

OFHEO

Examination Guidance

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Subject: Examination for Corporate Governance

To: OFHEO Examiners
OFHEO Office of Director, Senior Associate Director and Associate Directors
Chief Executive Officers of Freddie Mac and Fannie Mae

I. Purpose and Scope.

This Guidance sets forth examination guidance and standards relating to the corporate governance 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 Enterprise Financial Safety and Soundness Act of 1992 and the OFHEO corporate governance regulation, 12 C.F.R. 1710.

II. References.

- a. Federal Housing Enterprises Financial Safety and Soundness Act of 1992.
- b. Corporate Governance Regulation, 12 C.F.R. Part 1710.
- c. Agreement between OFHEO and Fannie Mae, September 27, 2004.
- d. Supplemental Agreement between OFHEO and Fannie Mae, March 7, 2005.
- e. Stipulation and Consent to the Issuance of a Consent Order, between OFHEO and Freddie Mac, December 9, 2003.
- f. Policy Guidance 00-001 (12/19/2000).
- g. New York Stock Exchange, Listed Company Manual, Corporate Governance Rules, as amended November 3, 2004, Section 303A of the NYSE Listed Company Manual (NYSE Rules).
- h. Sarbanes-Oxley Act of 2002 (SOA).

III. Guidance.

a. Board of directors.

1. Independence and service.

i. Directors—Majority Independent. A majority of the members of an Enterprise board of directors must be independent, as required by 12 C.F.R. 1710.11(a)(2). To be independent, a board member must meet the definition of independence under the NYSE Rules.¹ An independent board member should be free of any relationship with the Enterprise or its management that may impair, or appear to impair, the director's ability to make independent judgments. No board member qualifies as independent unless the board of directors affirmatively determines that the board member has no relationship with the Enterprise that undermines such independence.

ii. Directors— Absence of Conflicts/Qualifications for Service. All board members should have no actual or apparent conflict of interests or other circumstance that makes it inappropriate for them to serve on the Enterprise board. Board members should meet the qualifications set by the Enterprise and maintain high ethical standards.

iii. Factors to be Considered. In assuring qualification of directors for service in (i) and (ii), including for the formal procedure provided below in paragraph (v) of this section, the board of directors should consider carefully specific conduct as well as factors of reputation risk, appearance of a lack of independence or impropriety and the ability to perform responsibilities. Examples of situations where concerns may arise regarding qualification for service include, but are not limited to,—

-- outside employment of a board member or immediate family members with a business engaging in significant business or competition with the Enterprise;

-- significant real estate transactions or significant other transactions with a business having substantial business relationships with the Enterprise;

-- receipt of charitable funds, from an Enterprise or its foundations, by an organization for which the individual or a member of their immediate family serves as a member of the board of directors, as a trustee or as an employee;

-- receipt of benefits from a company doing business with the Enterprise that would not be available to the public;

-- significant adverse legal determinations against an individual; or

¹ The NYSE Rules provide that a director is not independent unless the board of directors affirmatively determines that the director has no material relationship with the listed company, either directly or as a partner, shareholder or officer. A director is not independent if the director or his family member has been employed by, or received compensation from, the listed company within a certain time period. Independence is also affected by the relationship between the directors' past employers and the listed company. Finally, a director is not independent if the director or a family member is affiliated with or employed by a present or former auditor of the listed company.

-- an inability of an individual to sign or otherwise comply with the Enterprise's code of conduct.

iv. Definition. The board of directors should define comprehensively board member independence as well as other qualifications for service for all board members and provide such definitions and any subsequent changes to the definitions to the appropriate Examiner in Charge ("EIC") or designee. At a minimum, criteria contained in such definitions must address current and past personal and family member employment and business relationships with the Enterprise, as well as relationships with entities and individuals that received compensation from the Enterprise.

