



OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

# NEWS RELEASE

**FOR IMMEDIATE RELEASE**

Wednesday, April 4, 2001

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**[www.ofheo.gov](http://www.ofheo.gov)**

**OFHEO SOLICITS COMMENTS ON  
TWO RULES:  
PROMPT SUPERVISORY RESPONSE AND  
CORRECTIVE ACTION and CORPORATE GOVERNANCE  
(The two documents are attached at end of release)**

WASHINGTON, D.C. — Armando Falcon, Jr., Director of the Office of Federal Housing Enterprise Oversight (OFHEO), safety and soundness regulator of Fannie Mae and Freddie Mac (the Enterprises), today announced that OFHEO was soliciting comments on two proposed rules. One rule would allow OFHEO to take "prompt corrective action" if there were a decline in capital at the Enterprises or initiate an inquiry, or "prompt supervisory response" before capital is impaired.

Additionally, OFHEO is seeking comment on a proposed regulation that essentially formalizes existing business practices and procedures of the Enterprises. "Corporate governance" involves the relationships between an Enterprise, its management, board of directors, shareholders, regulators and other stakeholders. OFHEO currently monitors such practices to ensure the Enterprises accomplish their public policy purposes in a safe and sound manner.

The prompt supervisory response and corrective action rule is intended to complement OFHEO's enforcement regime. In addition, it addresses the gap between the approval and enforcement of the risk-based capital rule currently awaiting approval from the Office of Management and Budget.

**PROPOSED REGULATIONS:**

**Prompt Supervisory Response and Corrective Action**

OFHEO is soliciting comments on a rule that would put in place a more formal process of supervision, one tied to the decline in capital and one initiated if the Enterprises meet certain "tripwires" that would trigger automatic supervisory responses from OFHEO before a threat to an Enterprise reaches the level of capital impairment. The establishment of the prompt supervisory response is to fashion a broad early intervention regime.

**Corporate Governance**

OFHEO is proposing a regulation to set forth minimum requirements with respect to corporate governance practices and procedures of Fannie Mae and Freddie Mac which codify existing law.

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# Federal Register

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**Tuesday,  
April 10, 2001**

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**Part III**

## **Department of Housing and Urban Development**

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**Office of Federal Housing and Enterprise  
Oversight**

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**12 CFR Part 1777  
Prompt Supervisory Response and  
Corrective Action; Proposed Rule**

**DEPARTMENT OF HOUSING AND  
URBAN DEVELOPMENT**

**Office of Federal Housing Enterprise  
Oversight**

**12 CFR Part 1777**

**RIN 2550-AA12**

**Prompt Supervisory Response and  
Corrective Action**

**AGENCY:** Office of Federal Housing  
Enterprise Oversight, HUD.

**ACTION:** Proposed regulation.

**SUMMARY:** The Office of Federal Housing Enterprise Oversight (OFHEO) solicits comments on a proposed regulation to set forth the procedures under which OFHEO administers the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, under which OFHEO takes prompt corrective action in response to specified declines in the capital levels of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation (collectively, the Enterprises). OFHEO also proposes to implement a system of prompt supervisory responses to be taken whenever certain developments internal or external to an Enterprise, which are specified in the proposed rule, warrant special supervisory review by OFHEO. The occurrence of such a development does not of itself establish that an Enterprise is in an unsound condition; rather, such a triggering occurrence provides a reasonable juncture for OFHEO to undertake a focused inquiry into the likely consequences of the development for the Enterprise.

**DATES:** Written comments on the proposed rule must be received by July 9, 2001.

**ADDRESSES:** All comments concerning the proposed rule should be addressed to Alfred M. Pollard, General Counsel, Office of Federal Housing Enterprise Oversight, 1700 G Street NW, Fourth Floor, Washington, DC 20552. Copies of all communications received will be available for public inspection and copying at the address above. All comments will be posted on the OFHEO web site at <http://www.ofheo.gov>. OFHEO requests that written comments submitted in hard copy also be accompanied by an electronic version in MS Word© or in portable document format (PDF) on 3.5" disk. Alternatively, comments may be submitted via electronic mail to: [RegComments@ofheo.gov](mailto:RegComments@ofheo.gov).

**FOR FURTHER INFORMATION CONTACT:**  
David W. Roderer, Deputy General

Counsel, (202) 414-6924, or Jamey Basham, Counsel (202) 414-8906 (not toll-free numbers), 1700 G Street NW, Fourth Floor, Washington, DC 20552. The telephone number for the Telecommunications Device for the Deaf is: (800) 877-8339 (TDD *only*).

