arrived at through the exercise of honest, unbiased judgment of what is in the best interests of the enterprise." S. Rep. No. 102-282, 102d Cong. 2d Sess. 25 (1992).

[32] Dahya & Travlos, *supra* note 32, (quoting Robert Monks, Lecture at Aspen Institute (July 1993)).

[33] 69 Fed. Reg. 19126, 19128 (Apr. 12, 2004). This suggestion is provided in the discussion of the rule concerning an enterprise's Board of Directors.

[34] 5 U.S.C. §§ 551(5), 553.

crisis, in corporate governance or otherwise. For example, OFHEO's regulations provide that OFHEO can take action (i) under prompt supervisory response process if an enterprise is conducting an activity that presents a risk to the safety and soundness of an enterprise or violation of applicable law, regulation, or order,[35] or (ii) under the cease-and-desist order process if any enterprise, officer or director is engaging in misconduct or an enterprise is engaging in conduct that is in violation of certain statutes or regulations or is an unsafe or unsound practice.[36]

In light of the above, Fannie Mae respectfully requests that OFHEO withdraw this portion of the proposal.

D. Disgorgement

Section 1710.13(b) of the proposed rule would require the chief executive officer and chief financial officer of the enterprise to reimburse the enterprise if the enterprise is required to prepare an accounting restatement due to material noncompliance, as a result of misconduct, with any "financial reporting requirement" under law or regulation. If this provision is triggered, these officers "shall reimburse the enterprise as provided under section 304 of [Sarbanes-Oxley]." Fannie Mae respectfully requests that OFHEO modify this provision consistent with Sarbanes-Oxley.

Section 304 of Sarbanes-Oxley limits disgorgement to a restatement of "any financial reporting requirement under the securities laws" and contains a provision under which the SEC may exempt any person from disgorgement as it deems necessary and appropriate. Fannie Mae is fully subject to Sarbanes-Oxley and thus to the disgorgement authority that Congress conferred on the SEC. If a restatement were necessary and disgorgement appropriate under section 304 of Sarbanes-Oxley, disgorgement would be a remedy with which the CFO and CEO would have to comply.

The proposed rule appears to extend the Sarbanes-Oxley remedy to "any financial reporting requirement under law or regulation" and provides no exemption. OFHEO's proposal provides no definition of this requirement, and therefore the proposal is unclear as to what "financial reporting requirement" could trigger the remedy. As an SEC registrant, accounting restatements for Fannie Mae are governed by the securities laws as implemented by the SEC.

We have attached to this comment letter a memorandum from the law firm of Kirkland & Ellis addressing the issues raised by section 1710.13(b).

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[35] 12 C.F.R. § 1777.10.

[36] 12 C.F.R. § 1780.1.

Fannie Mae respectfully requests that the proposal be amended to be consistent with the disgorgement provisions under Sarbanes-Oxley. This could be accomplished by replacing the words "law or regulation" with "the securities laws" and adding "(a)(1) and (2)" after "section 304."

E. Proposed New Standards for Compensation

OFHEO's proposal prohibits compensation that is not "reasonable and appropriate" and requires that compensation be "consistent with the long-term goals of the Enterprise" and "shall not focus solely on earnings performance."[37]

In 1992, Congress carefully considered the standards that should apply to the compensation of senior executives of the companies. The 1992 Act prohibits Fannie Mae from providing executive compensation that is not "reasonable and *comparable*" with compensation for employment in other similar businesses.[38] Section 1723a(d)(2) of the Charter Act requires the Fannie Mae Board to establish compensation for officers and employees 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 for all executive officers . . . of the corporation shall be based on the performance of the corporation."[39] The "reasonable and *appropriate*," standard proposed by section 1710.13(a) is not found in the 1992 Act or the Fannie Mae Charter.[40] We are concerned that the term "appropriate" is not defined by the proposal and therefore does not allow the companies to determine what standards OFHEO will apply when determining compliance.

For the foregoing reasons, Fannie Mae respectfully requests that OFHEO amend this proposal to track the language of the 1992 Act and Fannie Mae's Charter.

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37 12 C.F.R. § 1710.13(a) (proposed).

38 12 U.S.C. § 4518(a) (emphasis added).

39 Fannie Mae Charter Act, § 309(d)(2).

40 *See Bowen v. Georgetown Hospital*, 488 U.S. 204, 207 (1988) ("It is axiomatic that an administrative agency's power to promulgate legislative regulations is limited to the authority delegated by Congress"); *Accord Lyng v. Payne,* 476 U.S. 926, 937 (1996) ("an agency's power is no greater than that delegated to it by Congress."). OFHEO's current governance rules require that compensation of directors, executive officers, and employees shall not exceed that which is "reasonable and commensurate" with their duties and responsibilities, and that language is also not derived from the 1992 Act.