v. Formal process. The board of directors should establish and implement a formal process for evaluating and documenting independence and other qualifications for service for a prospective board member prior to his or her being seated on the board. A comparable process should be used to evaluate the independence of each seated board member at least annually. In addition, the board of directors should establish and implement a process for prompt written notification to the board and the appropriate Examiner in Charge ("EIC") or designee of any transaction, event, or circumstance that affects a board member's independence or other qualification for service.² If the board determines an event or situation raises concerns under the criteria for service, but does not pose a problem rising to the level of denying the individual the ability to stand for election or to remain on the board, information about the board's determination shall be detailed in a report to the EIC or designee.

vi. Annual report. The board of directors shall report in writing, at least annually, to the appropriate EIC on the independence evaluation for each seated board member. The board of directors shall also report in writing to the EIC on the independence evaluation for a proposed member for a vacated seat no less than 10 business days preceding his or her being seated on the board of directors.

2. Board member qualifications.

i. Expertise. The board of directors shall be comprised of members such that as a group it is knowledgeable in the areas of business, finance, accounting, risk management, public policy, mortgage lending, real estate, low-income housing, and homebuilding.

ii. Time commitment. The board of directors, in assessing the qualifications of a prospective board member, should consider whether the number, if any, of other board memberships of the prospective board member will permit him or her sufficient time to devote to his or her duties and responsibilities.

3. Limits on service of board members.

i. Length of service. A board member may not serve on the board for more than 10 years or past the age of 72, whichever comes first; a board member, however, may serve his or her full term if he or she has served less than 10 years or is 72 years on the date of his or her election or

² As used in this Guidance, the term "EIC" includes the designee of the EIC.

appointment to the board; 12 C.F.R. 1710.11(a).

ii. Waiver. The Director, in his or her sole discretion, may waive the term limits for good cause, if such waiver is requested in writing. Waiver requests should provide a justification for the request and be submitted as soon as possible before the term limit is reached. The Director's decision to grant or disapprove a waiver request shall be final.

4. Frequency of meetings.

The board of directors shall meet at least eight times a year and no less than once each calendar quarter to carry out its obligations and duties under applicable laws, rules, regulations, and guidelines; 12 C.F.R. 1710.11(b)(1).

5. Non-management board member meetings.

In accordance with 12 C.F.R 1710.11(b)(2), non-management directors of an Enterprise shall meet at regularly scheduled executive sessions without management participation. Non-management directors are all those who are not company officers and may include directors who are not independent. If there are non-management directors who are not independent, the board of directors should schedule an executive session including only independent directors at least once each year.

6. Quorum; proxies.

A quorum of the board of directors of an Enterprise is at least a majority of the seated board of directors and a board member may not vote by proxy; 12 C.F.R. 1710.11(b)(3).

7. Information to board members by management.

In accordance with 12 C.F.R. 1710.11(b)(4), management shall provide such adequate and appropriate information to board members that a reasonable board member would find important to fulfill his or her fiduciary duties and obligations. Management should provide to the board—consistent with this standard—material information relevant to the Enterprise's business and to its safety and soundness. Management should present full and complete information to the board of directors in a way that allows the board adequate time for reflection and consideration of all the relevant issues. Time for questions and answers should be part of all board presentations.

8. Committees of the board of directors.

i. Required committees. In accordance with 12 C.F.R.1710.12(c), a board shall have the following committees: an audit committee, a compensation committee, and a nominating/corporate governance committee. Each of these committees must be in compliance with the charter, independence, composition, expertise, duties, responsibilities, and other requirements set forth under the NYSE rules,³ and, with respect to the audit committee, with section

³ The NYSE Rules provide that a listed company's nominating committee charter must at least address the qualifications of a prospective board member, the selection of nominees, corporate governance guidelines, and the

301 of the SOA.⁴ An Enterprise should consider establishing a risk management oversight committee and a compliance committee.

ii. Frequency of meetings. The committees shall meet with sufficient frequency to carry out their obligations and duties under applicable laws, rules, regulations, and guidelines; 12 C.F.R. 1710.12.

iii. Committee reports. The board of directors may rely on committee reports in overseeing the actions of the Enterprise; 12 CFR 1710.12(a). The board should have in place a process for reviewing the adequacy and completeness of committee reports received by the board, and should request further analysis or investigation where reports are found to be inadequate.

b. Responsibilities of board and management with respect to Enterprise operations.