**SUPPLEMENTARY INFORMATION:**

**Background**

Title XIII of the Housing and Community Development Act of 1992, Public Law 102-550, entitled the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (1992 Act), established OFHEO. OFHEO is an independent office within the Department of Housing and Urban Development with responsibility for ensuring that the Enterprises are adequately capitalized and operate safely and in conformity to the requirements of applicable statutes, rules and regulations, including their respective charter acts.<sup>1</sup> The Enterprises were established to effect specific public purposes under Federal law, including the provision of liquidity to the residential mortgage market and the promotion of the availability of mortgage credit benefiting low- and moderate-income families and areas that are underserved by lending institutions.<sup>2</sup>

The enumerated statutory authorities of the Director explicitly include the authority to issue rules to carry out the duties of the Director,<sup>3</sup> as well as other broad supervisory powers similar to those of the Federal bank regulatory agencies. OFHEO is empowered to conduct examinations of the Enterprises; to require the Enterprises to provide reports;<sup>4</sup> to establish capital standards for the Enterprises;<sup>5</sup> and, in appropriate circumstances, to exercise administrative enforcement authority essentially similar to that granted by Congress to the Federal bank regulatory agencies. OFHEO's enforcement authorities include the power to issue temporary and permanent cease and desist orders to an Enterprise or its executive officers or directors, and to otherwise sanction or impose civil money penalties when appropriate.<sup>6</sup> OFHEO's enforcement regime, addressing the scope of these authorities and the applicable rules of practice and

procedure, is set forth in part 1780 of OFHEO's regulations.<sup>7</sup>

In addition, subtitle B of the 1992 Act<sup>8</sup> requires OFHEO to establish certain capital thresholds for the Enterprises. The statute directs OFHEO to assign capital classifications to the Enterprises based on those capital thresholds, and authorizes OFHEO to reclassify an Enterprise notwithstanding the thresholds. An Enterprise that is not classified as "adequately capitalized" is required to obtain OFHEO's approval for, and carry out, a formal plan to restore the Enterprise's capital. Statutory provisions also prohibit an Enterprise from making any capital distribution that would result in the Enterprise not meeting the capital thresholds, absent OFHEO's approval, and imposes additional restrictions on capital distributions so long as the Enterprise is not classified as adequately capitalized. An Enterprise that is not classified as adequately capitalized may also be subject to a variety of regulatory limitations and restrictions as deemed to be appropriate by OFHEO.

**Prompt Supervisory Response to  
Factors Beyond Capital**

As the exclusive safety and soundness regulator of the Enterprises, OFHEO has been constituted with broad supervisory authorities, in order to detect and address safety and soundness problems that may arise, and has broad enforcement powers in order to ensure that any safety and soundness deficiencies are promptly remedied. OFHEO is empowered to require such reports and actions by the Enterprises as the agency deems to be appropriate to enable OFHEO to monitor the risks encountered by the Enterprises so as to reduce the possibility of loss long before actual losses reach the level of capital impairment.<sup>9</sup> In order to provide a broad early intervention regime that addresses both capital-related and non-capital-related supervisory concerns, OFHEO proposes to commit itself to undertake specified prompt supervisory

<sup>7</sup> 12 CFR part 1780; see 65 FR 81775 (December 27, 2000) (OFHEO notice of proposed rulemaking to amend purpose and scope section of part 1780, to summarize agency's statutory enforcement powers).

<sup>8</sup> 12 U.S.C. 4614-4619, 4622, 4623.

<sup>9</sup> See, e.g., OFHEO Policy Guidance PG-00-001, *Minimum Safety and Soundness* (Dec. 19, 2000) (setting forth the minimum supervisory requirements used by OFHEO in reviewing and ensuring the adequacy of policies and procedures of the Enterprises in the areas of asset underwriting and credit quality, balance sheet growth, market risks, information technology, internal controls, audits, information reporting and documentation, and board and management responsibilities and functions). OFHEO PG-00-001 available at <http://www.ofheo.gov>.

<sup>1</sup> 12 U.S.C. 4513(a). See also 12 U.S.C. 4513(b)(1)-(5), 4517, 4521(a)(2)-(3), 4631(a)(3), 4636(a)(1).

<sup>2</sup> See Federal Home Loan Mortgage Corporation Act, 12 U.S.C. 1451 *et seq.*; Federal National Mortgage Association Charter Act, 12 U.S.C. 1716 *et seq.*; 1992 Act at 12 U.S.C. 4561-4567, 4562 note.

<sup>3</sup> 12 U.S.C. 4513(b)(1).

<sup>4</sup> 12 U.S.C. 4514, 4517, 1456(c), 1723a(k).

<sup>5</sup> 12 U.S.C. 4611-4614.

<sup>6</sup> 12 U.S.C. 4631-4641.

responses to address both capital and non-capital considerations.

