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By Courier and Electronic Mail

Freddie Mac
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1700 G Street, NW
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Washington, DC 20552

Re: **Corporate Governance, Proposed Regulation**
66 *Fed. Reg.* 47557 (September 12, 2001), RIN 2550-AA20

Dear Mr. Pollard:

Freddie Mac appreciates the opportunity to comment on the rules 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.

A well-qualified and effective board of directors is one of the most important elements in maintaining the safety and soundness of a financial institution. Freddie Mac's board always has consisted of highly-qualified directors who are actively engaged in oversight of management and formulation of long-term corporate strategy. Freddie Mac's corporate governance practices have been consistent with both applicable state law and recognized "best practices" in governance. Indeed, in each of the last three years – since OFHEO began its comprehensive annual examinations of board governance in 1998 – OFHEO has found that the board governance practices at Freddie Mac (and at Fannie Mae) have exceeded safety and soundness standards.[1] We are not aware of any material corporate governance failings ever identified by OFHEO's experienced team of examiners. To the contrary, their reports have concluded that the Enterprises' practices are exemplary, as illustrated by their most recent conclusions concerning Freddie Mac's board:

> "The Board discharges its duties and responsibilities in a manner that exceeds safety and soundness standards. The Board is appropriately engaged in the development of a strategic direction for the company, and ensures that management appropriately defines the operating parameters and risk tolerances of the Enterprise in a manner consistent with the strategic direction; legal standards; and ethical standards. The Board has an effective process for hiring and maintaining a quality executive management team, and has processes in plac[e] designed to hold the executive management team accountable for achieving the defined goals and objectives. The Board of Directors has sufficient, well-

[1] *See* OFHEO Reports to Congress for 1999, 2000 and 2001. "Exceed[ing] safety and soundness standards" is OFHEO's highest safety-and-soundness rating.

> organized time to carry out its responsibilities, and is appropriately informed of the condition, activities and operations of the Enterprise."[2]

Notwithstanding these outstanding results and OFHEO's formal recognition of them, OFHEO now proposes to radically change the rules under which the Enterprises' boards of directors have been operating. There is neither administrative precedent nor academic support for OFHEO's novel approach. Indeed, extensive scholarship in this area supports the conclusion that the proposed regulations would (i) make it much more difficult for the Enterprises to continue to attract and retain highly-qualified individuals to serve on their boards, and (ii) significantly impair the ability of those who are willing to serve on the boards to do so effectively. As a result, the proposed regulations would threaten the Enterprises' safety and soundness, rather than protect it. This result would be directly contrary to the mission for which OFHEO was created by Congress in 1992. Therefore, it is essential that OFHEO adopt a very different approach to these proposed regulations if it is to remain faithful to its Congressional mandate.

Freddie Mac recognizes that OFHEO is legitimately concerned with the safety and soundness of the Enterprises, and that OFHEO has authority over such matters as prescribed in § 1313 of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992[3] ("the 1992 Act"). However, that authority does not alter the well-developed principles of modern corporate governance, which call for a flexible set of rules that promote attraction and retention of a high-quality board of directors and an environment in which those directors can oversee and work with management both effectively and efficiently.

OFHEO's proposal would not follow these essential principles. Instead, the proposal would introduce a new system of federal corporate governance rules that would be very different from the corporate governance laws and standards that currently apply to the Enterprises and to other corporations, including other federally regulated financial institutions. The new standards also would be far more onerous. For example, unlike state corporate governance law, the proposed regulations would require directors to "*ensure*" particular outcomes from their actions, such as the integrity of financial reporting systems and the responsiveness of management to federal regulators. Most fundamentally, OFHEO's proposal effectively would eliminate the well-accepted "business judgment" rule, under which directors are held to satisfy their responsibilities as long as they exercise good faith business judgment in making their decisions. In fact, the proposal would alter substantially the fundamental rules and recognized best practices under state corporate governance law, by transforming generally accepted "aspirational standards" (which are intended to **guide** the conduct of directors) into binding rules of conduct with which directors must comply to avoid penalties.

The confusion and uncertainty that would accompany adoption of the proposed regulations would compound their adverse impact. It is critical that the meaning and application of new rules be clear to those who must comply with them. This is particularly true where, as OFHEO proposes here, significantly higher standards are to be imposed. However, those new standards are in many instances vague and undefined (and often indefinable). It also would be unclear in many instances

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[2] OFHEO 2001 Report to Congress at 19 (June 15, 2001). OFHEO made a similar appraisal of Fannie Mae's Board of Directors. *Id.* at 17.

[3] 12 U.S.C. § 4513.

whether the new federal standards would supplement or supplant the applicable state law standards. As a result, there would be considerable confusion as to what rules directors must comply with, what those rules mean, and how directors and senior management are supposed to resolve such questions. Are the Enterprises and their directors to look, for example, to existing state law interpretations and decisions, to new OFHEO interpretations, to scholarly comment, or elsewhere to resolve questions and ambiguities? In an area as important as corporate governance, these are extremely troubling questions for the Enterprises and their directors.

OFHEO's proposal to limit indemnification in OFHEO administrative proceedings would worsen substantially the adverse impact of its proposed standards of conduct. Modern corporate governance practices recognize that attempts to coerce desired director conduct through the threat of sanctions – particularly personal financial liability – are likely to **reduce** the contribution that the board makes to the governance of a company. In the case of the Enterprises, any such reduction in board participation could compromise safety and soundness. It is also well recognized that an approach based on personal liability deters qualified individuals from serving as directors, notwithstanding the need that OFHEO has acknowledged for the Enterprises to "be able to continue to attract and retain the highest caliber of board members."[4]

Furthermore, OFHEO's proposal to regulate the compensation of the Enterprises' directors and **all** their officers and employees exceeds the precise and limited authority that Congress granted to OFHEO. OFHEO's authority to regulate compensation extends only to **executive** officers of the Enterprise, and only to the standard expressly set forth by Congress.

OFHEO asserts that the proposed regulations are "substantively similar to those required by federal bank regulatory agencies with respect to the regulated financial institutions."[5] In fact, the banking agency regulations do **not** provide support for OFHEO's expansive proposal – for several reasons. First, in many areas, OFHEO's proposal exceeds the scope of the banking agency governance requirements. Second, in other areas, OFHEO proposes to establish as **binding regulations** principles similar to those that the banking agencies have published as **informal guidance**. Those banking agency guidelines can be enforced against bank directors only if the directors are first given notice that the regulator considers specific acts or practices to be in violation of the guidelines and the directors subsequently fail to modify those acts or practices on a prospective basis. The proposed regulations, on the other hand, would permit OFHEO to bring enforcement proceedings against Enterprise directors, with damage to their reputations and possible unindemnified financial penalties, based on **past** acts or practices, without prior notice that OFHEO considered those specific acts or practices to be inconsistent with the regulations. Thus, the proposed regulations differ from the banking regulations to a much greater extent than OFHEO suggests.

Third, in certain key areas where the banking agencies have promulgated requirements similar to those proposed by OFHEO (in particular, compensation and indemnification), the banking agencies clearly have statutory authority to impose such requirements, while OFHEO clearly lacks such authority. The regulations governing other federally-chartered financial institutions have a separate and very different statutory basis, growing out of historical circumstances in the bank and thrift industry that have no application to the Enterprises. The banking regulations do not provide an

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[4] 66 *Fed. Reg.* at 47557.
[5] *Id.*

appropriate model to regulate corporate governance at the Enterprises and do not support the broad scope of OFHEO's proposal.

In summary, OFHEO has proposed to issue broad federal governance requirements of uncertain scope and application, coupled with a substantial reduction in the indemnification that has traditionally been available to Enterprise directors. Adoption of this proposal would impair, rather than improve, the high quality of corporate governance that OFHEO has found to exist at the Enterprises to date. This adverse impact would be even more pronounced in the event of a period of financial stress, when retention and dedication of able directors is most important.

The adverse impact of the proposed regulations cannot be cured by minor adjustments. OFHEO must substantially modify its proposed approach if it is to achieve a result that would promote continued good governance at the Enterprises and satisfy applicable legal standards. OFHEO should not attempt to promulgate an ambiguous set of federal rules of conduct that would be binding on the Enterprises and their directors.

Notwithstanding occasional governance lapses from time to time in our national corporate system, the trend in recent years has been toward significantly better corporate governance. As one of the leading scholars on corporate governance has observed:

> "The common experience of informed observers is that the level of directorial care has risen significantly in the last ten years or so; that directors today are more attentive to their responsibilities, more ready to displace inefficient CEOs, more concerned about corporate structure, more active in setting agendas and determining corporate strategy, and so forth....What has caused this shift to a greater level of care? Pretty clearly, not an increased threat of liability."[6]

Instead of imposing an increased threat of liability on Enterprise directors, OFHEO should permit the Enterprises to continue to follow state law corporate governance rules (including the body of authoritative state interpretations that amplify those rules) and best practices and to indemnify directors as permitted under state law.

In brief, if OFHEO issues regulations with respect to corporate governance at the Enterprises, those regulations should:

- permit the Enterprises and their directors to operate under and to rely upon a designated body of state law, without an overlay of additional federal rules governing director conduct and responsibilities and other board practices;
- prohibit indemnification only to the extent specified by Congress; and
- regulate compensation only in the manner and to the extent specified by Congress.

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[6] *Melvin A. Eisenberg*, Symposium: Corporate Law and Social Norms, 99 Colum L. Rev 1253, 1266 (1999) ("*Eisenberg*, Symposium").

In Section I of our comments, we discuss the major areas of concern that are summarized above. In Section II, we comment on the individual provisions of the proposed regulations, focusing first on those provisions that give rise to our greatest concerns and then on other aspects of the proposed regulations.

I. GENERAL COMMENTS

According to OHFEO's preamble, the proposed regulations are intended to improve the quality of corporate governance. However, they would have the opposite effect. They would create a number of significant obstacles to effective corporate governance, including the transformation of what are normally non-binding principles into binding rules of conduct, the introduction of substantial uncertainty and confusion concerning the conduct that is required of directors, and the imposition on directors of substantially greater exposure to personal liability. These obstacles in turn would impair significantly the quality of governance at the Enterprises, by diverting the time and attention of directors from their critical oversight role, distorting the directors' decisionmaking process, and discouraging qualified individuals from serving on the Enterprise boards.[7] In addition, the proposed regulations would exceed the authority that Congress granted to OFHEO with respect to corporate governance.