1. General board responsibilities.

i. Conduct and responsibilities. As provided in 12 CFR 1710.15(b), the board of directors is responsible for directing the conduct and affairs of the Enterprise in furtherance of the safe and sound operation of the Enterprise and must remain reasonably informed of the condition, activities, and operations of the Enterprise. The board should affirmatively investigate questionable practices or uncertainties regarding operations by questioning management and actively participating in board presentations and information gathering. The board of directors must require that adequate policies and procedures are in place to assure its oversight of matters including –

(A) Corporate strategy, major plans of action, risk policy, programs for legal and regulatory

oversight of the evaluation of the board and management. The charter must also address an annual performance evaluation of the committee.

The compensation committee charter must list its responsibilities which are at least to review and approve corporate goals and objectives relevant to CEO compensation, to evaluate CEO performance, to make recommendations with respect to non-executive officer compensation, incentive compensation and equity-based plans, and to produce a compensation committee report on executive officer compensation as required by the SEC. Finally, the compensation committee charter must address its annual performance evaluation.

The NYSE Rules require that the audit committee have at least three members and satisfy Rule 10A-3 of the Securities and Exchange Act of 1934. The NYSE Rules further require all audit committee members to be independent. The audit committee's written charter must address oversight of the listed company's financial statements, the company's compliance with legal and regulatory requirements, the independent auditor's qualifications and performance of the listed company's internal audit function. The charter must further set forth the duties of the audit committee for annual review of the company's internal quality control by the independent auditor, discuss annual audited financial statements, earnings releases, policies with respect to risk assessment and risk management, periodic meetings with management and independent auditors, and setting clear hiring policies for independent auditors.

⁴ Section 301 of SOA provides that each member of the audit committee shall be a member of the board of directors, and shall be independent. To be considered "independent", the member of the audit committee may not receive, other than for service on the board, any consulting, advisory, or other compensatory fee from the issuer (in this case the Enterprise), and may not be an affiliated person of the issuer (Enterprise). The audit committee shall be directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by the issuer (Enterprise). The audit committee shall establish procedures for the "receipt, retention, and treatment of complaints" regarding accounting, internal controls, and auditing. The audit committee has the authority to engage independent counsel and other advisors, and to provide for appropriate funding for payment to those advisors.

compliance and corporate performance, including but not limited to prudent plans for growth and allocation of adequate resources to manage operations risk;

(B) Hiring and retention of qualified senior executive officers and succession planning for such senior executive officers;

(C) Compensation programs of the Enterprise;

(D) Integrity of accounting and financial reporting systems of the Enterprise, including independent audits and systems of internal control and the engagement of external auditors;

(E) Process and adequacy of reporting, disclosures, and communications to shareholders, investors, and potential investors;

(F) Extensions of credit to board members and executive officers; and

(G) Responsiveness of executive officers in providing accurate and timely reports to Federal regulators and in addressing the supervisory concerns of Federal regulators in a timely and appropriate manner; 12 C.F.R. 1710.15(b).

ii. Guidance. The board of directors should refer to the body of corporate law elected by the Enterprise in its bylaws and to publications and other guidance provided by OFHEO for the conduct and responsibilities of the board; 12 C.F.R. 1710.15(c).

2. Annual review of requirements.

i. Annual review— Board. At least annually, the board of directors of the Enterprise shall review, with appropriate professional assistance, the requirements of laws, rules, regulations and guidelines that are applicable to its activities and duties. The Enterprise shall provide the appropriate EIC with the materials and procedures to be employed in such review and will keep the EIC apprised of the progress of such review.

ii. Annual review— Management. At least annually, the senior management of the Enterprise should review, with appropriate professional assistance, the requirements of laws, rules, regulations and guidelines that are applicable to its activities and duties. The Enterprise should provide the EIC with the materials and procedures to be employed in such review, and will keep the EIC apprised of the progress of such review.