As a financial institution supervisory agency, OFHEO's concerns may include a diverse array of considerations—ranging from matters such as declining collateral values to issues such as asset quality, liquidity, and operational difficulties—that could result in substantial losses to an Enterprise long before capital is impaired. When, in the course of the supervisory process, OFHEO detects any significant changes in indicators reflecting upon such matters, it is appropriate that the agency analyze the situation at that juncture, rather than relying on declines in capital to prompt agency action. If the analysis indicates problems exist, supervisory responses might reasonably include a mixture of early warning and early action initiatives that would be effective before specific problems negatively affect an Enterprise. OFHEO is proposing to adopt a prompt supervisory response regulation that makes the agency's regime for such analysis and early intervention transparent to the public. As recognized by the Government Accounting Office (GAO), a comprehensive prompt corrective action regime that includes prompt supervisory response based on non-capital indicators is likely to be less burdensome and more effective than a system that is exclusively capital-based.<sup>10</sup>

Federal bank regulatory agencies have long employed supervisory criteria other than capital when assessing capital-related classifications. For example, the regulations of the Federal banking agencies provide that the agencies may reclassify a depository institution to a lower capital classification if an unsafe or unsound practice relating to asset quality, management, earnings, or liquidity has not been corrected.<sup>11</sup> Under the proposed rule, OFHEO would adopt a system under which OFHEO commits itself to undertake prompt supervisory responses, but such responses would not necessarily include alteration of the capital classifications of an Enterprise. The prompt supervisory response regime is founded on OFHEO's broad authority under the 1992 Act to take such actions as are necessary to ensure that the Enterprises are, among other

things, operating safely in accordance with law, including by adopting supervisory policies and standards through regulation or other guidance,<sup>12</sup> by requiring the Enterprises to submit reports,<sup>13</sup> and by taking enforcement or other remedial actions, such as temporary or permanent cease and desist orders, pursuant to subtitle C of the 1992 Act.

#### **Prompt Supervisory Response Provisions of the Proposed Rule**

Subpart A of the proposed rule sets out the prompt supervisory response regime, under which OFHEO will monitor various supervisory concerns in addition to an Enterprise's capital classification, and may require prompt action by an Enterprise to remedy or prevent losses or threatened losses, or other threats to safety and soundness. The procedures under subpart A of the proposed rule are separate from the capital-based prompt corrective action regime described below under subpart B of the proposed rule, but they may be used in conjunction with subpart B. Similar to the procedures under subpart B, subpart A of the proposed rule would establish a set of "tripwires," looking to various developments that are appropriate junctures for a supervisory review to ascertain the financial or operational consequences of such developments upon the Enterprise. The occurrence of these tripwires would trigger automatic supervisory responses from OFHEO.

As described in § 1777.1(a) and § 1777.1(b), the rule would be issued under OFHEO's above-discussed broad statutory authority to take such actions as the Director of OFHEO deems appropriate to ensure that the Enterprises operate in a safe and sound manner, including administrative enforcement actions, together with OFHEO's reporting and examination authorities. As is set out in § 1777.1(b), the purpose of subpart A of the rule would be to fashion a broad early intervention regime to address both capital concerns and other serious supervisory considerations. However, as is stated in § 1777.1(b), OFHEO's initiation of the procedures under the proposed rule would not necessarily indicate that a violation of law or regulation has occurred or that an unsound condition exists; rather, the proposed rule is consistent with the process OFHEO employs in reviewing the conduct of an Enterprise's affairs as a safety and soundness regulator. The supervisory responses under the

proposed rule, described below (including a supervisory letter, an action plan, or a notice to show cause) do not constitute orders under the 1992 Act for purposes of 12 U.S.C. 4631 or 4636. They are simply steps in a process under which OFHEO will review issues and, as necessary and appropriate, provide supervisory guidance to the Enterprises.

Section 1777.10 lists various developments, the emergence of which might reasonably indicate that the Enterprise is experiencing or will soon experience some form of unusual stress that is not yet reflected in its capital level. Upon the occurrence of any of the items listed in § 1777.10 of the proposed rule, OFHEO would take one or more of the supervisory responsive actions enumerated in § 1777.11.

Nevertheless, as is noted under § 1777.2(a), identification of particular developments under § 1777.10 in no way limits the authority of OFHEO to take action with regard to other issues impacting upon the Enterprises' capital, safety and soundness, and compliance with applicable law. Moreover, as is noted under § 1777.2(c), the enumeration of supervisory responsive actions in § 1777.11 does not limit OFHEO's discretion to take whatever form of supervisory action OFHEO deems necessary under the 1992 Act. For example, circumstances might indicate to OFHEO that more expedient use of enforcement tools is warranted.

Section 1777.10 sets out a list of ten potential developments that would cause OFHEO to initiate a review under subpart A. The list includes both environmental indicators tied to market factors and internal indicators tied to factors within a particular Enterprise. The marketplace indicators enumerated in the proposed rule look to certain specified changes in housing prices. The internal indicators include specific items related to an Enterprise's interest rate risk, net income, net interest margin, equity, and loan delinquencies, as well as certain operational and governance matters. OFHEO specifically invites public comment whether there are other marketplace or internal indicators appropriate for inclusion in § 1777.10.

Section 1777.11 sets out the proposed supervisory responsive actions to be taken if one of the developments enumerated in § 1777.10 is detected by OFHEO in connection with an examination or otherwise as the agency exercises its routine supervisory functions and oversight of the Enterprises. There are a number of alternatives.

<sup>10</sup> See General Accounting Office Report GAO/ GGD-97-18, *Bank and Thrift Regulation, Implementation of FDICIA's Prompt Corrective Regulatory Action Provisions* (Nov. 21, 1996) at pp. 49-53.

