

Examination Guidance

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PG-06-002

Subject: Examination for Compensation Practices

To: OFHEO Director of Supervision
OFHEO Office of the Director and Associate Directors
Chief Executive Officers of Fannie Mae and Freddie Mac

I. PURPOSE AND SCOPE.

This Guidance sets forth expectations relating to the compensation programs of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) (collectively, the Enterprises) consistent with the safety and soundness responsibilities of the Office of Federal Housing Enterprise Oversight (OFHEO) under the Federal Housing Enterprises Financial Safety and Soundness Act of 1992; the OFHEO executive compensation regulation, 12 C.F.R Part 1770; and the OFHEO corporate governance regulation, 12 CFR Part 1710.

II. REFERENCES.

- a. Federal Housing Enterprises Financial Safety and Soundness Act of 1992.
- b. Executive Compensation Regulation, 12 CFR Part 1770.
- c. Corporate Governance Regulation, 12 CFR Part 1710.
- d. OFHEO Examination Guidance PG-06-001, Examination for Corporate Governance (Nov. 8, 2006).
- e. Stipulation and Consent to the Issuance of a Consent Order, between OFHEO and Fannie Mae, May 23, 2006.
- f. New York Stock Exchange, Listed Company Manual, Corporate Governance Rules, as modified Nov. 3, 2004, Section 303A of the NYSE Listed Company Manual, as modified from time to time (NYSE rules).
- g. Sarbanes-Oxley Act of 2002 (SOX).

III. GUIDANCE.

a. Compensation of board members, executive officers, and employees.

1. General standard.

Compensation programs of the Enterprises should be structured to attract, retain, and reward competent and skilled staff. Compensation of board members, executive officers, and employees of an Enterprise shall be reasonable, comparable, and appropriate and shall be commensurate with the duties and responsibilities of such persons in other similar businesses, including publicly-held financial institutions or major financial services companies. Compensation shall be consistent with the long-term goals of the Enterprise and shall not focus solely on earnings performance, but shall take into account risk management, operational stability, and legal and regulatory compliance; 12 CFR § 1710.13(a).

2. Additional standards relating to compensation programs.

A. Measures of Performance. Compensation programs should not be heavily dependent on a single performance measure, such as earnings per share, but should have diverse financial and non-financial measures to mitigate inappropriate incentives. Incentives should have an appropriate mix of short- and long-term incentives and should be founded primarily on objective measures with clear limits on opportunities for subjective alteration, where practicable. Inappropriate conduct should not be rewarded and effective performance should be encouraged. Compensation measures for the internal auditor, chief compliance officer, and other officers, as determined in consultation with OFHEO, should be appropriate to the roles of such officers and should not create conflicts of interest.

B. Measures for Internal Audit and Compliance Positions. For internal audit, compliance, ethics and investigations positions, including executive officers, performance measurement should include, in consultation with OFHEO, appropriate focus on performance of these activities and not principally on the financial performance of the Enterprise.

C. Measures for Executive Officers. For executive officers, except as provided in paragraphs III.a.2.A. and B., compensation should be tied significantly to long-term performance of the Enterprise. Executive officers should be motivated over the long-term with interests similar to those of shareholders. Alignment with the interests of shareholders could be achieved through equity-based elements of compensation as well as a meaningful ownership stake acquired and retained by executive officers over time.

D. Documentation of Goals. Internally-set corporate goals affecting the level of executive officer pay tied to corporate performance should be subject to review and action by the board of directors, and should be fully documented and disclosed to executive officers.

3. Additional standards relating to employment agreements or contracts.

A. Definition of the Term “Employment Agreement or Contract.” For purposes of paragraph III.a.3., the term “employment agreement or contract” shall mean a written arrangement with an executive officer providing for employment for a term of six months or more and/or a standard of conduct for termination of employment.

B. Term. Employment agreements or contracts for executive officers should not exceed a term of three years, unless an exception is granted by the Director.

C. Option to Renew. Employment agreements or contracts for executive officers may contain an option to extend or renew. However, any extension or renewal is considered a new agreement, subject to OFHEO supervision; 12 CFR § 1770.1(b)(2).

D. Escrow Provision. Future employment agreements or contracts for executive officers should provide for an escrow of benefit payments not protected from alienation or forfeiture under Employee Retirement Income Security Act (ERISA) or any other applicable law or regulation where OFHEO or any other agency has communicated allegations of misconduct concerning such officer’s official duties at the Enterprise and OFHEO has directed the Enterprise to escrow such funds.

E. Debarment Provision. Employment agreements or contracts should contain a provision that employees discharged for misconduct or “for cause” may not be engaged, employed, or otherwise provide services to the Enterprise, whether for compensation or not, subsequent to the separation of such employees from the Enterprise, unless otherwise required by law, except upon request to OFHEO, in exceptional circumstances. Nothing in such provision shall preclude the participation of the individuals in any government inquiry, regulatory matter, litigation, internal investigation, or information-gathering related thereto.

F. Terms for Employment Agreements or Contracts. Future employment agreements or contracts should appropriately include provisions for termination “for cause” or similar actions, as well as so-called “claw-back” provisions that set clear standards for taking such actions with appropriate thresholds and legal standards, consistent with ERISA and any other applicable law or regulation.