3. Organization, staffing, compensation, and related matters.

i. General. In accordance with 12 C.F.R. 1710.15(b), the board of directors is responsible for directing the conduct and affairs of the Enterprise in furtherance of the safe and sound operation of the Enterprise. The board should oversee internal organization and staffing adequacy which provide appropriate separation between the risk management function (oversight of risk taking) and the control function (oversight of accounting and financial reporting) of the Enterprise.

ii. Independent review. No less frequently than every five years, the board should cause to be conducted an independent review of the Enterprise's organizational, structural, staffing, and control issues, including lines of reporting, independence of functions, segregation of duties, alignment of functions, roles and responsibilities, staff qualifications, key person dependencies, and adequacy of resources.

iii. Separation of functions. The board should ensure that the functions of the chairperson of the board and chief executive officer, once separated, remain separated until such time that the Director, upon request of the board of directors, determines to terminate, either on a temporary or permanent basis, such separation.

iv. Executive officers. Prior to the board initiating a search for the positions of chief executive officer, chief financial officer, chief risk officer, or chief compliance officer, the board should provide the appropriate EIC with its written search criteria and shall keep the EIC informed of the status of the search.

v. Expertise. The board should ensure that adequate policies and procedures are in place to ensure that management has adequate expertise to fulfill its duties and obligations. In particular, either the position of controller or the position of chief financial officer, however so designated, should be filled by a Certified Public Accountant.

vi. Compensation. The board shall ensure that the Enterprise establishes a compensation system that does not focus solely on earnings performance, but one that takes into account risk management, operational stability and legal and regulatory compliance as well; 12 C.F.R. 1710.13.

vii. Extensions of credit. The board shall ensure that adequate policies and procedures are in place that prohibit the Enterprise, directly or indirectly, including through any subsidiary, from extending or maintaining credit, or arranging for the extension of credit in the form of a personal loan, to or for any board member or executive officer of the Enterprises as provided by section 402 of the SOA; 12 C.F.R. 1710.16.⁵

viii. Indemnification; dismissal; restitution. The board shall ensure that adequate policies and procedures are in place regarding indemnification of current and former board members and current and former executive officers. Such policies and procedures should address, among other matters:

(A) Standards relating to indemnification, investigation by the board of directors, and review by independent counsel; 12 C.F.R. 1710.20; and standards for denying indemnification where misconduct or failure to obey laws or regulations is involved;

(B) Procedure and standards for dismissal of employees for failure to obey laws, rules, and regulations or other possible misconduct that relates to or may affect the Enterprise that is not of an inconsequential nature; and

⁵ Section 402 of SOA prohibits personal loans, or extensions of credit, to any board member or executive officer.

(C) Policies for seeking restitution or for obtaining reimbursement, indemnification or guarantee against loss from employees where the employee's misconduct or failure to obey a law or regulation has resulted in a loss to the Enterprise.

c. Code of conduct and ethics.

1. Establishment of code.

In accordance with 12 C.F.R. 1710.14 (a), an Enterprise shall establish and administer a written code of conduct and ethics. The code must be reasonably designed to assure the ability of board members, executive officers, and employees of the Enterprise to discharge their duties and responsibilities, on behalf of the Enterprise, in an objective and impartial manner. The code shall include standards required under section 406 of the SOA.⁶ The code should contain such standards as are necessary to promote honest and ethical conduct. The standards should include, but are not limited to, the ethical handling of actual or apparent conflicts of interest between personal and professional relationships, full, fair accurate and timely disclosure of material information to shareholders and regulators, and compliance with applicable rules and regulations.

2. Review of code.

In accordance with 12 C.F.R. 1710.14(b), not less than every three years, an Enterprise shall review the adequacy of its code of conduct and ethics for consistency with practices appropriate to the Enterprise and shall make appropriate revisions to such code. The Enterprise should submit to the appropriate EIC a copy of the findings and recommendations of the review, within 30 business days of completing the review, and should provide a copy of the code, as revised, to the EIC within five business days of the issuance of any revision.