<sup>11</sup> 12 CFR 6.4(d) (Office of the Comptroller of the Currency); 12 CFR 208.40 (Board of Governors of the Federal Reserve System); 12 CFR 325.104 (Federal Deposit Insurance Corporation).

<sup>12</sup> 12 U.S.C. 4513(b)(1), 4513(b)(5).

<sup>13</sup> 12 U.S.C. 4514, 1456(c), 1723a(k).

In every case, OFHEO would initiate a Level I supervisory action under § 1777.11(a), within five days of OFHEO's determination that a § 1777.10 development has occurred. The Enterprise would receive a supervisory letter formally advising the Enterprise that OFHEO has begun the prompt supervisory response process to address the recent development and containing other information depending on the facts and circumstances. OFHEO may direct the Enterprise to supply information about the situation, respond to OFHEO's specific questions or concerns, take corrective or remedial action, or other action deemed appropriate. OFHEO seeks to avoid requiring particular actions, encouraging management of the Enterprises to design the most appropriate course. Unless the development in question has occurred precipitously, OFHEO would have in all likelihood already have commenced a supervisory dialog with the Enterprise about the situation, and the information obtained and points already established through such dialog would affect the content of the supervisory letter.

Based on the Enterprise's response to the supervisory letter and other appropriate factors, OFHEO would promptly determine whether additional supervisory actions would be necessary. Material provided by the Enterprise in response to the supervisory letter may cause OFHEO to conclude that the development creates no substantial supervisory concern or that the Enterprise's management of the risks and concerns presented by the development is adequate. In other cases, the supervisory letter process may indicate that some level of supervisory concern is warranted, but the letter process itself and continuing supervisory dialogue may be all that is required to cause the Enterprise to undertake sufficient corrective or remedial measures.

If additional supervisory actions were deemed necessary, OFHEO would have a variety of alternatives under § 1777.11. Level II supervisory action, as set out in § 1777.11(b), would provide for a special review of an Enterprise. A special review could be useful in supplementing information already obtained by OFHEO through the examination process, and could provide OFHEO with a clearer picture of the situation than could otherwise be obtained through letters or reports. Such review would be conducted by OFHEO's Office of General Counsel, Office of Research and Model Development, Office of Examination and Oversight, Office of Policy Analysis

and Research, or such other department or individual as determined by the Director. Following completion of the special review, OFHEO would promptly determine whether additional supervisory action was warranted.

Under Level III supervisory action set out in § 1777.11(c), OFHEO would direct the Enterprise to prepare and submit an action plan addressing the development. Among other things, the Enterprise's action plan would be required to include information about the circumstances leading up to the development and an assessment of its possible effects upon the Enterprise. The Enterprise would also describe its proposed course of action for dealing with the development, including an analysis of alternatives available to the Enterprise. If OFHEO determined that the action plan was insufficient to resolve the supervisory issues created by the development, OFHEO would direct the Enterprise to revise the plan. However, if OFHEO determined that the supervisory issues would not be resolved even under a revised plan, OFHEO would promptly determine what other supervisory action should be initiated.

Under Level IV supervisory action, as set out in § 1777.11(d), OFHEO would require the Enterprise to show cause why OFHEO should not initiate formal enforcement action against the Enterprise. OFHEO is not, however, required to issue a show cause notice prior to initiating an administrative enforcement action.

The proposed rule contemplates that Level II through Level IV supervisory responsive action need not be carried out sequentially. For example, depending on the facts and circumstances, OFHEO might deem it appropriate to combine Level I action with another Level of action at the initiation of the process. For another example, the Level I process might subsequently cause OFHEO to initiate simultaneous Level II and Level III responses.

In addition, as specified in § 1777.12, OFHEO might also turn to any of the informal or formal supervisory tools available to OFHEO under the 1992 Act. OFHEO might do so at any time, notwithstanding the pendency of Level I-Level IV action. OFHEO might also use such supervisory tools to take action against an Enterprise that failed to make a submission or comply with a directive from OFHEO in connection with actions under Level I-IV. Moreover, OFHEO might use such supervisory tools to address an Enterprise's failure to implement an appropriate action in

response to a supervisory letter or under an action plan.

#### Summary of Prompt Corrective Action Provisions of the 1992 Act

Subtitle B of the 1992 Act directs OFHEO to classify the Enterprises into one of four capital classifications ("adequately capitalized," "undercapitalized," "significantly undercapitalized," or "critically undercapitalized,"), based on the level of capital maintained by the Enterprise. For these purposes, OFHEO assesses the Enterprises' capital by reference to two standards.