A. The Proposed Regulations Would Create A Number Of Serious Obstacles To Effective Governance.

The proposed regulations would impact adversely the structure of corporate governance at the Enterprises in at least three ways: (i) they would create binding rules of conduct with the threat of liability; (ii) they would leave directors unable to determine how to conform their conduct to the regulations; and (iii) they would greatly increase the exposure of individual directors to personal financial liability.

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[7] *See, e.g.*, Comments of Professor Lawrence A. Hamermesh, Widener University School of Law, submitted in this rulemaking proceeding ("Hamermesh Comments"); Comments of Professor Donald Langevoort, Georgetown University Law Center, submitted in this proceeding ("Langevoort Comments"); *Melvin Aron Eisenberg*, Corporate Law and Social Norms, 99 Colum. L. Rev. 1253 (1999); *James J. Hanks, Jr.*, Evaluating Recent State Legislation on Director and Officer Liability Limitation and Indemnification, 43 Bus. Law. 1207 (1988); *Charles Hansen*, The ALI Corporate Governance Project: Of the Duty of Due Care and the Business Judgment Rule, a Commentary, 41 Bus. Law. 1237 (1986); *Donald C. Langevoort*, The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability, 89 Geo. L.J. 797 (2001); *Bayless Manning*, The Business Judgment Rule and the Director's Duty of Attention: Time for Reality, 39 Bus. Law. 1477 (1984); *Lawrence E. Mitchell*, A Critical Look at Corporate Governance, 45 Vand. L. Rev. 1263 (1992); *John F. Olson*, How to Really Make Audit Committees More Effective, 54 Bus. Law. 1097 (1999) (audit committee members); *E. Norman Veazey, Jesse A. Finkelstein and C. Stephen Bigler*, Delaware Supports Directors with a Three-Legged Stool of Limited Liability, Indemnification, and Insurance, 42 Bus. Law. 399 (1987); *American Law Institute*, Principles of Corporate Governance: Analysis and Recommendations (1994), Vol. 1, pp. 134-37, Vol. 2, pp. 240-42, 265.

- ***The Proposed Regulations Would Alter A Fundamental Aspect Of The Existing Corporate Governance Structure By Creating Binding Rules Of Conduct With The Threat Of Liability.***

First, OFHEO's proposal would impose on directors new and significant burdens that they do not face under state law and that simply are inappropriate. For example, the proposed regulations include a long list of "responsibilities" of directors. The proposed regulations would require that directors "**ensure**" certain outcomes, including the safe and sound operation of the Enterprises, the integrity of their accounting and financial reporting systems, and the compliance of compensation plans with applicable laws, rules and regulations. The proposed requirement that directors guarantee outcomes is wholly inconsistent with the role that directors have long played, and continue to play, under state law. Although the precise formulation differs among jurisdictions, directors are required under the established state law structure to exercise loyalty and care, and to apply their business judgment in the best interests of the corporation. As long as directors act in accordance with these standards, they are **not** subject to personal liability even if their judgments prove wrong or adverse results occur.

OFHEO's proposal would alter one of the fundamental aspects of the structure of existing corporate governance law. The proposal ignores the crucial distinction between two categories of governance rules or standards, which one governance expert has referred to as (i) relatively strict, but non-binding, "rules of conduct", and (ii) more tolerant, but binding, "standards of review."[8] The first category, non-binding rules of conduct (or "aspirational" principles"[9]), are principles that a director is expected – but not legally required – to satisfy. The second category, binding standards of review (or "remedial duties"[10]) consists of standards relating to due care that a reviewing body applies *post hoc* to a director's conduct to determine whether liability will be imposed on the director. The business judgment rule is one such standard.

The distinction between aspirational principles and standards of review is critical to effective corporate governance. It is necessary because of the unique role played by outside corporate directors and the serious adverse impact that unduly strict corporate governance rules can have on the conduct of those directors, and therefore on the governance process itself. At the same time, the "aspirational" principles provide guidance to directors in making the inherently difficult and multi-faceted judgments with which they are regularly faced. By imposing liability on directors only for violations of the more tolerant standards of review (and not for failure to satisfy the more stringent aspirational principles), modern corporate governance rules avoid making directors

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[8] *Eisenberg*, The Divergence of Standards of Conduct and Standards of Review in Corporate Law, 62 Fordham L. Rev. 437 (1993) ("*Eisenberg*, Divergence"). *See, also*, *Brehm v. Eisner*, 746 A.2d 244, 256 (Del. 2000) ("[T]he law of corporate fiduciary duties and remedies for violation of those duties are distinct from the aspirational goals of ideal corporate governance practices. Aspirational ideals of good corporate governance practices for boards of directors that go beyond the minimal legal requirements of the corporation law are highly desirable, often tend to benefit stockholders, sometimes reduce litigation and can usually help directors avoid liability. But they are not required by the corporation law and do not define standards liability."); *Mitchell*; *E. Norman Veasey*, An Economic Rationale for Judicial Decisionmaking in Corporate Law, 53 Bus. Law. 681, 699-700 (1998) (suggesting aspirational norms for directors in the following areas: director independence; the relationship between the board and management; time spent on board matters; service on other boards; independent committees and evaluation of the CEO; legal compliance programs; and disclosure of material information); Langevoort Comment; Hamermesh Comment.

[9] *Mitchell,* 45 Vand. L. Rev. at 1310.

[10] *Id.*

"unduly risk averse or otherwise preoccupied with liability."[11] The distinction between the two types of standards also "take[s] account of fairness (in particular, the difficulty of determining whether a business decision was reasonable)."[12]

The banking agencies have recognized the importance of the distinction, and therefore have put their "rules of conduct" for directors in the form of non-binding guidance, none of which is as detailed as the binding regulations that OFHEO has proposed. Indeed, as discussed below, in 1995 the OCC proposed revising its regulations to require bank directors to ensure a bank's compliance with applicable laws and regulations and safe and sound banking practices.[13] However, the OCC concluded that it could not craft a regulation that would provide "clear and useful guidance" to directors without being overly detailed.[14] The OCC therefore abandoned the proposal, referring directors instead to existing OCC guidance.[15] OFHEO similarly should abandon the far more detailed set of binding rules of conduct for directors that it has proposed.

- ***Directors Would Be Unable To Determine What Conduct Is Required Of Them Under The Proposed Regulations.***

Second, OFHEO's proposal would infuse potentially crippling uncertainty into the governance process. As discussed in greater detail below,[16] the proposed new standards employ terms that are not defined, and indeed cannot be defined in a regulatory context. The proposal also attempts to codify many aspects of corporate governance that have long been dealt with by state law in general terms. Under state law, details concerning these matters are filled in by reference to case law and best practices and by deference to the experienced judgment of directors and officers. This approach, which has evolved in the United States for over a century, permits flexible application of the rules and avoids imposing inappropriate legal burdens on directors. It is only through such a flexible, common-law approach to specific factual situations that corporations, directors, shareholders and everyone else with a stake in the corporate governance system can be confident that the ever-changing array of corporate governance issues will be resolved appropriately.

The proposal also would fail to satisfy OFHEO's stated intention "[t]o dispel any legal uncertainty as to whether and to what extent State or Federal law applies to corporate governance practices and procedures of the Enterprises."[17] Although OFHEO's proposal is overly intrusive in many areas, its provisions do not address every issue that is covered by state corporate governance law. In those cases in which it is unclear whether the proposal is intended to take precedence, the proposal provides no guidance concerning the relationship between the proposed provisions and those of state law. For example, Virginia law provides that committee action alone cannot satisfy a director's duty of care, but like the law of many other states, it expressly permits directors to rely on committee reports under appropriate circumstances. OFHEO's proposal provides that committee action shall have **no** effect on a director's liability and says nothing about reliance on committee reports. If Freddie Mac elects to follow Virginia law under the proposal (as it intends to

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[11] *Eisenberg*, Divergence, 62 Fordham L. Rev. at 464-65.
[12] *Id.*
[13] 60 *Fed. Reg.* 11924, 11937-38 (March 3, 1995) (proposed § 7.2010).
[14] 61 *Fed. Reg.* 4849, 4855 (Feb. 9, 1996).
[15] *Id.* at 4867 (§ 7.2010).
[16] See the discussion of proposed §§ 1710.20 and 1710.21 in Section II.A of this comment letter.
[17] 66 *Fed. Reg.* at 47558.

do), would the proposed provision concerning committees and director liability override – or be supplemented by – the Virginia provision specifically permitting reliance on committee reports?

Like any entity or individual subject to statute or regulation, the Enterprises and their directors need to be able to understand what rules apply to them and what conduct is necessary to conform to those rules. Today, when Enterprise directors and those who advise them seek such an understanding, they need to determine how the state law governance rules will be applied to their conduct. They can find the guidance they need in decades of jurisprudence and in the constantly evolving "best practices" for well-governed corporations that emerge as a consensus from the dialogue among judges, scholars, practitioners and the array of corporate stakeholders.[18] However, that history, context and dialogue, and those best practices, would be of little value to the Enterprises and their directors in attempting to determine the answers to new questions that would be posed by OFHEO's proposed regulations. Specifically, (i) what do OFHEO's ambiguous new federal standards mean, and (ii) what is the relationship between those new standards and the state law rules that the Enterprises have designated? Absent clear answers, there undoubtedly would be confusion and uncertainty about what directors must do in order to comply with the new regulations.

- ***The Proposed Regulations Would Greatly Increase The Exposure Of Individual Directors To Personal Liability.***

Third, OFHEO's proposal would significantly limit the availability of indemnification to directors in administrative proceedings initiated by OFHEO. This aspect of the proposal would substantially increase the risk of personal financial liability that directors would face as a result of the rules of conduct set forth in the proposed regulations.