F. Other Comments

Overlapping Regulation. Certain sections of OFHEO's proposal duplicate the requirements of Sarbanes-Oxley, as implemented by the SEC, and the NYSE corporate governance rules.[41] Adoption of overlapping rules could result in differing enforcement or interpretation standards.[42]

Limits on Director Service. The proposed rule would limit the service of a Board member to no more than 10 years or past the age of 72, whichever comes first. In finalizing the proposal, we respectfully request that OFHEO consider the following information.

Fannie Mae has adopted term limits that contain enough flexibility to retain directors who have developed knowledge of, and insight into, Fannie Mae over a period of time and who, accordingly, provide valuable contributions to the Board.[43] The approach taken by Fannie Mae is consistent with OFHEO's objective of promoting "the highest level of functioning of the board of directors." Industry and academic work also urges flexibility and Board discretion in this area.[44] The NYSE rules allow companies and their shareholders to use their own discretion in

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[41] *See, e.g.,* section 1710.11(a)(3) and (b)(2) (independence by board members and non-management board member meetings); section 1710.12(c) (required committees); section 1710.16 (prohibition on extensions of credit to board members and executive officers); and section 1710.17 (certification of disclosures by chief executive officer and chief financial officer). *See also* Executive Order 12866, section 1(b)(6) requiring agencies to avoid inconsistent, incompatible or duplicative regulations.

[42] Public Disclosure of Financial and Other Information, 68 Fed. Reg. 16715, 16717 (Apr. 7, 2003) (preamble to OFHEO's rules on financial disclosure explaining the basis for such rules in OFHEO's authority as safety and soundness regulator). OFHEO's interpretations of such rules may not be entitled to judicial deference. In similar circumstances, courts have refused to defer to agency interpretations of standards that might be subject to conflicting interpretations by more than one agency. *Rapaport v. U.S. Dep't of Treasury*, 59 F.3d 212, 216-17 (D.C. Cir. 1995) (declining to give *Chevron* deference to the OTS's interpretation of banking enforcement standards "because [OTS] shares responsibility for the administration of the statute with at least three other agencies. The alternative would lay the groundwork for a regulatory regime in which either the same statute is interpreted differently by the several agencies or the one agency that happens to reach the courthouse first is allowed to fix the meaning of the text for all"); *Cf. Reactor Operator v. U.S. Nuclear Regulatory Comm'n*, 939 F.2d 1047, 1051 (D.C. Cir. 1991) ("[r]eviewing courts do not owe the same deference to an agency's interpretation of statutes that, like the APA, are outside the agency's particular expertise and special charge to administer.").

[43] Fannie Mae currently has in place a term limit of 10 years, with the possibility of one-year extensions for an additional 5 years "for good reason." If Fannie Mae adopts OFHEO's term limits, the Chair of our Nominating and Corporate Governance Committee, Ann Korologos, and the Chair of our Audit Committee, Tom Gerrity, would be forced to step down from the Board despite the Nominating Committee's careful consideration of their tenures and decision to renominate them. *See* Fannie Mae Proxy Statement, April 23, 2004, at 23.

[44] David C. Karp, *The New Disclosure & Corporate Governance Regime*, 1348 PLI/Corp 863, 889 (Dec. 2002) (recommending against term limits because "they hold the disadvantage of losing the contribution of directors who have been able to develop, over a period of time, increasing insight into the company as a whole."); *see also Dumping the Dead Weight*, Corp. Board Member Mag., Special Issue 2003: *What*

developing director qualification requirements, including director tenure and retirement.[45] The Business Roundtable also contemplates that director tenure and retirement should be left to the discretion of the company, its Board, and shareholders and not be established by rule.[46] TIAA-CREF does not support arbitrary limitations on the length of director service, but believes that Boards should establish retirement policies to contribute to Board vitality.[47] In addition, the American Bar Association Task Force on Corporate Responsibility does not recommend mandating term limits and instead specifically leaves the consideration of the limits to individual Boards.[48]

We respectfully suggest that OFHEO require the Board to consider the adoption of tenure and age limitations and make public its determinations.[49] However, if OFHEO adopts this regulation in its current form, Fannie Mae requests that the rule be modified to include the following: (1) a transition period of 4 years to allow Fannie Mae to replace directors who will become ineligible under the proposed rule over time; (2) a provision allowing the Board to waive the term and age limits for certain directors where the Board determines that their continued

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Directors Think (providing comments from various directors on term limits and summarizing that most are against regulated term limits due to loss of talent and favor instead self-policing by the Board of qualifications for membership); *Lessons from Enron: A Symposium on Corporate Governance*, 54 Mercer L. Rev. 683, 704 (Winter 2003) (featuring a roundtable discussion in which Superior Court Judge Ben Tennille called term limits "a terrible idea" that would complicate the analysis of director liability in a shareholder lawsuit rather than improve Board accountability); Sana Siwolop, *When Deadwood Doesn't Refer to the Table*, N.Y. Times (Oct. 27, 1999) (discussing alternatives to term limits).