The first capital standard is based on ratios of core capital instruments to on balance sheet assets and off balance sheet obligations. The ratios are set according to percentages contained in 12 U.S.C. 4612 and 4613, subject to certain adjustments by OFHEO, and calculated in accordance with guidance from OFHEO under part 1750 of OFHEO's regulations.<sup>14</sup> The statute provides for a "minimum capital" level based on these ratios, as well as a "critical capital" level, based on lower ratios, that triggers additional enforcement requirements and authorities under subtitle B of the 1992 Act.<sup>15</sup>

The other capital standard is for "risk-based capital." Rather than applying leverage ratios, this risk-based capital level requires the Enterprises to hold sufficient total capital to maintain a positive capital position during a hypothetical ten-year stress period characterized by statutorily-prescribed stressful credit conditions and large movements in interest rates, plus an additional amount to cover management and operations risk. Section 4611 of Title 12 directs OFHEO to develop a stress test which, when applied to an Enterprise's current business, will project the amount of total capital that would be necessary to survive the stresses described in the statute during the stress period. OFHEO has issued a proposed rule to amend 12 CFR part 1750 to set out this risk-based capital level. 64 FR 18084 (April 13, 1999).

Section 4614 of Title 12 directs OFHEO to classify each Enterprise as adequately capitalized, undercapitalized, significantly undercapitalized, or critically undercapitalized, using each

<sup>14</sup> 12 CFR part 1750.

<sup>15</sup> OFHEO's regulations at 12 CFR 1750.4 describe how the minimum capital level of an Enterprise is to be calculated. OFHEO calculates the critical capital level in accordance with 12 U.S.C. 4613. As is discussed below, OFHEO is proposing to include a regulatory definition of the critical capital level in part 1777.

Enterprise's compliance with the minimum capital level, critical capital level, and risk-based capital level as reference points. However, as provided in 12 U.S.C. 4614(d) and 4615(c), OFHEO is not to include consideration of an Enterprise's risk-based capital level during the classification process, until the expiration of one year following the effective date of OFHEO's risk-based capital regulation. Until such time, OFHEO is to classify each Enterprise by reference to its minimum capital level and critical capital level.

Section 4614 of Title 12 also grants OFHEO broad discretionary authority to reclassify an Enterprise into a lower capital classification in appropriate circumstances. OFHEO may reclassify an Enterprise at any time if the Director of OFHEO determines, in his or her discretion, that the Enterprise is engaging in conduct not approved by the Director that could result in a rapid depletion of the Enterprise's core capital. Under this standard, if OFHEO determines that some action or inaction (including a failure to respond appropriately to changes in circumstances or unforeseen events) on the part of an Enterprise could result in losses that might impair the Enterprise's capital position, OFHEO can intervene promptly. Or, if action or inaction could contribute significantly to deepening losses, this standard empowers OFHEO to act before increasing losses achieve such severity that the Enterprise's capital in excess of regulatory minimums is exhausted. Section 4614 also authorizes OFHEO to make a discretionary reclassification any time the Director determines, in his or her discretion, that the value of property subject to mortgages held or securitized by the Enterprise has decreased significantly.

OFHEO is to issue a capital classification for each Enterprise at least quarterly, as required by 12 U.S.C. 4614. The procedure for classification (including reclassification) is outlined in 12 U.S.C. 4618. OFHEO is to provide the Enterprise with prior written notice of the capital classification that the agency intends to make. The Enterprise then has 30 days (subject to limitation or extension as OFHEO deems appropriate) to respond. OFHEO then, in its discretion, makes a final determination of the Enterprise's capital classification, including consideration of any relevant information the Enterprise submitted in its response.

Subtitle B specifies certain steps that will automatically result upon an Enterprise's classification in a category lower than adequately capitalized. An Enterprise that is classified as

undercapitalized or significantly undercapitalized must submit a capital restoration plan to OFHEO, describing, among other things, how and when the Enterprise will restore its capital position and the types and levels of activities in which the Enterprise will engage during the term of the plan. OFHEO will approve or reject a plan. In the latter case, the Enterprise must revise the plan and resubmit it for OFHEO's review. An Enterprise's failure to submit a plan in a timely manner, or to submit a plan that is acceptable to OFHEO, is grounds for OFHEO to reclassify the Enterprise into the next lower capital category. In addition, if OFHEO determines that an Enterprise has failed to make, in good faith, reasonable efforts necessary to comply with an approved capital restoration plan, including the schedule for fulfilling the plan, then OFHEO may reclassify the Enterprise into the next lower capital category.

An Enterprise that is classified in any category lower than adequately capitalized is prohibited from making any capital distribution that would result in the Enterprise being classified into a lower category. A capital distribution is defined by the 1992 Act to include (i) dividends and distributions in cash or in kind made with respect to any shares or other ownership interests in an Enterprise, except a dividend consisting only of shares of the Enterprise; (ii) any payment made by an Enterprise to repurchase, redeem, retire, or acquire any of its shares or an extension of credit to finance such a transaction, or any transaction that OFHEO determines by regulation to be a capital distribution in substance. 12 U.S.C. 4502(2).<sup>16</sup> An Enterprise that is classified as significantly undercapitalized is further prohibited from making any capital distribution, absent written approval by OFHEO pursuant to statutorily-specified standards. It should also be noted that, without restriction as to an Enterprise's capital classification, each Enterprise's charter act prohibits the Enterprise from making any capital distribution that would decrease the capital of the Enterprise to an amount less than the risk-based capital level or the minimum capital level, absent written approval by OFHEO.<sup>17</sup>

<sup>16</sup>The statutory definition provides an exception for payments that OFHEO determines are made by an Enterprise to repurchase its shares for the purpose of fulfilling an obligation of the Enterprise under an employee stock ownership plan qualified under section 401 of the Internal Revenue Code of 1986, or any substantially equivalent plan.