B. The Resulting Impact Of The Regulations Would Substantially Impair The Quality Of Governance At The Enterprises.

The changes in governance structure that would result from the proposed regulations would adversely impact the quality of governance at the Enterprises in several ways. First, the effort needed to understand and then to comply with the regulations would divert the board's limited resources from its critical oversight role. Second, the increased exposure to personal liability would distort directors' decisionmaking. Third, greater personal exposure would discourage qualified individuals from serving as directors.

- ***The Time And Attention Of The Board Would Be Diverted From Its Critical Oversight Role.***

If the proposed regulations were adopted, directors and those who advise them about their responsibilities (including management, attorneys, accountants, auditors and others) would need to devote significant time and attention to analyzing what directors need to do in a myriad of specific factual contexts in order to comply with the regulations. Without any place to look for guidance, they would need to try to determine how, and to what extent, the current (and traditional) level of board oversight of management must be increased and/or otherwise altered with respect to **each**

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[18] *See, e.g., ABA Committee on Corporate Laws,* "Corporate Director's Guidebook, Third Edition," The Business Lawyer, Vol. 56, p. 1575 (August 2001) ("Guidebook").

aspect of Enterprise business in order to provide a reasonable comfort level for directors concerning their proposed obligations to "ensure" a variety of results.

Moreover, the board and those who advise them would need to determine how to meet the board's significantly expanded obligations in the face of the proposed provision that, as noted above, appears to override state law rules permitting the full board to delegate responsibility to, and to rely on, board committees.[19] This aspect of the proposal appears to undercut the entire board-committee structure, which is fundamental to modern corporate governance. If the full board and individual directors cannot rely on committee action, how can the board possibly accomplish the functions for which it is responsible under state law, let alone the long list of federal responsibilities proposed by OFHEO?

No matter how the issue of board committees is resolved, the board and its advisors would need to develop **very specific** answers to questions such as the following:

- How should the numerous management reports on which directors rely be augmented or otherwise altered to **ensure** that **each** director is sufficiently informed under the proposed regulations? Each Enterprise director has a distinct background and an individual range of experiences and expertise. Because each director would have **individual** responsibility and potential **individual** financial exposure with respect to each of the proposed regulatory requirements, the directors and management likely would need to implement management reporting and director information systems tailored to the **individual** backgrounds of **each** individual director. This task would be both overwhelming and absurd. Such a system also would be inconsistent with the statutory provisions which specify particular areas of background for the directors of the Enterprise boards who are appointed by the President.[20]

- How can **each** director **personally** ensure that every compensation plan administered by management complies with all tax, employment and other applicable laws and regulations?

- How much additional information would **each** director need to obtain and analyze to **personally** guarantee that every senior executive candidate is qualified for the position?

- What can **each** director possibly do within his or her available time to **personally** ensure the integrity of all of Freddie Mac's accounting and financial reporting systems?

- How can each director guarantee the responsiveness of executive officers to information needs and supervisory concerns of federal regulators without **personally** reviewing each such request or issue and management's response?

If the proposed regulations were issued without substantial change, they would trigger an intensive effort by the board and its advisors to arrive at answers to these and other similar questions. A substantial portion of the limited time and resources of the members of the board would then have to be reallocated to the activities that the board (and senior management) have determined to be necessary to comply with the regulations. The time and resources that would need to be devoted to

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[19] Proposed § 1710.11(a) is discussed in greater detail below, in Section II.D of this comment letter.
[20] 12 U.S.C. § 1452(a)(2)(A); 12 U.S.C. § 1723(b).

such activities would come at the expense of the **real business of corporate governance** – the board's exercise of its expertise and judgment, as Congress intended, to oversee management's conduct of Enterprise business and operations. Uncertainty and confusion about directors' obligations and how to satisfy them, and a focus on the trees (and even the branches) instead of the forest, would come to dominate the corporate governance process at the Enterprises. The ability of directors to perform their essential role in that process therefore would be seriously undermined.[21]

- ***The Board's Decisionmaking Process Would Be Distorted.***

Like all corporations, the Enterprises constantly must make business decisions that involve taking and managing risks, including operational risk, technology risk, human capital risk, etc. Credit risk and market/interest rate risk are particularly critical to the ability of Enterprises to carry out their housing finance mission (including the financing of housing for low-income and moderate-income families). Congress concluded that the traditional model of corporate decisionmaking and risk assessment was the model that would best enable the Enterprises to fulfill their housing finance mission, and embodied this view in the Enterprises' authorizing statutes. Specifically, Congress provided for the Enterprises to be governed and to make strategic decisions like other privately-held corporations, subject to certain specific safety and soundness safeguards outlined by statute.

However, the proposed regulations would expose Enterprise directors to a threat of personal liability that other corporate directors do not face. Enterprise directors therefore undoubtedly would perceive that a risk-averse strategy would be less likely to expose them to personal liability. This perception inevitably would cause directors to take an unduly cautious approach in evaluating the business and economic risks that the Enterprises face in order to fulfill their housing finance mission.[22]

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[21] *See, e.g., Langevoort*, 89 Geo. L.J. at 825-26, 830 ("we would expect the level of trust between insiders and the monitors [on the board] to diminish, resulting in less candid disclosure and reduced advice seeking; increased accountability leads to "the tendency to spend undue time and attention justifying previous decisions that now might seem questionable"; "[i]f we think that directors have much to offer strategically and in terms of monitoring within a limited time and attention frame, then we should hesitate to force them to shift some of that attention toward some other issues (such as reporting accuracy) unless we are convinced that it is truly a better use of their time"); *Manning,* 39 Bus. Law at 1485-86 ("[I]n the real world the most important business judgment that is actually made by a board is the judgment it makes about its own agenda or about the way it arranges for its agenda to be set. That judgment must, as a generalization, be honored by the law and protected against hindsight second guessing..."); *Olson*, 54 Bus. Law at 1102, 1108, 1111 (as a result of overloading audit committee members with too many responsibilities, "committee effort and energy may be dissipated in so many directions that the committee becomes ever more busy but ever less effective"; "[w]hat is reasonably clear is that the way to get more effective work from audit committees is not to require more reports, impose more formal experience qualifications, or create a greater risk of committee members being named as defendants"); *ALI* at 137 ("the need...to avoid the counterproductive effects (*e.g.*, ...diminished efficiency) that disproportionate penalties could produce"); The Judge–William Allen (interview with William Allen, former Chancellor of Delaware Court of Chancery), Directors & Boards, Vol. 26, No. 1, page 42 at 43 (2001) (*"Allen Interview"*) ("The board has to be engaged in thoughtful review of strategy and the basic structures of the corporation, but cannot be engaged in management as they don't have the time or the information required to do so."); Hamermesh Comment; Langevoort Comment.

[22] *See, e.g., Langevoort*, 89 Geo. L.J. at 818 ("[m]ost costs of subjecting directors to increased liability risk are well-recognized" and include "overprecaution"); *ALI* at 137, 240 ("counterproductive effects...that disproportionate penalties could produce" include "risk aversion"; "threat of liability may make corporate officials excessively risk-averse in their decisionmaking, thereby injuring shareholders and diminishing

- ***Qualified Individuals Would Be Unwilling To Serve As Directors.***

Finally, any rational director or candidate for an Enterprise board would recognize that the proposed regulations would increase substantially his or her potential exposure to personal financial liability in comparison with service on other corporate boards. There are a limited number of individuals qualified to sit on the boards of major financial institutions such as the Enterprises, and those individuals have the opportunity to sit on the boards of many such institutions and other sophisticated corporations. The proposed standards of conduct and responsibilities would impose obligations that go far beyond the current requirements of state law and best practices. Uncertainties about the application and meaning of the proposed rules would compound this problem, as directors and board candidates would be unable to determine in advance what they would be required to do in order to comply with the regulations. The proposed restriction on indemnification would further increase that risk. Particularly in light of the growing acceptance of the principle that qualified individuals should limit the number of boards on which they sit, the increased risks created by the proposed regulations are certain to result in a decrease in the ability of the Enterprises to attract and retain qualified directors, especially in periods of economic stress when strong directors are most important.[23]

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efficiency"); *Dennis J. Block, Nancy E. Barton, and Alan E. Garfield,* Advising Directors on the D&O Insurance Crisis, 14 Sec. Reg. L.J.130, 132 (1986) (exposure to liability could result in "an unhealthy over-cautiousness" on the part of directors); Hamermesh Comment; Langevoort Comment.

[23] Between 1989, when the Financial Institutions Reform, Recovery & Enforcement Act substantially increased bank regulatory agency enforcement powers against individuals, and 1991, 20% of banks suffered director resignations or refusals to serve that were motivated by fear of personal liability, according to a study performed by the American Association of Bank Directors. Comments of American Association of Bank Directors, OCC Rules Docket No. 95-04 (June 1, 1995). *See, also, Langevoort,* , 89 Geo. L. J. at 818, 825-26 ("well-recognized" "costs of increased director liability" include "refusals of good people to serve"; "board service generally would become less appealing" as a result of increased liability); *Hanks*, 43 Bus. Law. at 1233 ("[M]any of the best-qualified directors will simply refuse to serve rather than subject their personal assets to a judge's or jury's retrospective evaluation of the adequacy of their conduct. Thus, personal liability may retard rather than promote corporate efficiency and productivity."); *Hansen*, 41 Bus. Law. at 1239 ("[I]f the directors are to be second-guessed as to the substance of their decisions, with accompanying liability, few will serve."); *Veazey*, 42 Bus. Law. at 400-401 (The trend of increasing director liability and reduced availability of D&O insurance resulted in "the ultimate irony in corporate governance – outside directors refusing to serve. Obviously, if competent directors are not willing to serve because of an unreasonable risk of exposure of their personal assets, the laudable policy of having independent directors as decisionmakers is seriously undermined." (footnote omitted)); *Block,* 14 Sec. Reg. L.J. at 131-132 ("[D]irectors may choose to resign instead of risking exposure to liability" and "may refuse to serve when the potential for liability is so vastly disproportionate to any benefits they might receive from the corporation. The result could be an exodus of talented individuals from corporate service..."); *Allen Interview* at 43 ("[T]hreatening directors with liability could have great negative consequences. Because corporations are so large, the potential liability in judgments could be huge, so at some point, even though there is D&O insurance and indemnification, if liability were a real risk people would not serve."); ALI at 240 (threat of liability coupled with difficulty of obtaining D&O insurance "may chill the willingness of independent directors to serve if the potential burdens of office are perceived to outweigh the corresponding benefits"); *Olson*, 54 Bus. Law. at 1102 (if overloaded with too many responsibilities, "good directors may decline to take on the burden of audit committee service"); Hamermesh Comment; Langevoort Comment. The general unavailability of D&O insurance in the mid-1980s had essentially the same impact on all corporate directors as OFHEO's proposal would have on Enterprise directors, by greatly increasing their exposure to personal

C. *Congress Did Not Intend That Governance At The Enterprises Be Regulated As OFHEO Has Proposed.*

OFHEO's proposed regulations exceed the authority granted by Congress to OFHEO. The regulations also would violate a fundamental legal principle by imposing **federal** corporate governance regulation on the Enterprises in the absence of express authority to do so. Finally, the provisions of the proposed regulations concerning compensation and indemnification conflict with specific statutory provisions that grant narrower authority to OFHEO.