G. No limits on Communication. Future employment agreements or contracts and confidentiality agreements should contain substantially similar language to the following: “This agreement in no way limits the ability of the employee to provide information covered by this agreement to a federal government department or agency to assist such entity in the fulfillment of its duties.” In addition, to avoid amendment to existing documents, an Enterprise should alter any existing policy on confidential information to permit employees to provide information to a federal department or agency to assist such entity in the fulfillment of its duties.

H. Contingent Benefits.

- i. Employment agreements or contracts with an executive officer shall contain language noting that any termination benefits provided therein are contingent upon the approval from the Director.¹ This means that the termination benefits are not effective until they are reviewed and approved by the Director; 12 C.F.R § 1770.5(a).
- ii. Review of termination benefits by OFHEO is performed when any individual agreement that includes termination benefits is entered into, as well as at the time the executive officer leaves his or her employment with an Enterprise. An executive officer's termination benefits package will be reviewed by OFHEO at the time of departure to determine if there have been benefit enhancements or modifications affecting any package previously approved by OFHEO. This contemplates review of any relevant benefit plan, contemporaneous with or subsequent to the creation of the termination agreement, if determined by OFHEO to have an effect on the termination benefits of the individual executive; 12 CFR § 1770.1(b).²
- iii. The review authority of OFHEO extends both to the "compensation" and to the individualized termination benefits package provided to an executive officer by an Enterprise. The term "compensation" is broadly defined to include benefits to an executive officer that are derived from post-employment benefit plans or programs, and to other compensatory benefit arrangements containing termination benefits that affect the executive officer individually or as part of a group. As a result, OFHEO reviews the value of benefits provided under such plans, programs, and arrangements on an ongoing basis in exercising its dual review authorities; 12 C.F.R §§ 1770.1 and 1770.3(d).
- iv. Review by OFHEO of termination benefits provided by an Enterprise to an individual determined by OFHEO to be an "executive officer" applies as long as the officer is designated by OFHEO as an "executive" officer, pursuant to OFHEO process, no matter when the executive officer departs, i.e., prior to or at the end of a contractual term, and no matter how the executive officer departs, i.e., on a voluntary or an involuntary basis; 12 CFR §§ 1770.1 and 1770.3(g).
- v. To carry out its executive compensation oversight responsibilities, OFHEO requires each Enterprise to submit relevant information; 12 CFR § 1770.4. This means that an Enterprise must fully inform OFHEO by providing complete information on compensation provided to an executive officer. For example, an Enterprise should note if an agreement is atypically structured for the type or level of position within the Enterprise, or if it reflects recruitment outside the normal comparator group.

¹ For purposes of this Guidance, the term "Director" means the Director of OFHEO or his or her designee.

² Should there be no individual agreement with the executive officer, OFHEO may evaluate the reasonableness, comparability, and appropriateness of termination benefits under relevant benefit plans. Also, review of de minimis changes to termination benefits may be waived by OFHEO.

I. Subsequent Employment. An Enterprise, by written agreement or otherwise, should not restrict employees from subsequently working for OFHEO or other federal government department or agency. Such a post-employment restriction may be against public policy.

4. Standards relating to termination benefits of executive officers.

A. Relevant Factors. In determining or approving termination benefits, the board of directors or compensation committee of each Enterprise should take into consideration relevant factors, including any wrongdoing on the part of the executive officer. Such wrongdoing includes any fraudulent act or omission; breach of trust or fiduciary duty; violation of law, rule, regulation, order, or written agreement; and insider abuse with respect to the Enterprise.

B. Resubmission of Termination Package. If the Director determines that termination benefits of an executive officer are not reasonable and comparable pursuant to 12 CFR Part 1770, the Enterprise shall review the individual benefits, renegotiate them with the executive officer, and resubmit the benefits to OFHEO for its determination that the termination package as a whole is reasonable and comparable.

C. Disclosure of Compensation and Benefits. An Enterprise should fully disclose the nature and scope of benefits to OFHEO to be provided upon the retirement of executive officers. An Enterprise that is not an SEC registrant should conform closely with SEC disclosure requirements.

D. Submission of Top Hat Plan. An Enterprise shall submit to OFHEO for review any plan, such as a Top Hat Plan, that extends benefits primarily to a select group of management or highly compensated employees prior to approval by or after approval by the compensation committee of the board of directors. Any change in benefits under such plan could alter the value of the total termination benefits package of an executive officer; 12 CFR § 1770.4(c).

E. Stock Options, Restricted stock, and Performance Shares. If an executive officer is terminated by an Enterprise “for cause” or for similar reasons, the Enterprise should require the forfeiture of unvested stock options, unvested restricted stock, and unpaid or unvested performance shares.

F. Accounting Restatement. If, as a result of misconduct, an Enterprise is required to prepare an accounting restatement due to the material noncompliance of the Enterprise with any financial reporting requirement under the federal securities laws, the chief executive officer and chief financial officer of the Enterprise shall reimburse the Enterprise to the extent required under section 304 of the SOX; 12 CFR § 1710.13(b).³ Compensation agreements or contracts with the chief executive officer and chief financial officer should include provisions providing for such reimbursement.