<sup>17</sup>The Federal Home Loan Mortgage Corporation Act at 12 U.S.C. 1452(b)(2), and the Federal

Upon classifying an Enterprise as critically undercapitalized, 12 U.S.C. 4617 requires OFHEO to appoint a conservator for the Enterprise, unless OFHEO makes a written determination, and the Secretary of the Treasury concurs in writing, that the appointment of a conservator likely would have serious adverse effects on economic conditions of national financial markets or on the financial stability of the housing finance market, and the public interest would be better served by taking some other enforcement action authorized by the 1992 Act. If OFHEO makes such a determination not to appoint a conservator, the Enterprise is subject to the same mandatory and discretionary supervisory responses as apply to a significantly undercapitalized Enterprise under 12 U.S.C. 4616. OFHEO is also vested with discretion under 12 U.S.C. 4616 to appoint a conservator for an Enterprise that is significantly undercapitalized, if OFHEO determines that the Enterprise's core capital is less than the minimum capital level and that alternative remedies available to OFHEO under the 1992 Act are not satisfactory.<sup>18</sup>

In addition to these automatic supervisory steps, 12 U.S.C. 4616(b) invests OFHEO with discretionary authority to take a variety of supervisory actions at any time with respect to an Enterprise that is classified as significantly undercapitalized. OFHEO may fashion such remedy or require supervisory action as appropriate including, but not limited to, any of the following:

- Limit any increase in, or require a reduction of, any borrowings and other types of obligations of an Enterprise, including off-balance sheet obligations;
- Limit or prohibit the growth of assets of an Enterprise or require reduction of its assets;
- Require an Enterprise to obtain additional capital in such form and amount as specified by OFHEO; and
- Require an Enterprise to terminate, reduce, or modify any program or activity that OFHEO determines entails excessive risk to the Enterprise.

The procedure for issuing an order to an Enterprise to take such remedial action is outlined in 12 U.S.C. 4618. OFHEO is to provide the Enterprise with prior written notice of the proposed order. The Enterprise then has thirty days (subject to limitation or expansion as deemed appropriate by

National Mortgage Association Charter Act at 12 U.S.C. 1718(c)(2).

<sup>18</sup>OFHEO is also empowered to appoint a conservator for an Enterprise under a number of circumstances enumerated in 12 U.S.C. 4619(a)(1) through (2).

OFHEO) to respond. OFHEO then, in its discretion, makes a final determination regarding issuance of a final order, including consideration of any relevant information the Enterprise submitted in its response. The order to take remedial action is enforceable by OFHEO through judicial action in the United States District Court for the District of Columbia, as provided in 12 U.S.C. 4635.

#### **Implementation of the Prompt Corrective Action Provisions of the 1992 Act by the Proposed Rule**

Subpart B of the proposed rule describes the scope of the actions OFHEO is authorized to take under the prompt corrective action statutory provisions in subtitle B of the 1992 Act, and the procedures by which such actions will be carried out.

The authority, purpose, and scope of subpart B is set out in §§ 1777.1(a) and (c), which briefly review the statutes underlying the rule (discussed above). Also, as is discussed in § 1777.1(d), the 1992 Act directs OFHEO to determine capital classifications for the Enterprises by reference to three capital triggers (the minimum capital level, the critical capital level, and the risk-based capital level), but 12 U.S.C. 4614(d) delays consideration of the risk-based capital level until one year after OFHEO's risk-based capital rule becomes effective. Section 4615 of Title 12, setting out the supervisory actions that are applicable to an Enterprise that is classified as undercapitalized, similarly provides that its provisions will not take effect until one year after OFHEO's risk-based capital rule becomes effective. Section 4614(d) provides that, until that time, an Enterprise shall be classified as adequately capitalized if the Enterprise maintains an amount of capital that equals or exceeds the minimum capital level.

Therefore, under subpart B of the proposed rule at § 1777.20, different sets of capital classifications will apply depending on whether the one-year post-effectiveness period for the risk-based capital rules has expired. Section 1777.20(a) contains the "permanent" set of capital classifications taking the risk-based capital level into account as well as the minimum capital level and critical capital level. This set of capital classifications will apply any time after the expiration of one year following the initial effective date of OFHEO's regulations establishing the risk-based capital test (issued under 12 U.S.C. 4611(e)). The currently-applicable "temporary" set of capital classifications is contained in § 1777.20(c), as an exception to

§ 1777.20(a) that applies until expiration of one year following the initial effective date of the risk-based capital regulations. This set of classifications is based on an Enterprise's minimum capital level and critical capital level, reflecting the classification criteria presently used by OFHEO. Section 4614(a) of Title 12, when read together with 12 U.S.C. 4616(c) (making statutory provisions calling for prompt corrective action with regard to a significantly undercapitalized Enterprise effective from the time the Enterprise is first classified under section 4614) and 12 U.S.C. 4617(d) (same, for a critically undercapitalized Enterprise), indicates that Congress intended OFHEO to classify the Enterprises for prompt corrective action purposes by reference to minimum capital and critical capital levels, pending implementation of the risk-based capital test.