3. Reporting misconduct.

The board of directors of an Enterprise should direct the General Counsel, Chief Compliance Officer or other designated officer of the Enterprise to report directly to the board any information relating to actual or possible misconduct that relates to or may affect the Enterprise by an executive officer or board member, or actual or possible misconduct that is not of an inconsequential nature by an employee of the Enterprise. The board should inform the Director of OFHEO of the substance of any such misconduct in a timely manner. The General Counsel, Chief Compliance Officer or other designated officer of the Enterprise should notify the Director of OFHEO of the alleged misconduct if the board does not notify the Director in a timely manner.

⁶ The standards for a code of ethics applicable to senior officers under Section 406 are such standards as necessary to promote honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest; full, fair, accurate, timely and understandable disclosure in periodic reports; and compliance with applicable rules and regulations.

d. Compliance program.

1. Establishment and reporting.

Each Enterprise shall establish a compliance program in accordance with the provisions of 12 C.F.R. 1710.19(b) and any written agreement or order. The head of the compliance office may be employed or removed from employment only upon approval of the board of directors. He or she shall report directly to the chief executive officer and independently to the audit or compliance committees of the board.

2. Internal investigation function.

The compliance program should include an internal investigation function that includes review of internal complaints, whistleblowers reports, ethics matters, and related topics. The head of the office and his or her staff must have access to adequate resources to perform the internal investigation function.

e. Risk management program.

1. Establishment and reporting.

Each Enterprise shall establish a risk management program in accordance with 12 C.F.R. 1710.19(a). The head of the risk management office (chief risk officer) may be employed or removed from employment only upon approval of the board of directors. The chief risk officer should be independent of the chief financial officer and shall report directly to the chief executive officer and independently to the board committee primarily responsible for risk. The head of each group responsible for oversight of market risk, credit risk, and operational risk should report directly to the chief risk officer.

2. Functions and responsibilities of head of risk management program.

The chief risk officer should provide, at a minimum—

i. Leadership. Provide overall leadership, vision, and direction for enterprise risk management including implementing a framework to manage all aspects of risk, ensuring that risk management activities are appropriate to the level of risk assumed, and developing risk management policies.

ii. Readiness program. Improve risk management readiness through communication and training programs, risk-based performance measurement and incentives, and other programs.

iii. Identification of risk. Ensure that risk is properly identified, measured, prioritized, managed, and reported at business and corporate levels; and that risk is properly understood and translated into meaningful business requirements, objectives, and metrics.

iv. **Appropriate Incentives.** Ensure that incentives are established to ensure that business units are fully engaged in managing their portion of the risk.

v. **Technologies.** Develop risk management technologies and the analytical, systems, and data management capabilities to support a risk management program; and implement a set of risk metrics and reports, including losses and incidents, key risk exposures, and early warning indicators.

f. Certification of disclosures by chief executive officer and chief financial officer.

The chief executive officer and the chief financial officer of an Enterprise shall review each quarterly report and annual report issued by the Enterprise and such reports shall include certifications by such officers as required by section 302 of the SOA.⁷

g. External auditing standards.

1. Audit partner change.

An Enterprise may not accept audit services from an external auditing firm if the lead or coordinating audit partner who has primary responsibility for the external audit of the Enterprise, or the external audit partner who has responsibility for reviewing the external audit, has performed audit services for the Enterprise in each of the five previous fiscal years; 12 C.F.R. 1710.18.

2. Audit firm engagement.

i. **Audit firm change.** Each Enterprise should change its external auditing firm no less frequently than every 10 years to assure safe and sound operations of the Enterprise.

ii. **Audit firm transition plan.** No later than one year prior to each auditing firm change, an Enterprise should submit to the EIC an auditing firm transition plan that addresses bidding and related processes, time schedules, operational problems, and other relevant facts, as may be requested by the EIC.

3. External auditor consulting review.

Senior management and the board of directors of the Enterprise should review all consulting work performed by the external auditor.

4. Communication with external auditor.

⁷ Section 302 of SOA addresses corporate responsibility for reports, and requires the CEO and CFO of each issuer to certify the appropriateness of the financial statements and disclosures contained in periodic reports and to certify that those financial statements and disclosures fairly present, in all material respects, the operations and financial condition of the issuer. The provision of the regulation and guidance will apply to Freddie Mac once it has filed documents that are covered by the provisions of section 302 of SOA.