OFHEO has authority under the 1992 Act to ensure that the Enterprises are "adequately capitalized and operating safely."[24] However, the proposed regulations, in their present form, exceed that authority. There is no suggestion in the legislative history of the 1992 Act that Congress intended or contemplated that OFHEO would attempt to substitute its own set of corporate governance rules for the state law rules on which the Enterprises, like other private corporations, have traditionally relied. Nor is there any such suggestion in the discussions of the role of the proposed new safety and soundness regulator for the Enterprises (which was subsequently assigned to OFHEO) in the April 1991 reports of the Treasury Department and the Congressional Budget Office, which were part of the basis on which the 1992 Act was drafted and enacted.[25] OFHEO's proposed governance regulations are simply at odds with the statutory scheme that Congress has enacted.

When it adopted the 1992 Act[26], Congress intended that the Enterprises be governed under state law like other privately-held corporations and found no need for federal legislation or regulation of the corporate governance practices and procedures of the Enterprises:

> "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 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

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financial liability. In response, many directors chose to abandon board service until exculpatory statutes were enacted to address the crisis. *See., e.g.*, *Hanks*, 41 Bus. Law. at (3); *Veazey*, 42 Bus. Law. at 400-401; *ALI* at 240; *Block,* 14 Sec. Reg. L.J.130; *Laurie Baum*, The Job Nobody Wants, Business Week, September 8, 1986; *Mary Ann Galante*, Corporate Boardroom Woes Grow; The D&O Crisis, The National Law Journal, August 4, 1986. To the limited extent that D&O insurance would remain technically available to Enterprise directors under OFHEO's proposal, it is doubtful whether insurers would provide such insurance at an acceptable cost in light of the significantly increased exposure of directors under the proposal, thereby exacerbating the very substantial disincentive to board service that the proposal would create.

[24] 1992 Act § 1313(a). OFHEO has authority to issue regulations to implement its authority (including regulations establishing capital standards and implementing its enforcement authority) and to perform several enumerated tasks, none of which relate in any way to the Board of Directors. 1992 Act, § 1313(b). OFHEO also has regulatory authority over "all other matters relating to the safety and soundness" of the Enterprises. 1992 Act § 1321.

[25] *See* Report of the Secretary of the Treasury on Government-Sponsored Enterprises (April 1991) at 10-15; Congressional Budget Office; Controlling the Risks of Government-Sponsored Enterprises (April 1991) at 180-89. These studies were mandated by Congress in § 13501 of the Omnibus Budget Reconciliation Act of 1990 (P.L. 101-508).

[26] 12 U.S.C. § 4501, *et seq.*

> 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."[27]

Congress has given no indication that it has changed its view since that time. And, in light of the acknowledged history of outstanding governance at the Enterprises, there is no reason for it to have done so.

Beginning as long ago as *National Bank v. Commonwealth*,[28] the Supreme Court has consistently held that federally chartered banks are generally subject to state law. In *Atherton v. FDIC*,[29] the Court held that there is no general "federal common law" that addresses corporate governance for federally chartered banks. Thus, in the absence of a binding regulation issued pursuant to delegated congressional authority, the courts should look to state law for the applicable corporate governance rules. The Court suggested that a likely source of such state law would be the state in which the federally chartered bank has its main office or maintains its principal place of business.

In *Atherton* and other cases, the Supreme Court has recognized the "internal affairs doctrine," a well-established conflict of laws principle. The doctrine provides that "only one State should have the authority to regulate a corporation's internal affairs – matters peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders – because otherwise a corporation could be faced with conflicting demands."[30] This principle is applicable here, as it was in *Atherton*, where the Court held that there was no need for a federal common law of corporate governance for federally-chartered institutions. The "internal affairs doctrine" seeks to ensure that "there be a single point of legal reference" for corporate governance matters.[31] The Court recognized that state law properly filled that role in *Atherton*. Similarly, state law properly fills that role in the case of the Enterprises. Establishing an unnecessary body of general federal corporate governance rules for the Enterprises that expands and overlays otherwise applicable state law creates just the risk of confusion and uncertainty that the Court cautioned against in *Atherton*.

Finally, in addition to exceeding OFHEO's general powers to promulgate corporate governance regulations, certain aspects of the proposed regulations exceed specific and carefully delineated statutory authority that Congress provided to OFHEO when Congress expressly addressed those issues. In particular, the proposals to regulate the compensation of directors and of employees other than executive officers and to limit indemnification in OFHEO administrative proceedings are contrary to specific grants of authority. These statutory provisions are discussed further in the sections that follow.

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[27] S.Rep. 102-282, 102d Cong., 2d Sess. 25 (1992).
[28] 76 U.S. 353 (1870).
[29] 519 U.S. 213 (1997).
[30] 519 U.S. at 223-24, quoting *Edgar v. MITE Corp.*, 457 U.S. 624, 645 (1982).
[31] 519 U.S. at 224.

II. PROVISION-BY-PROVISION COMMENTS

A. New Federal Law Concerning the Role of Directors

Section 1710.10 of the proposed rule would require Freddie Mac to elect to follow and to be bound by the corporate governance practices and procedures of Virginia, Delaware or the Model Business Corporation Act, and to make this election in its bylaws within 90 days.

Freddie Mac agrees that state law should continue to provide the governance rules for the Enterprises. Indeed, Freddie Mac's bylaws have long provided that Virginia law would provide the rule of decision for interpreting those bylaws. However, we believe that OFHEO should rely on those state laws, and the case law interpreting them, rather than establishing its own parallel set of regulatory governance requirements such as the provisions of proposed Subpart C dealing with the conduct and responsibilities of directors. If adopted in their current form, those provisions would have an immediate negative effect on the Enterprises' ability to attract and retain high quality Board members – thereby undermining, rather than enhancing, the Enterprises' safety and soundness.

OFHEO also should clarify the manner in which it might implement the "safety and soundness" provision in proposed § 1710.10(a). In particular, OFHEO should make clear that it would not seek to bar an Enterprise from following some aspect of its designated state law procedures in a manner that could increase retroactively the potential liability of an officer or director for prior conduct. OFHEO should provide that such authority will be exercised only with prospective effect on officers and directors.[32]

In addition, OFHEO should make clear that it does not intend to transform the state law governance rules to be adopted by the Enterprises into federal rules, to be interpreted and enforced by OFHEO in potential conflict with the state courts and federal courts applying those state laws. This result would magnify the uncertainty and increase the potential exposure faced by Enterprise directors. This result could be avoided, for example, by including a provision in proposed § 1710.10 stating that such state law governance rules shall remain subject to interpretation and enforcement solely by the appropriate state court or by federal courts interpreting state law.

- ***Proposed § 1710.20 – Conduct of Board Members***

The proposed rule would require Freddie Mac directors to comply with a variety of standards of conduct, including acting on a fully informed, impartial, objective and independent basis, in good faith and with due diligence, care and loyalty, in the best interests of the shareholders and Freddie Mac, and in compliance with the Charter Act and other applicable laws and regulations, and devoting "sufficient time and attention" to his or her responsibilities as a director.

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[32] For example, the introductory portion of proposed § 1710.10(a) might be revised in the following manner: "Each Enterprise shall elect to follow and be bound by the corporate governance practices and procedures of one of the following bodies of law, except to the extent such procedures are inconsistent with safety and soundness, as determined by the Director by regulation or order but affecting only director or officer conduct occurring after the date of such regulation or order, and applicable Federal law, rules, and regulations...."

Virginia law and other state codes embody many of the same requirements, but in different and significantly less specific terms, relying on case law to supplement the statutory provisions.

The proposed OFHEO standards would create considerable difficulty because of the uncertainty and confusion that they would generate concerning their scope and interpretation. Unless these standards are intended to have precisely the same meaning as the corresponding state law requirements, there is no way to know how to interpret them in a reliable, informed fashion. For example:

- How informed is "fully informed"? Surely it is not good governance for directors to attempt to know everything that senior management knows, even about the issues that the Board oversees.

- Is a director "impartial [and] objective" if he or she is acting in the best interests of the shareholders and/or the Enterprise, as required, even though such action could be characterized as being neither "objective" nor "impartial"?

- By referring to the "best interests of the shareholders and the Enterprise," rather than the traditional reference to the interests of the corporation (which is understood to mean the shareholders), is OFHEO suggesting that those interests do **not** coincide?

- How much time is "sufficient," and for what purpose must it be sufficient? There is no way to give content to such a requirement, other than to conclude that it must mean that a director is required to spend the time necessary to carry out his or her responsibilities. The requirement therefore would be superfluous and would serve no purpose other than to generate confusion and to occupy time and attention of directors (and those advising them) that should be devoted to corporate oversight.