As discussed in § 1777.2(b), the prompt corrective action provisions are but one aspect of OFHEO's broad supervisory authority to ensure that the Enterprises maintain capital that is adequate for their safe and sound operation. Maintenance of the minimum capital level and risk-based capital level upon which an Enterprise's capital classification is based does not alone establish that the Enterprise is operating in a safe and sound manner or possesses sufficient capital to address all circumstances. Such capital levels are statutory floors, to be considered together with other factors when assessing the strength of the Enterprise, such as asset quality and diversity, liquidity, earnings, operations, and expected growth, or any unusual stress to the Enterprise. Classification of an Enterprise as "adequately capitalized" under subtitle B of the 1992 Act indicates that the Enterprise is at least in compliance with these floor levels as of the particular times stated in the classification determination, but it does not necessarily mean that the Enterprise's capital is sufficient in light of all such considerations. OFHEO has authority to require an Enterprise to hold additional capital when the circumstances indicate additional capital is necessary or appropriate in light of the overall strength of the Enterprise and markets.

Moreover, the prompt corrective action provisions represent but one kind of supervisory response available to OFHEO to deal with capital deficiencies at an Enterprise. The 1992 Act grants OFHEO broad discretion to take other supervisory actions as may be deemed by OFHEO to be appropriate, including issuing temporary and permanent cease and desist orders, imposing civil money

penalties, appointing a conservator, entering into a written agreement the violation of which is actionable through enforcement proceedings, or entering into any other formal or informal agreement with an Enterprise.

Moreover, the selection of one form of action or a combination of actions does not foreclose OFHEO from pursuing any other action.

The definitions in § 1777.3 cross-reference to OFHEO's capital rules at 12 CFR part 1750 in defining core and total capital. Section 1777.3 defines the minimum capital level as the minimum amount of core capital specified for an Enterprise pursuant to 12 U.S.C. 4612, as determined under OFHEO's capital rules at § 1750.4. The definition of critical capital in § 1777.3 refers to the calculation of core capital required to meet the minimum capital level under § 1750.4 of OFHEO's capital rules, making the appropriate adjustments thereto in order to implement the lower percentages specified in 12 U.S.C. 4613 as compared to 12 U.S.C. 4612. Thus, § 1777.3 defines the critical capital level as the amount of core capital that is equal to the sum of one half of the amount determined under § 1750.4(a)(1) and five-ninths of the amounts determined under § 1750.4(a)(2) through § 1750.4(a)(7). Section 1777.3 defines the risk-based capital level to mean the amount of total capital specified for an Enterprise pursuant to 12 U.S.C. 4611, as determined under OFHEO's regulations implementing section 4611.<sup>19</sup>

The definitions of "affiliate" and "Enterprise" are taken from 12 U.S.C. 4502(1) and 4502(6), respectively. The 1992 Act, in defining an Enterprise to include the Enterprise's affiliates, vests OFHEO with broad jurisdiction over the supervision and regulation of such affiliates as appropriate in differing circumstances. Section 4502(1) defines an affiliate to be any entity that controls, is controlled by, or is under common control with an Enterprise. The 1992 Act does not, however, define control, leaving the term to be interpreted by OFHEO in light of the context in which the term is used and the particular provision of the 1992 Act at issue. In determining whether control exists for the purposes of exercising jurisdiction over an affiliate of an Enterprise under any particular provision of the 1992 Act, OFHEO considers the nature of the particular provision and the facts and circumstances involved. Among other things, OFHEO considers whether an entity exercises a controlling influence

<sup>19</sup> As discussed above, OFHEO has proposed such rules, to be located in 12 CFR part 1750.

over the management and policies of a particular entity, including by ownership of, or the power to vote, a concentration of any class of voting securities, by the ability to elect or appoint members of the board of directors or officers of the entity, or by other means.

The definition of "capital distribution" is taken from 12 U.S.C. 4502(2). Although the statute authorizes OFHEO to expand the capital distribution definition by regulation, OFHEO is not at this time proposing to cover any category of payments beyond those listed in the statutory definition; OFHEO specifically requests public comment addressing whether and what additional types of payments should be covered.

As discussed above, § 1777.20(c) contains a set of capital classifications based on an Enterprise's minimum capital level and critical capital level, reflecting the classification criteria presently used by OFHEO. These classifications apply until the expiration of one year following the initial effective date of OFHEO's regulations establishing the risk-based test:

- *Adequately capitalized*: Pending phase-in of the risk-based capital test, an Enterprise is deemed to be classified as adequately capitalized so long as it meets the minimum capital level, as required by 12 U.S.C. 4614(d), unless OFHEO has exercised its discretion to reclassify the Enterprise into any lower capital classification.