45 The NYSE corporate governance rules require listed companies to adopt and disclose corporate governance guidelines, including director qualification standards that reflect the independence requirements of Section 303A. However, the NYSE specifically allows listed companies and their shareholders to independently choose whether to develop other substantive qualification requirements, such as director tenure and retirement. NYSE Listed Company Manual Section 303A.

46 The Business Roundtable's Principles of Corporate Governance recommend that a Board "have a process for evaluating whether the individuals sitting on the Board bring the skills and expertise appropriate for the corporation and how they work as a group." The Business Roundtable further recommends that the Board "establish procedures for the retirement or replacement of board members" and contemplates that such procedures could include a mandatory retirement age or a term limit. The Business Roundtable, Principles of Corporate Governance (May 2002). The Business Roundtable has also noted, though, that term limits are generally not favored because "they can deprive a corporation of its most experienced board members." The Business Roundtable, Statement on Corporate Governance (Sept. 1997).

47 TIAA-CREF, Policy Statement on Corporate Governance (2000), *available at* <http://www.tiaa-cref.org>.

48 *Preliminary Report of the American Bar Association Task Force on Corporate Responsibility*, 58 Bus. L. 189, 200-01 (Nov. 2002).

49 *See* Executive Order 12866, sections 1(b)(8) and 6(a)(3)(B), requiring an agency to adopt, to the extent feasible, performance objectives rather than manner of compliance and to demonstrate how a proposed regulation meets an identified need.

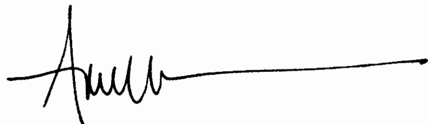
service would provide significant benefits to the Board and its ability to effectively oversee management of the company, so long as the Board makes public its decisions; and (3) a change from the words "serve on" to "be nominated" in order to clarify that a Director not be required to resign immediately on his or her seventy-second birthday or anniversary date of ten years of Board service.

Board and Committee Meetings. OFHEO proposes to require Board meetings at least twice each quarter.[50] Fannie Mae does not object to holding eight Board meetings a year; it already holds at least eight meetings each year. Rather, Fannie Mae respectfully requests that the proposed requirement be amended to require Board meetings at least eight times each year, which shall include at least one meeting each quarter, so that meetings are held when needed.[51]

* * *

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

Sincerely,



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50 12 C.F.R. § 1710.11(b)(1) (proposed).

51 *See* Executive Order 12866, sections 1(b)(8) and 6(a)(3)(B), requiring an agency to adopt, to the extent feasible, performance objectives rather than manner of compliance and to demonstrate how a proposed regulation meets an identified need.

KIRKLAND & ELLIS LLP

MEMORANDUM

June 2, 2004

Validity of Proposed Section 1710.30

This memorandum addresses the validity of 12 C.F.R. § 1710.30, a proposed amendment to the corporate governance regulations promulgated by the Office of Federal Housing Enterprise Oversight ("OFHEO"). The proposed amendment provides as follows:

> 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.

We believe that this proposed amendment is unlawful on both substantive and procedural grounds.

1. Substantive Grounds

Under the Administrative Procedure Act ("APA"), administrative agencies must act "'in accordance with law,' 5 U.S.C. § 706(2)(A)—which means, of course, *any* law, and not merely those laws that the agency itself is charged with administering." *FCC v. NextWave Personal Communications, Inc.*, 537 U.S. 293, 300 (2003) (emphasis in original). While agencies may enact their own regulations, to the extent authorized by their organic statutes and otherwise in accordance with law, they have no power to "modify" the laws otherwise enacted by Congress or state legislatures. In other words, if the agency wants to impose a new obligation on Fannie Mae, it must do so pursuant to its *own* regulatory authority (to the extent permissible), and not by "modifying" the obligations otherwise imposed by federal or state law, which the agency has no power to do. The fact that the agency has chosen to incorporate such federal and/or state laws into its own regulations is immaterial: the agency can always seek to modify its own regulations, but cannot modify those otherwise applicable laws. Indeed, the agency's suggestion that it has the power to "modify" substantive provisions of federal and state law applicable to Fannie Mae violates not only the APA, but basic principles of separation-of-powers and federalism.