³ The provision shall apply with respect to Freddie Mac at such time as Freddie Mac is required to file financial reports with the Securities and Exchange Commission under the Securities Exchange Act of 1934.

5. Termination benefits – general.

OFHEO will review actions, however characterized, that provide benefits to an executive officer of an Enterprise if such benefits may be regarded as termination benefits. Attempts to avoid OFHEO review of such benefits may lead to remedial action by OFHEO.

6. Contracts for consulting services.

An Enterprise should advise the Director of any contracts for consulting services between the Enterprise and any former executive officer who held a position of Executive Vice President or above. Contracts close in time to the departure of an executive officer, but entered into after departure, should be reported and may be considered to be termination benefits.

b. Submission of comparability information.

1. Comparability study for covered executive officers.

Every five years, each Enterprise shall submit a comprehensive comparability study for covered executive officers to the Director; 12 CFR § 1770.4(b).

2. Comparability information supporting request for OFHEO approval of termination benefits.

Each Enterprise shall submit to OFHEO a comparability study or other assessment acceptable to the Director for an executive officer who has a termination agreement subject to OFHEO review as part of the information submitted in support of a request for OFHEO approval of termination benefits; 12 CFR § 1770.4(d).

3. Certifications.

The compensation committee of the board of directors of an Enterprise or a senior officer, as appropriate, should certify that any decision concerning compensation for an executive officer or officers takes into account, to the extent appropriate to the decision, the information provided by a comparability study or other assessment and should submit the certification to OFHEO. The committee or the appropriate senior officer should certify that the studies addressed in subsection b. were prepared by an outside executive compensation consultant firm and that the engagement of such consultant and the consultant's qualifications were submitted to OFHEO for review. Certifications should be provided in such form as directed by OFHEO. This provision does not apply to benefits of general applicability or changes to such benefits, unless they provide a disproportionate benefit to executive officers in comparison to other employees.

4. Review of comparability information.

OFHEO will review all comparability information in making its determination. OFHEO may undertake its own comparability study in furtherance of its responsibilities, in the discretion of the Director.

c. Board of directors responsibilities.

1. Compensation committee.

The board of directors of each Enterprise shall have a compensation committee. The committee must be in compliance with the charter, independence, composition, expertise, duties, responsibilities, and other requirements set forth under the NYSE rules, 12 CFR § 1710.12, and OFHEO Examination Guidance PG-06-001, Examination for Corporate Governance (Nov. 8, 2006).

2. Compensation committee reports.

The compensation committee reports should disclose the nature of the “comparator” group with which the compensation committee is comparing the Enterprise’s compensation for executive officers, the basis of selection of the group, and where in the range established by that comparison the Enterprise targets the compensation. Compensation committee minutes shall be provided to OFHEO in full, except as otherwise provided under 12 CFR § 1770.4(b).

3. Independent consultant.

In determining compensation for the chief executive officer (or for any other executive officer, as determined appropriate by the board of directors), the board of directors or the compensation committee thereof should engage, independent of Enterprise management, a compensation consultant.

IV. ADDITIONAL MATTERS.

a. Guidance compliance report.

In addition to any reports or notifications required by this Guidance, the board of directors shall cause to be submitted a summary description of the Enterprise’s compliance with this Guidance (“Guidance compliance report”) to the Director within 150 days of the publication date of the Guidance. The board of directors shall assure that the Guidance compliance report includes a summary of the plans, policies, procedures and organizational structure the Enterprise has developed and all other actions taken to comply with the provisions of this Guidance. The board shall cause to be submitted annual updates to the initial report to Director.

b. Safety and soundness.

If an Enterprise fails to comply with the requirements of the OFHEO executive compensation regulation, the Director may take corrective or remedial action to require an individual to make restitution or reimbursement to the Enterprise of excessive compensation, including inappropriately paid termination benefits; 12 CFR § 1770.5(b). Any failure of the Enterprise to meet relevant terms of the OFHEO corporate governance or executive compensation regulation may raise safety and soundness concerns and may be determined to constitute an unsafe and unsound practice.

c. Preservation of existing authority.

Nothing in this Guidance in any way limits the authority of OFHEO to otherwise address unsafe or unsound conditions or practices or violations of applicable law, regulation, or supervisory order. Action referencing this Guidance may be taken separate from, in conjunction with or in addition to any other enforcement action available to OFHEO. Compliance with the Guidance in general would not preclude a finding by the agency that an Enterprise is otherwise engaged in a specific unsafe or unsound practice or is in an unsafe or unsound condition, or that such practice or condition requires corrective or remedial action. Other supervisory action is not precluded against an Enterprise that has not been cited for a deficiency under the Guidance. Conversely, an Enterprise's failure to comply with one of the supervisory requirements set forth in the Guidance may not warrant a formal supervisory response from OFHEO, if OFHEO determines the matter may be otherwise addressed. For example, OFHEO may require the submission of a plan to achieve compliance with the particular requirement or standard.