In interpreting and giving meaning to these new federal requirements, are Freddie Mac and its directors supposed to look for guidance to Virginia law, to Delaware or other state law, to some unspecified federal "common law," or to as yet unissued OFHEO interpretations? For example, how does the proposed requirement that directors act "in good faith and with due diligence, care and loyalty" and "in the best interests of the shareholders and the Enterprise" differ from the Virginia requirement that a director discharge his or her duties "in accordance with his good faith business judgment of the best interests of the corporation," as supplemented by judicial decisions?[33]

These issues of interpretation are critical to Board members, especially in relation to difficult issues of judgment that often are central to an organization's long-term well-being. Yet, under OFHEO's proposal, directors would lose the ability to obtain reliable legal guidance concerning their obligations as directors. Such a result would not advance the best interests of the public, the Enterprises, their directors, or OFHEO.

In contrast to OFHEO's proposed approach, the federal banking agencies have issued informal guidance, rather than binding regulations, that address **in general terms** matters such as independence, loyalty, diligence, "regular" attendance at Board meetings, etc. Such guidance

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[33] Va. Code § 13.1-690.

permits banking institutions to look to and to rely on state law for the standards that govern the actions of their directors.[34] Indeed, OFHEO itself has issued extensive informal guidance on governance matters in the form of its examination guidelines.[35]

- ***Proposed § 1710.21 – Responsibilities of Board of Directors***

The proposed rule would make Freddie Mac directors responsible for ensuring that Freddie Mac is operating in a safe and sound manner. It would make directors expressly responsible, at a minimum, for reviewing and overseeing corporate strategy, hiring and retaining qualified senior executives, ensuring that officer and employee compensation complies with applicable law, ensuring the integrity of accounting and financial reporting systems, ensuring that appropriate controls exist to monitor risk and compliance with the charter and other laws and regulations, remaining informed of Freddie Mac's condition, activities, and operations, overseeing the adequacy of investor reporting, and ensuring the responsiveness of executives to Federal regulators. The proposal refers directors to "publications and formal pronouncements of OFHEO for further guidance."

In Freddie Mac's Charter Act, Congress provided that "[w]ithin the limits of law and regulation, the Board of Directors shall determine the general policies that govern the operations of the Corporation."[36] OFHEO's specification of director responsibilities goes far beyond this statutory provision, and far beyond the "best practice" standards that are applied under state law. And this provision, like others discussed above, will plainly create confusion as to the nature of directors' responsibilities.

First, the proposed rule imposes burdens and requirements on directors that far exceed those imposed by state law or generally accepted corporate governance best practices. For example, by making directors responsible for "**ensuring**" a number of corporate outcomes, these provisions would appear to make directors strictly liable for any number of adverse events that could occur, such as any inaccuracies in Freddie Mac's accounting or financial reporting systems, any violation of applicable wage and hour laws, and the hiring of any senior executive who, as a result of poor performance, might be viewed in hindsight as having been less than fully qualified.

Similarly, the proposal's codification of director responsibilities also places directors at risk for exercising their business judgment as to the appropriate level of oversight in which they should engage and the extent of discretion that they should delegate to management. This is bad regulatory policy and, once again, conflicts with state law and best practices.

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[34] For example, as discussed below, the OCC regulations permit national banks to rely on a designated body of state corporate governance law and refers the banks to OCC publications for further guidance. 12 C.F.R. § 7.2010. One such publication, the Director's Book published by the OCC, lists "be[ing] diligent" and "be[ing] loyal to the bank's interests" as a director's two "individual interests" that are discussed in the publication. Office of the Comptroller of the Currency, The Director's Book: The Role of the National Bank Director (March 1997) at 69-76.

[35] *See* OFHEO Examination Handbook, Examination Guidance (Doc. EG-98-01) at 19-24, 28-29 ("Internal Controls," "Audit," "Management Information" and "Board Governance").

[36] The phrase "within the limits of law and regulation" clearly refers to legal and regulatory limits on the substantive activities of Freddie Mac that necessarily limit the policies that can be set by the Board.

State governance laws do not require perfect decision-making by directors. Rather, directors are required to comply with their duties of loyalty and care and to exercise their good faith business judgment in the best interests of the corporation.[37] The business judgment rule, "well established in case law, protects a disinterested director from personal liability to the corporation and its shareholders, even though a corporate decision the director has approved turns out to be unwise or unsuccessful."[38] OFHEO, however, appears to be proposing a strict liability standard that is in stark contrast to more than a century of state corporate law jurisprudence and practice[39] and to the express desire of Congress "not ... 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."[40]

Second, the proposal addresses the scope of director oversight with terms that are in some cases so vague that they would not permit directors to understand what conduct is called for to conform to the regulations. For example, in proposed § 1710.21(a):

- What constitutes corporate "strategy" as opposed to tactical or operational matters?
- What are "major" plans of action?
- What is risk "policy" as opposed to risk practices or procedures?
- How detailed must oversight be to constitute "monitoring" of performance?
- In whose judgment and by what criteria must a senior executive be "qualified"?
- What are "appropriate" systems of control to identify and monitor risk and compliance?
- What level of reporting detail is necessary for directors to "remain informed"?

These concepts and terms are often found in the literature explaining best practices in governance.[41] They are appropriate for use in providing guidance to directors, but their vagueness makes them wholly inappropriate for use in a codification of governance **requirements** with which directors must comply to avoid liability.[42] This is no doubt why corporate governance statutes enacted by

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[37] *See, e.g.,* Va. Code § 13.1-690 (A) (business judgment rule); Guidebook at 1582-86.
[38] Guidebook at 1586.
[39] *See* Hamermesh Comment.
[40] S.Rep. 102-282, 102d Cong., 2d Sess. 25 (1992).
[41] For example, the Guidebook describes time commitment, the need to be informed, the right to rely on others, and inquiry as "**considerations**" that directors "**should take into account**" in exercising their duty of care and includes the following as "**questions**" that a "director should be particularly concerned that **the corporation has established and implemented programs designed to address**:" quality of disclosure, compliance with law, commitments of resources, adequacy of internal controls, protection of assets and counseling of directors. Guidebook at 1582-83, 1587-89 (emphasis added).
[42] Similar concerns are raised by proposed § 1710.21(b), which refers directors to "publications of and formal pronouncements of OFHEO for guidance on the responsibilities of the board of directors." If the regulations are revised to provide "guidance" for directors, then a reference to other unspecified guidance would not pose

states have remained relatively general, with details filled in by the courts in specific factual contexts. However, such judicial interpretations of applicable state law would no longer be a reliable source of guidance for Enterprise directors, thus compounding the confusion and uncertainty created by this proposed new federal specification of director responsibilities.

Many of the banking agencies have published guidance that specifies certain areas of responsibility for directors, but none is as detailed as the OFHEO proposal and none takes the form of binding regulations. Indeed, in 1995 the OCC initially proposed revising its regulations to impose on directors "the responsibility for supervising the management of the bank to ensure that the bank is operated in compliance with the policies and procedures established by the board, all applicable laws, rules and regulations, and safe and sound banking practices."[43] In response to comments that it was inappropriate to require directors to "ensure" a bank's legal and regulatory compliance, the OCC "acknowledge[d] the limitations inherent in crafting a regulation in this complex area that is not overly detailed yet provides directors with clear and useful guidance as to their responsibilities."[44] The OCC abandoned the proposed regulatory provision in favor of one stating simply that "the business and affairs of the bank shall be managed by or under the direction of the board of directors," and referring directors to OCC publications for additional guidance.[45]

In sum, the problems that would be created by proposed § 1710.21 cannot be cured by mere changes to its language, such as elimination of the word "ensure." Instead, the entire concept of separate federal regulatory standards for director responsibilities should be eliminated, just as the bank regulatory agencies eliminated comparable provisions from their proposed bank regulations in 1996.

- ***Proposed §§ 1710.11. 1710.12, 1710.20 and 1710.21 – Compliance with other applicable laws, rules and regulations***

At least five proposed provisions would require the board or a board committee to ensure or otherwise to be responsible for compliance with other "applicable laws, rules and regulations." These provisions deal with the conduct of directors generally (§§ 1710.20(a)(4) and 1710.21(a)(4)) and with compensation (§§ 1710.11(B)(2), 1710.12 and 1710.21(a)(3)). Provisions such as these could be read to transform any conduct inconsistent with any federal, state or local "laws, rules, and regulations" to which the Enterprises or an individual director might be subject into a violation of the OFHEO regulations, even in matters wholly unrelated to OFHEO's mission, such as tax and employment matters. Moreover, such a violation could be seen as a matter for enforcement by OFHEO – with very limited indemnification rights – in an OFHEO proceeding.

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a problem. However, binding rules of conduct that impose sanctions, particularly on individual directors, cannot incorporate unspecified "publications and pronouncements", adopted outside the regulatory process.

[43] 60 *Fed. Reg.* 11924, 11937-38 (March 3, 1995) (proposed § 7.2010).

[44] 61 *Fed. Reg.* 4849, 4855 (Feb. 9, 1996).

[45] *Id.* at 4867 (§ 7.2010). OCC also adopted a provision, like that proposed by OFHEO, which permits banks to adopt one of several bodies of state corporate governance rules. 12 C.F.R. § 7.2000(b). However, as noted above, OCC did not also adopt rules imposing a lengthy list of overlapping federal responsibilities on directors. Moreover, the OCC provision requiring compliance with applicable Federal banking statutes and regulations and safe and sound banking practices applies to "national bank[s]," **not** to individual directors. (12 C.F. R. § 7.2000(a)).

Those unspecified other "laws, rules and regulations" are subject to whatever enforcement authority was deemed appropriate by Congress or by the state government that enacted them, whereas OFHEO's statutory enforcement authority is generally limited to violations of the 1992 Safety and Soundness Act and the Enterprises' Charter Acts. Congress did not authorize or intend OFHEO to be the enforcer of all laws, rules and regulations that are issued by any governmental entity and that apply to the Enterprises and/or their directors. OFHEO should not try to "bootstrap" itself into that role merely by including a duplicative requirement in its own regulations that the Enterprises and their directors must comply with all such laws, rules and regulations.