2. Procedural Grounds

With respect to procedure, the proposed amendment is invalid because (even assuming that OFHEO had the power to "modify" the substantive standards of federal or state law), the agency could not exercise such power merely "upon written notice" to Fannie Mae. Rather, because any such "modification" is clearly substantive (as opposed to interpretative) in nature, it would have to be promulgated pursuant to notice-and-comment rulemaking under the APA. *See* 5 U.S.C. § 553(5); *see also National Family Planning & Reprod. Health Ass'n, Inc. v. Sullivan,* 979 F.2d 227, 234-35, 241-42 (D.C. Cir. 1992). That requirement applies not only to the promulgation of regulations in the first instance, but also to repeals, amendments, and modifications of such regulations. *See, e.g., Alaska Professional Hunters Ass'n v. FAA,* 177 F.3d

1030, 1033-34 (D.C. Cir. 1999); *Paralyzed Veterans of Am. v. D.C. Arena*, 117 F.3d 579, 586 (D.C. Cir. 1997). Thus, a modification of the substantive standards governing Fannie Mae under OFHEO's corporate governance regulations would require notice-and-comment rulemaking. The requirements for notice-and-comment rulemaking under the APA are very specific, and mere "written notice" to the regulated entity will not suffice. *National Family Planning*, 979 F.2d at 235.

Christopher Landau

KIRKLAND & ELLIS LLP

MEMORANDUM

June 7, 2004

Validity of Proposed Section 1710.13(b)

This memorandum addresses the validity of 12 C.F.R. § 1710.13(b), a proposed amendment to the corporate governance regulations promulgated by the Office of Federal Housing Enterprise Oversight ("OFHEO"). The proposed amendment provides as follows:

> (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 [Sarbanes-Oxley Act, 15 U.S.C. § 7243].

We believe that this proposed amendment is invalid on both substantive and procedural grounds.

1. Substantive Grounds

As an initial matter, a disgorgement remedy is one in which the violator of a law is forced to pay back (or "disgorge") "profits causally connected to the violation." *SEC v. First City Fin. Corp., Ltd.*, 890 F.2d 1215, 1231 (D.C. Cir. 1989); *see also id.* ("[D]isgorgement primarily serves to prevent unjust enrichment."); *SEC v. Tome*, 833 F.2d 1086-96 (2d Cir. 1987) ("The paramount purpose of ... ordering disgorgement is to make sure that wrongdoers will not profit from their wrongdoing."). The proposed amendment, however, does not provide for the "disgorgement" of unjust enrichment. Rather, through its cross-reference to section 304 of the Sarbanes-Oxley Act, the proposed amendment requires a CEO or CFO to forfeit a bonus or certain profits on the sale of securities *regardless* of whether there is any connection to the financial reporting violation. Such forfeiture is not "disgorgement," because no attempt is being made at a "reasonable approximation of profits causally connected to the violation." *First City*, 890 F.2d at 1231. Rather, it is a pure fine or penalty.

OFHEO's authority to impose civil fines or penalties against officers and directors of an enterprise, however, is strictly limited by statute. In particular, OFHEO cannot assess a fine or penalty against an executive officer or director for violating a "regulation" without showing, at a minimum, either (1) a "pattern of misconduct," or (2) a violation involving "recklessness" and "a material loss to the enterprise." 12 U.S.C. § 4636(b)(2). And even upon such a showing, OFHEO cannot impose a fine or penalty in excess of $10,000 for each day the violation continues. Because proposed subsection 1710.13(b) does not incorporate these limitations, it is inconsistent with the statutory limits on OFHEO's authority to impose fines or penalties.

2. Procedural Grounds

In addition, OFHEO has not offered any legal or policy justification for proposed section 1710.13(b) consistent with OFHEO's organic act and facts gathered by the agency. Like any other administrative agency, OFHEO "must examine the relevant data and articulate a satisfactory explanation for its action including a 'rational connection between the facts found and the choice made.'" *Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983) (quoting *Burlington Truck Lines v. United States*, 371 U.S. 156, 168 (1962)). OFHEO is not free to adopt various provisions of Sarbanes-Oxley as its own without justifying such regulations by reference to OFHEO's statutory authority and facts in the record. The fact that Congress adopted a forfeiture provision enforceable by the SEC in the Sarbanes-Oxley Act does not, *ipso facto*, justify OFHEO in implementing its own forfeiture provision. OFHEO has a higher burden of justification than Congress. *See id.* at 43 n.9 ("We do not view as equivalent the presumption of constitutionality afforded legislation drafted by Congress and the presumption of regularity afforded an agency in fulfilling its statutory mandate."). Thus, OFHEO must explain not only its statutory authorization but the policy necessity of its proposal, and that task should be more difficult—not easier—given the existence of Sarbanes-Oxley. In the absence of any independent legal or factual justification, the regulation is unsustainable. *See, e.g., PG&E Gas Transmission Northwest, Corp. v. FERC,* 315 F.3d 383, 390 (D.C. Cir. 2003) (quoting *Greater Boston Television Corp. v. FCC,* 444 F.2d 841, 852 (D.C. Cir. 1970)).

Christopher Landau