The Enterprise's engagement letter with the external auditor should provide that the external auditor will give the EIC, Chief Accountant or designee access to senior audit partners on the engagement and their work papers, without Enterprise personnel in attendance. In addition, the engagement letter should provide that the external auditor, without the approval of the Enterprise, shall meet with the EIC or Chief Accountant with such frequency and about such matters as determined by the EIC or Chief Accountant. The matters covered by such communications between OFHEO and the external auditor may include, but are not limited to,—

- i. Violations. Violations of any applicable law, rule, regulation, order, or guideline discovered during the audit.
- ii. Errors. Errors discovered.
- iii. Loss of trust. Loss of trust or confidence in any officer or board member of the enterprise.
- iv. Threats of retaliation. Threats of retaliation for lack of acquiescence to an Enterprise's accounting policies and practices.
- v. Transactions. Transactions that have a minimal business purpose or that are unusual.
- vi. New Policies. Implementation of new accounting policies.
- vii. Disagreements. Disagreements with the Enterprise over accounting policies that required resolution by the national office of the external auditor.

h. Other auditing matters.

1. Audit committee charter.

The Enterprise's audit committee shall oversee the auditing functions. Pursuant to 12 C.F.R. 1710.12(c), the audit committee shall be in compliance with all the requirements of section 301 of SOA,⁸ and the NYSE Rules.⁹ The audit committee shall have a charter which addresses the committee's purpose, which must be, at a minimum, to assist board oversight of the integrity of the Enterprise's financial statements, the Enterprise's compliance with legal and regulatory requirements, the independent auditor's qualifications and independence, and the performance of the Enterprise's internal audit function and independent auditors. The audit committee charter or other appropriate corporate documentation should indicate that the head of the Enterprise's internal audit unit is responsible for full disclosure of control weaknesses, related risk exposures, and progress on remedial actions to the audit committee.

⁸ See footnote 4, *supra*.

⁹ See footnote 3, *supra*.

2. Independent internal audit function.

The internal audit unit should function separately and independently of the chief financial officer and should report directly to the audit committee.

3. Formal procedure for development of policy.

The Enterprise should establish a formal written procedure for development of accounting policy and create a system for full disclosure to the audit committee of these policies and their compliance with regulatory and GAAP requirements. The Enterprise should establish a complete accounting guide that lists all of the Enterprise's accounting policies and procedures, including a procedure for documenting the business purpose of all significant derivative transactions.

IV. Additional Matters.

a. Guidance compliance report.

In addition to annual reports and other specific reports required by this Guidance, the board of directors should cause to be submitted a summary description of the implementation of this Guidance ("Guidance compliance report") to the appropriate EIC within 150 days of the issuance date of the Guidance. The board of directors should assure that the Guidance implementation report includes a summary of the plans, policies, procedures and organizational structure it has developed and all other actions taken to comply with the provisions of this Guidance. The board should cause to be submitted annual updates to the initial report to the EIC.

b. Safety and soundness.

Any failure of the Enterprise to meet the terms of the OFHEO corporate governance regulation or to meet the terms of the NYSE Rules may raise safety and soundness concerns and may be determined to constitute an unsafe and unsound practice.

c. Implementation.

Implementation of parts III.a.1. and III.a.2. by the Enterprises is not required to commence for sixty days after the issuance of this Guidance.

d. 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. OFHEO has the ability to act in the case of a poorly performing Enterprise auditor at any time, not just at the time of a planned change. Action referencing the 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 requiring corrective or remedial action with regard to such practice or condition. That is, 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 in a satisfactory manner. For example, OFHEO may require the submission of a plan to achieve compliance with the particular requirement or standard.

e. Designation.

In designating a staff member to receive notification or reports, the EIC may designate an OFHEO staff member under his supervision or an OFHEO staff member of another office within OFHEO, such as Office of the Chief Accountant or Office of General Counsel.