B. Indemnification – Proposed §§ 1710.30 and 1710.31

The proposed restrictions on indemnification in §§ 1710.30 and 1710.31 would have a direct adverse impact on the Enterprises' ability to attract highly qualified individuals to serve on their Boards.

- ***OFHEO Administrative Proceedings***

The proposed rules would prohibit indemnification of directors and executive officers in any OFHEO administrative proceeding that results in a final order or settlement pursuant to which the director (or executive officer) is assessed a civil money penalty or is required to cease and desist from or take any affirmative action. The proposal would permit partial reimbursement with respect to any charges as to which a formal and final finding was made in favor of the director or executive officer.[46]

Congress did not give OFHEO authority to impose the proposed limitation on indemnification of Enterprise directors. In § 4636(g) of the 1992 Act, Congress prohibited indemnification of directors or executive officers for any "third-tier" penalty (as defined in § 4636(b)(3)) imposed by OFHEO. Had Congress also intended to prohibit, or to authorize OFHEO to prohibit, indemnification under any other circumstances, it would have done so – but it did not.

Banking agency rules contain restrictions on indemnification in administrative enforcement proceedings similar to those proposed by OFHEO. Indeed, OFHEO's proposed indemnification provisions appear to be based directly on provisions of those rules. However, the banking agency indemnification regulations were promulgated pursuant to an express grant of specific statutory authority by Congress in 1990. That authority permitted federal banking agencies to prohibit indemnification in connection with any administrative proceeding in which the potential indemnitee is assessed a civil penalty, removed or prohibited from participating in conducting the affairs of the institution, or required to take certain types of affirmative action.[47]

It is not surprising that Congress took a far more limited approach when it addressed indemnification for the Enterprises in the 1992. The pervasive limitation on bank indemnification

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[46] The proposed rule would permit "reasonable" payments to be made for insurance coverage and for partial indemnification as to which a favorable finding has been made. Proposed § 1710.31(b). "Reasonable" is not (and cannot be) defined. Inclusion of that word would preclude the ability of directors to rely on the availability of indemnification and would give OFHEO unwarranted discretion to prohibit a payment even if it did not threaten the safety and soundness of an Enterprise.

[47] 12 U.S.C. § 1828(k)(5).

that Congress authorized in 1990 was part of Congress' urgent response to the thrift debacle and the rising tide of bank failures. In 1989, Senator D'Amato reviewed the exigent circumstances that had led to the increased thrift enforcement powers granted to federal regulators a few months earlier in the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, as part of the initial Congressional reaction to the thrift crisis. He then praised the positive impact that Freddie Mac, with its new board of directors structure, would have on the safety and soundness of the thrift industry. Senator D'Amato recognized that Freddie Mac and its board of directors were part of the solution, not part of the problem:

> "Mr. President, as a member of the Banking Committee, I cooperated in the chairman's efforts to produce a thrift bill. This legislation was necessary; and, last April when we voted, expeditious action was required because the thrift industry was losing enormous amounts of money. Therefore, the funding to close or merge these hemorrhaging institutions was a dire necessity.
>
> As with every other major piece of legislation, we all would have written certain parts of the Senate bill differently. However, as with all legislation, especially major legislation under emergency circumstances, much compromise has attended the road to the floor. In that context, I supported a prudent funding mechanism and regulatory reforms to clean up the fiscal debris and assure that excesses did not occur again.
>
> As many know a terrible cost has already been visited upon the thrift industry and the American public. The Senate bill as passed last spring was designed to exact additional costs as repayment for losses and abuses and at some institutions elsewhere in the country that were beyond the control of the vast majority of good savings and loans in my State.
>
> I supported S. 774. It contained many laudable provisions. Among these was the conversion of the Board of Freddie Mac from a governmental to a private sector orientation. With this new structure, Freddie Mac will be still better able to perform its important function as a secondary mortgage market intermediary. I am proud of the role I played in cosponsoring, with Senator Cranston, a provision of the Senate bill to establish an 18-member board with 13 shareholder-elected members for Freddie Mac. Furthermore, I am pleased that this provision is in the conference report.
>
> The home mortgage lender of the future will depend even more upon an efficient and liquid secondary mortgage market. S. 774's provisions of Freddie Mac, included in the conference report, will bring still more of the genius of the free market to bear on the activities of Freddie Mac. Just as occurred last year when we caused the preferred stock of Freddie Mac to be publicly traded for the first time, the thrift industry will be made stronger, safer and sounder by privatizing the governance of Freddie Mac."[48]

As the thrift crisis continued to escalate into 1990, Congress took even stronger action, which included authorizing the Federal Deposit Insurance Corporation to restrict "golden parachute" and indemnification payments to directors, officers, employees and controlling stockholders of FDIC-insured institutions.[49] The legislative history of this legislation, which was part of the

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[48] 135 Cong. Rec. S10182, S10213 (August 4, 1989).

[49] *See* Title XXV § 2523 of P.L. 101-647, 104 Stat. 4786, 4868 (adding new section 18(k) to the Federal Deposit Insurance Act, 12 U.S.C. § 1828(k)).

Comprehensive Crime Control At of 1990, makes clear that the thrift provisions were directed at blatant criminal activity, such as embezzlement, not errors of judgment:

> "H.R. 5269, the 'Comprehensive Crime Control Act of 1990,' is intended to provide a legislative response to various aspects of the problem of crime in the United States....
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> * * *
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> "Society also pays a heavy price for the activities of 'white-collar' criminals. No more vivid or current example of this price can be found than in the unfolding savings and loan scandal, in which executives of thrift institutions and others associated with them enriched themselves by fraudulently diverting immense amounts of funds from those institutions. It is estimated that the ultimate cost of this scandal may be as much as $500 billion—a[n] amount that might otherwise be put to useful purposes in our society."[50]

Although there was little debate concerning the indemnification provisions themselves, the closely-related golden parachute restrictions were characterized as an effort to prevent those responsible for the crisis from enriching themselves at the taxpayers' expense: "Directors, officers and others responsible for an institution's failure or near failure should not be permitted to line their pockets with an insured institution's money at the expense of the insurance funds."[51]

One of the few comments on the indemnification provisions explained those provisions not as a deterrent against future misconduct, but as part of the overall legislative program to exact punishment and disgorgement from those who had unlawfully profited at the public's expense: "[The indemnification provisions] will prevent directors and officers from escaping personal liability for violations of law, by prohibiting institutions from paying their legal fees and fines in such actions."[52]

The mood and intent of Congress in enacting these provisions was summed up by the remarks of Congressman Schumer, who chaired the House Judiciary Subcommittee on Criminal Justice:

> "[T]he American public lived through an unprecedented crime wave in the 1980's. Without even knowing it, the average American was terrorized by thugs whose weapons were pens, not guns; whose attire was a suit, not a ski mask; whose place of attack was a boardroom, not a back alley. While no pistol was pointed at their heads, the American people got mugged anyway.
>
> The one thing the street crook and the S&L criminal have in common is their goal: the public's money. Over the past decade, the taxpayer has been robbed of billions in the most pervasive financial swindle of our times.

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[50] H. Rep. 101-681(I) at 69 (House Judiciary Committee Report).
[51] "Legislative Options for Improving Prosecutions of Financial Institutions Crimes," Hearing before the House Subcommittee. on Criminal Justice, Committee. on the Judiciary, on H.R. 4990, H.R. 5044, H.R. 5050, H.R. 5098, H.R. 5101, and H. Res. 407, 101st Cong., 2d Sess. Ser. No. 121 (July 11, 1990) at 174 (Testimony of FDIC/RTC Chairman L. William Seidman).
[52] H. Rep. 101-681(I) at 182.

> By all accounts, Americans are at the end of their rope; they want explanations, they want answers, and most of all they want solutions. They have been robbed once; they will not take kindly to the notion of forking over yet more tax dollars to drain the S&L cesspool without decisive action against the crooks who perpetrated this horror.
>
> ....One year from now, this House will be able to look back and pinpoint specific ways in which it helped bring S&L criminals to justice."[53]

The situation facing Congress two years later, when it enacted the much more limited indemnification prohibition found in § 4636(g) of the 1992 Act, could not have been more different. There was no history of improper (let alone fraudulent or criminal) conduct at the Enterprises to be addressed and no crisis to be resolved. Nor was there any history of self-enrichment by directors at public expense. Senator Riegle reflected this contrast when he explained in June 1992 why Congress had been unable to enact legislation regarding the Enterprises in 1991:

> "[W]e had a major problem in the Federal banking system where we had to provide emergency funding to bail out the Federal deposit insurance system for banks; some $70 billion of public loans had to be provided along with a series of banking reforms. That took precedence because of its overriding urgency, and the GSE legislation had to stand aside."[54]

Indeed, the 1992 Act contained an express Congressional finding that "considering [their] current operating procedures, ...the enterprises...currently pose low financial risk of insolvency."[55] The 1990 Congressional response to the thrift crisis did not reflect a broad policy determination that similar harsh treatment was necessary or appropriate for other institutions, like the Enterprises, whose governance practices and results were vastly superior to those of the troubled thrifts. It therefore would be inappropriate to use the 1990 thrift legislation and implementing regulations as a model for regulation of the Enterprises' boards under the more limited legislation adopted by Congress for that purpose in 1992. Instead, the proposed regulation should be amended to conform to the authority that Congress expressly provided in the 1992 Act; *i.e.*, to prohibit indemnification for third-tier penalties.

- ***Civil Actions and Other Administrative Proceedings***

In civil actions and administrative proceedings not initiated by OFHEO, the proposed rules would permit an Enterprise to indemnify its directors pursuant to state law, provided that the indemnification payment would not materially adversely affect the endanger the Enterprise's safety and soundness. OFHEO should make clear that the proviso refers only to the unlikely situation in which the **amount** of the indemnification payment might be so large that it would threaten an Enterprise's safety and soundness. Otherwise, an attempt could subsequently be made to interpret this rule to permit OFHEO to determine, **after** a director has engaged in conduct that is being challenged in a judicial or non-OFHEO administrative proceeding, that indemnification for any

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[53] 136 *Cong. Rec.* H6003-6004 (July 31, 1990).
[54] 138 *Cong. Rec.* S8449 (June 18, 1992).
[55] 12 U.S.C. § 1392(3).

liability or expenses that the director might incur as a result of that conduct should be prohibited for **policy** reasons relating to the Enterprise's safety and soundness. Such a retroactive determination would be patently unfair to directors, and even the theoretical risk that the rule might be reinterpreted in that manner could significantly hamper the Enterprises' efforts to recruit and retain qualified directors. Apart from situations in which the amount of an indemnification payment poses a safety and soundness concern, applicable state law should be allowed to govern all indemnification in non-OFHEO proceedings.

C. Compensation – Proposed § 1710.12

The proposal would require that the compensation of directors, executive officers and employees not exceed that which is reasonable and commensurate with their duties and responsibilities and that such compensation comply with applicable laws and regulations. Although the proposed regulations treat all three groups in the same manner, the statutory scheme applies in different ways to compensation of directors, of executive officers, and of other officers and employees. Congress did not give OFHEO authority to regulate the compensation of directors and of employees other than executive officers. And, with respect to executive officers, OFHEO should modify its proposed regulation to make it consistent with the standard specified by Congress.

Statutory Provisions. Freddie Mac's Charter Act authorizes it "to fix and provide for the compensation and benefits of officers, employees, attorneys, and agents **as the Board of Directors determines reasonable and comparable with compensation for employment in other similar businesses (including publicly held financial institutions or other major financial services companies) involving similar duties an responsibilities....**"[56] Under the 1992 Act, the Director of OFHEO is directed to "prohibit the enterprises from providing compensation to any **executive officer** of the enterprise that is not **reasonable and comparable with compensation for employment in other similar business (including other publicly held financial institutions or major financial services companies) involving similar duties and responsibilities.**"[57] The 1992 Act also authorizes the Director of OFHEO, without HUD review or approval, "to make such determinations, take such actions, and perform such functions as the Director determines necessary regarding...prohibiting the payment of excessive compensation by the enterprises to any **executive officer** of the enterprises under Section 1318 [quoted above]."[58]

Executive Officers. OFHEO is expressly authorized to promulgate a rule prohibiting "excessive compensation" to **executive officers** of the Enterprises.[59] However, Congress clearly spelled out what it meant by "excessive compensation", using identical language in **both** the Charter Act **and** the 1992 Act; *i.e.*, compensation that exceeds that which is "reasonable and comparable with compensation for employment in other similar businesses (including publicly held financial institutions or other major financial services companies) involving similar duties and responsibilities".[60] As OFHEO itself explained in its final regulations on executive compensation, issued on the same day as this proposal, the 1992 Act "requires the Director [of OFHEO] to prohibit an Enterprise from providing compensation to any executive officer that is not reasonable

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[56] Charter Act § 303(c)(9), 12 U.S. C. § 1452(c)(9) (emphasis added).
[57] 1992 Act § 1318(a), 12 U.S.C. § 4518(a) (emphasis added).
[58] 1992 Act, § 1313(b), 12 U.S.C. § 4513(b) (emphasis added).
[59] 12 U.S.C. § 4518(a) (emphasis added).
[60] 12 U.S.C. § 303(c)(9); 12 U.S.C, § 4518(a).

and comparable with that paid by other similar businesses to executives doing similar work, *i.e.*, having similar duties and responsibilities. Businesses used for comparison purposes include publicly held financial institutions or major financial services companies."[61]

For reasons that it has not explained, OFHEO has now chosen to modify this Congressionally mandated standard, proposing instead in § 1710.12 to prohibit compensation that is in excess of that which is "reasonable and commensurate with their duties and responsibilities...." Congress made clear on two occasions that the reasonableness of the compensation of executive officers of the Enterprises is to be judged against compensation for positions involving similar duties and responsibilities in publicly held financial institutions, other major financial services companies, and other similar businesses. The proposed regulation potentially places the Enterprises in the position of having to comply with two different standards, one in the statute and another in these regulations. Congress did not authorize OFHEO to deviate from the statutory standard, and the proposed regulations should be revised to conform to it in the case of executive officers.

Other Officers and Employees. For officers who are not executive officers, and for other employees of the Enterprises, the Charter Act authorizes the Freddie Mac to fix and provide for the compensation of such individuals "as the Board of Directors determines reasonable and comparable" under the same standards that apply to executive officers.[62] However, **unlike executive officers**, the 1992 Act does **not** authorize OFHEO to prohibit, or to take any action to prohibit, the payment of excessive compensation to officers and employees who are **not** executive officers.[63]

Even if OFHEO's authority to protect the safety and soundness of the Enterprises otherwise could plausibly be argued to include the authority to regulate the compensation of such individuals, any such argument would clearly be overridden by one of the fundamental rules of statutory construction: *"expressio unius est exclusio alterius"*; *i.e.,* when a statute addresses a series of matters, individuals or other topics, any omissions from that list should be understood as intentional exclusions.[64] Here, the intent of Congress **not** to authorize OFHEO to regulate compensation of non-executive officers and other employees is clear. When it passed the 1992 Act in 1992, Congress added to the Enterprise Charter Acts the current language concerning compensation and expressly included **all** officers and employees in the list of individuals for whom the Enterprises were authorized to fix and provide for "reasonable and comparable" compensation (as determined by the Board of Directors).[65] However, when it drafted Sections 1313 and 1318 of the **same statute**, and repeated precisely the same "reasonable and comparable" standard that it used in the Enterprise Charter Acts, Congress chose to give OFHEO authority and direction to implement that standard **only with respect to executive officers** of the Enterprises. As Senator Riegle noted in debate, OFHEO was given authority to enforce specific provisions of the 1992 Act and "sections of the charter acts dealing with capital distribution, financial reporting, **executive officer** compensation, and any other provision relating primarily to safety and soundness."[66] In the

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[61] 66 *Fed. Reg.* 47550, 47554 (Sept. 12, 2001).
[62] 12 U.S.C. § 1452(c)(9).
[63] *See* 12 U.S.C. §§ 4513(b) and 4518.
[64] *See* Sutherland Statutory Construction, § 47.23 (5th Ed).
[65] 1992 Act, §§ 1381(j)(1), 1382(f)(1).
[66] 138 *Cong. Rec.* 17904, 17921 (August 8, 1992) (emphasis added).

face of that legislative history, the proposed regulation should be revised to eliminate non-executive officers and other employees from its scope.

Directors. It is equally clear that the proposed regulation should not encompass the issue of director compensation. Congress set a "reasonable and comparable" standard for the compensation of "officers, employees, attorney and agents" in the provisions of the Enterprise Charter Acts that authorize the enterprise to hire such individuals. However, it included no restriction on director compensation in either the Charter Act provisions providing for the election and appointment of directors or the 1992 Act provisions giving OFHEO limited authority to prohibit excessive compensation. Under these circumstances, there is a compelling inference that Congress did not intend to include director compensation within OFHEO's regulatory authority under the 1992 Act.

Banking Agency Guidelines. The interagency banking guidelines that prohibit excessive compensation for executive officers, employees, directors and principal shareholders of banking institutions do not support OFHEO's proposed compensation rule with respect to Enterprise directors, non-executive officers and other employees. The banking guidelines were not issued based on the bank regulators' general safety and soundness authority. Instead, the guidelines were issued expressly to implement a specific statute that requires all federal banking agencies to prescribe standards prohibiting compensation to "any executive officer, **employee, director, or principal shareholder**" that would be excessive or that could lead to material financial loss.[67] Such specific language is notably absent from OFHEO's grant of statutory authority. Indeed, the existence of such specific statutory authority for the interagency banking guidelines regarding compensation confirms the conclusion that OFHEO lacks authority for the similar provisions that it has proposed with regard to compensation of directors, non-executive officers and other employees.

D. Other Provisions

- ***Proposed § 1710.2 – Definitions***

Certain of the terms defined in proposed § 1710.2 would no longer be used if Freddie Mac's comments concerning other proposed provisions are adopted and the corresponding definitions should be deleted. In addition, Freddie Mac has the following comments on certain of the proposed definitions:

- The definition of "**agent**" should be modified to remove the reference to persons who act "for the benefit of" Freddie Mac. Persons who act on their own, "for the benefit of" Freddie Mac, but who do not act at the direction of or otherwise "on behalf of" Freddie Mac should not be included in the definition for any purpose.

[67] 12 U.S.C. §§ 1831p-1(a)(1)(F) and 1831p-1(c) (emphasis added).

- For the reasons discussed below, the definition of "**conflict of interest**" should be revised so that it does not refer to a person's ability to perform duties and responsibilities "in an objective and impartial" manner. Instead, Freddie Mac suggests the definition used in its Code of Conduct for directors, which defines a conflict of interest as "a situation in which an actual or apparent question of loyalty arises between a director's personal interest (financial or otherwise) and his or her responsibilities to Freddie Mac."

- The definitions of "**executive officer**" and "**senior executive officer**" differ somewhat from the combined definition of "executive officer" adopted by OFHEO in the Executive Compensation regulations that were published on September 12, 2001.[68] To avoid confusion, the definitions in the proposed governance regulations should be conformed to the definition in the compensation regulations, including the provision in the compensation regulations that OFHEO will identify the officers who are covered.

- The defined term "**legal expenses**" should be changed to "liability and legal expenses" to more clearly correspond to the definition, which includes any judgment, fine, settlement, etc., in addition to any expenses that are incurred.

- ***Proposed § 1710.10 – Applicable Law***

In the event that OFHEO promulgates a provision requiring an amendment to Freddie Mac's bylaws to designate a body of state corporate governance law (or for any other purpose), a period of 180 days – rather than 90 days – following the effective date of the regulations needs to be provided. Good governance practices mandate that any proposed amendment to an Enterprise's bylaws be carefully drafted and reviewed by management and then circulated to directors for their review prior to the meeting at which the amendment is to be considered. This process is typically initiated many weeks before the Board meeting at which the amendment is to be considered. Depending on when the regulations are promulgated, the proposed 90-day time period could require consideration of bylaw amendments at a quarterly Board meeting scheduled to take place within weeks, or even days, of the promulgation of the regulations, which would be neither advisable nor feasible.

- ***Proposed § 1710.11(a) – Board Committees – General Provisions***

This portion of the proposed rule would authorize Freddie Mac to establish Board committees, but would specify that no committee may amend the bylaws or relieve the full Board or any Board member of any legal responsibility that it otherwise may have.

Virginia law, like the law of other states, contains provisions that address the relationship between director liability and committee actions. Virginia law provides that committee action "**alone**" does not constitute compliance with the applicable standards of conduct, but it also expressly permits a director to rely on committee reports if he or she believes in good faith that the committee merits confidence.[69] OFHEO's proposal has a far more onerous provision stating that committee action has **no impact** on the liability of directors **and** the proposal lacks an accompanying provision

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[68] 44 *Fed. Reg.* 47550 (Sept. 12, 2001).
[69] Va. Code, §§ 13.1-689(E) and 13.1-690(B)(3).

authorizing reliance on board committees. If directors must assume full liability for any action they take based on the recommendation or report of a board committee then, as a practical matter, they cannot rely on committee reports and recommendations. This result would require the full board to handle all of the matters that are currently handled both by the board and by the board committees. Such a task would not only be inconsistent with the proposal's own provisions concerning audit and compensation committees, but would be entirely impossible.

- ***Proposed § 1710.11(b)(1) – Board Committees – Audit Committee***

This portion of the proposed rule would require the Enterprises to have an audit committee that complies with all audit committee requirements of the New York Stock Exchange (the "Exchange").

Both of the Enterprises are listed on the Exchange. The ultimate consequence of a violation by one of the Enterprises of the Exchange's audit committee requirements rules would be a violation of that Enterprise's Listing Agreement with the Exchange and, ultimately, delisting of the Enterprise from the Exchange (although it seems highly unlikely that an Enterprise would ever permit this situation to occur). However, by incorporating the Exchange rules into OFHEO regulations, the Exchange rules would be brought within OFHEO's interpretive and enforcement authority. Thus, for example, when an issue arises concerning even a relatively minor procedural matter, (*e.g.*, the timing of the annual affirmation to the Exchange concerning the audit committee requirements), it would apparently no longer be sufficient under the proposed OFHEO regulations to discuss that issue with the Exchange staff and to obtain their informal advice and/or clearance. Instead, the same question also would be a matter of OFHEO interpretation and enforcement. Individual directors also would be exposed to liability if the Enterprise took an approach that was acceptable to the Exchange but which OFHEO determined not to be consistent with its interpretation of the Exchange rules.

OFHEO should rely on the Exchange to continue to interpret and enforce the Exchange audit committee rules, rather than incorporating those rules into its own regulations. If OFHEO is concerned about the highly unlikely possibility that an Enterprise might fail to be listed on the Exchange at some time in the future, it could require that under that situation, the Enterprise nevertheless would be required to comply with the audit committee rules of the Exchange.

- ***Proposed § 1710.11(b)(2) – Board Committees – Compensation Committee***

This aspect of the proposed rule would require Freddie Mac to have a compensation committee, comprised of at least three Board members who are independent (as defined in the Exchange rules for **audit committee** members). Their duties would include approving compensation for senior executives and "ensuring" that executive and employee compensation complies with applicable law.

As discussed above, OFHEO has authority to regulate the compensation of executive officers, but not that of other officers or employees or directors. Even if OFHEO had authority to limit director and employee compensation, however, OFHEO's proposal to regulate **how** the Board must make its determinations concerning compensation is neither necessary nor justifiable. Any statutory or regulatory provisions governing compensation at Freddie Mac will apply to **any** director who oversees compensation. There is no basis to conclude that a compensation committee composed solely of "independent" directors is essential to "safety and soundness" concerns.

Indeed, the authority expressly granted by Congress to Freddie Mac in the Charter Act includes the authority to "fix...the compensation of officers [and] employees...**as the Board determines** reasonable and comparable..." and to "make and enforce such bylaws, rules and regulations **as may be necessary or appropriate** to carry out the purposes or provisions of [the Charter Act]."[70] OFHEO's authority under the 1992 Act to take such actions "as the Director determines **necessary**" regarding prohibiting the payment of excessive compensation to executive officers or the safety and soundness of the Enterprises does not authorize OFHEO to micro-manage the **procedures** by which the Board makes its compensation determinations pursuant to the Charter Act.

The proposal also exceeds best practices in governance. Irregularities and deficiencies in financial reporting at some companies have in recent years produced a consensus that has led to best practices and requirements – including those of the Exchange – concerning the need for an independent audit committee to detect fraud and to ensure accurate financial reporting. However, there is no such factual predicate or consensus concerning compensation committees, which perform a very different set of functions.

Notably, the federal banking agencies do not impose such a compensation committee requirement. Apart from audit committees, the federal banking agencies appropriately leave the subject of board committee structure to the sound judgment of the institutions' directors.

Finally, OFHEO's proposal to make directors responsible for "ensuring" that compensation plans for executive officers and employees comply with applicable laws (or, as discussed above, for ensuring any other outcome) is contrary to existing applicable law and best practices, as well as a very substantial threat to Board operations and to Freddie Mac's ability to recruit and retain qualified directors. The prevailing standard for Board oversight of compliance with laws is that set forth in *Caremark International Inc. Derivative Litigation*,[71] decided under Delaware law, in which the court held that the duty of a corporate director is to attempt in good faith to assure the existence of a corporate information and reporting system that will allow management and the board to reach informed judgments concerning the corporation's compliance with law.[72] OFHEO's proposal to impose strict liability on directors for "ensuring" Freddie Mac's compliance with all compensation-related laws would impose a vastly different, and untenable, burden on Freddie Mac's Board.

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[70] 12 U.S.C. § 1452(c)(9) and 1452(c)(3) (emphasis added).
[71] 698 A.2d 959 (Del.Ch. 1996)
[72] *Id.* at 971-72. *See* Guidebook at 1587 (the board should receive reasonable assurances that employees are informed of corporate policies directed at compliance and should periodically review (but not administer) compliance programs and endeavor to be reasonably satisfied that appropriate programs are in place).

- ***Proposed § 1710.13 – Quorum***

The proposed rule would require Freddie Mac's bylaws to provide that a quorum of the Board is a majority of the entire Board and that a director may not vote by proxy.

This rule would unnecessarily and inappropriately supplant otherwise applicable state law. OFHEO's proposed regulation would override the Virginia law provisions that Freddie Mac follows, which permit a company's articles of incorporation or bylaws to adjust the quorum requirement upward or, within limits, downward.[73] Freddie Mac has acted under this provision to impose a minimum quorum requirement of six directors, even if a smaller number would constitute a majority in the event that a large number of board seats were vacant. A large number of vacancies is a realistic possibility because Freddie Mac does not control the timing of the appointment by the President of five members of Freddie Mac's board. This bylaw provision, which is designed to enhance and protect the governance process at Freddie Mac, is consistent with the body of Virginia law that Freddie Mac would adopt under the proposed regulations yet would apparently be inconsistent with the new quorum provisions set forth in the proposed regulations. There is simply no need for such federal intrusion on the state governance rules under which the Enterprises have long operated.

- ***Proposed § 1710.14 – Conflict of Interest Standards.***

The proposed rule would require that Freddie Mac establish and administer written conflict-of-interest standards that will provide reasonable assurance that directors, officers and other employees and agents of Freddie Mac discharge their responsibilities in an objective and impartial manner. Freddie Mac has long had a comprehensive code of conduct, including conflict of interest provisions, which was revised extensively and then reviewed by OFHEO's examination staff only last year.

The proposed provision, in its current form, requires the Enterprises to adopt standards that "**will provide reasonable assurance** that board members, executive officers, employees, and **agents**...discharge their responsibilities in an **objective and impartial** manner" (emphasis added). If such a regulatory provision is to be promulgated, it should be changed in three ways.

First, any such provision should not be written in a manner that imposes an absolute yet subjective standard concerning the effectiveness of an Enterprise's code of conduct (*i.e.*, that it "**will** provide reasonable assurance").

Second, as discussed above, the meaning of the phrase "objective and impartial" is unclear in this context, because directors, officers and employees have a duty to act in the interest of the shareholders and/or the Enterprise.

Third, inclusion of "agents" within this provision would create a significant problem, particularly in light of the term's proposed definition, which would include outside counsel, accountants, and any other consultants or contractors "who ac[t] on behalf or for the benefit of an Enterprise, such as representing an Enterprise in contacts with third parties or providing professional services" to

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[73] Va. Code § 13.1-688.

Freddie Mac. It is not reasonable to require the Enterprises to make their codes of conduct applicable to such individuals, nor is it feasible for the Enterprises to attempt to do so.

For these reasons, Freddie Mac suggests that any such provision do no more than to call on the Enterprises to "establish and administer written standards that are designed to preclude situations in which board members, executive officers and employees face a conflict of interest when discharging their responsibilities on behalf of the Enterprise."

III. CONCLUSION

The commitment of the Enterprises to high-quality corporate governance, the quality of the directors that they have been able to attract and retain on their Boards, their ability to rely on well-established yet flexible state law governance rules, and the efforts of OFHEO's examination staff all have combined to produce a documented record of first-class corporate governance at the Enterprises.

OFHEO's proposal would put all of these elements at risk for no sound reason and, in certain key respects, without legal authority. OFHEO's proposal to promulgate an ambiguous and onerous code of corporate governance rules would create confusion and uncertainty that will serve only to divert the resources and attention of the Enterprise boards and to interfere with the oversight function that they are intended to provide. At the same time, the proposal would increase the potential liability of current and potential Enterprise directors, thereby impairing the Enterprises' ability to attract and retain high-quality directors and further reducing the overall quality of Enterprise governance.

OFHEO should continue to permit the Enterprises to follow and to rely upon state law corporate governance rules and best practices. OFHEO also should confine its regulation of indemnification and compensation to the matters contained in the provisions enacted by Congress.

Thank you for the opportunity to comment. If Freddie Mac can be of further assistance, please do not hesitate to contact me.

Sincerely,

Maud Mater