- *Undercapitalized*: As discussed above, 12 U.S.C. 4614(d) provides that an Enterprise that meets the minimum capital level is to be classified nevertheless as adequately classified, notwithstanding 12 U.S.C. 4614(a)(2). However, pending phase-in of the risk-based capital level, an Enterprise that meets the minimum capital level could be classified as undercapitalized through discretionary reclassification by OFHEO.

- *Significantly undercapitalized*: An Enterprise will be classified as significantly undercapitalized if it meets the critical capital level but fails to meet the minimum capital level, unless OFHEO has exercised its discretion to reclassify the Enterprise as critically undercapitalized.

- *Critically undercapitalized*: An Enterprise will be classified as critically undercapitalized if it does not meet the critical capital level.

- *Discretionary reclassification*: Section 4614(b) of Title 12 authorizes OFHEO to reclassify an Enterprise into the next lower capital classification at any time, in the discretion of the Director of OFHEO. Appropriate

grounds for reclassification include a finding by the Director that the Enterprise is either engaging in action or inaction (including a failure to respond appropriately to changes in circumstances or unforeseen events) that could result in a rapid depletion of the Enterprise's core capital, or that the value of property subject to mortgages held or securitized by the Enterprise has decreased significantly. Other reclassifications, based on other sections of subtitle B of the 1992 Act pertaining to failure to submit an acceptable capital restoration plan or implement it, are located in § 1777.7, the section addressing capital restoration plans.

For purposes of OFHEO's discretionary authority to reclassify an Enterprise based on "conduct that could result in a rapid depletion of core capital" under 12 U.S.C. 4614(b), OFHEO interprets "conduct" to include action or inaction (including a failure to respond appropriately to changes in circumstances or unforeseen events). Notably, the statute does not require OFHEO to find that depletion of the Enterprise's core capital is underway or imminent, but requires only that OFHEO determine that such depletion is a possible consequence of the conduct in question. Congress, having already established the capital classifications based on capital levels to address scenarios in which an Enterprise's capital is in decline, established a broad standard for discretionary reclassification, to authorize early intervention by OFHEO when appropriate.

Section 1777.20(a) contains the set of capital classifications taking the risk-based capital level into account as well as the minimum and critical capital levels. This set of classifications will replace the set under § 1777.20(c) one year after the initial effective date of OFHEO's regulations establishing the risk-based capital test:

- *Adequately capitalized*: An Enterprise will be classified as adequately capitalized if the Enterprise meets the risk-based capital level and the minimum capital level, unless OFHEO has exercised its discretion to reclassify the Enterprise into any lower capital classification.

- *Undercapitalized*: An Enterprise will be classified as undercapitalized if it meets the minimum capital level but does not meet the risk-based capital level, unless OFHEO has exercised its discretion to reclassify the Enterprise into any lower capital classification.

- *Significantly undercapitalized*: An Enterprise will be classified as significantly undercapitalized if the Enterprise meets the critical capital

level but fails to meet the minimum capital level, unless OFHEO has exercised its discretion to reclassify the Enterprise as critically undercapitalized.

- *Critically undercapitalized*: An Enterprise will be classified as critically undercapitalized if the Enterprise does not meet the critical capital level.

- *Discretionary reclassification*: As discussed above, 12 U.S.C. 4614(b) authorizes OFHEO to reclassify an Enterprise into the next lower capital classification at any time, in the discretion of the Director of OFHEO. Appropriate grounds for reclassification include a finding by the Director that the Enterprise is either engaging in action or inaction (including a failure to respond appropriately to changes in circumstances or unforeseen events) that could result in a rapid depletion of the Enterprise's core capital, or that the value of property subject to mortgages held or securitized by the Enterprise has decreased significantly. Other reclassifications, based on other sections of subtitle B of the 1992 Act pertaining to failure to submit an acceptable capital restoration plan or implement it, are located in § 1777.7, the section addressing capital restoration plans.

Under § 1777.20(a), the minimum and critical capital levels are the determinative standard for assessing whether an Enterprise falls into the significantly undercapitalized or critically undercapitalized classification based on capital, without regard to whether the Enterprise maintains total capital at or above its risk-based capital level. In enacting the 1992 Act, Congress intended that the minimum and critical capital levels be the "tripwires" for the prompt corrective actions specified in 12 U.S.C. 4616 and 4617. The amount of capital an Enterprise is required to hold to meet its risk-based capital level could be less than the amount of the capital required to meet its minimum capital level or even its critical capital level. To effectuate congressional intent, the rule avoids a result under which an Enterprise that failed to meet its minimum capital level or critical capital level could avoid classification as significantly undercapitalized or critically undercapitalized merely by maintaining total capital in compliance with its risk-based capital level.

As is provided in § 1777.20(b), if an Enterprise is reclassified by OFHEO on grounds that the Enterprise is engaging in action or inaction that could result in a rapid depletion of core capital, OFHEO will continue to take such conduct into account for each subsequent determination of the Enterprise's capital classification, until OFHEO determines that the action,



inaction, or condition in question has ceased and been remedied to OFHEO's satisfaction. For example, if OFHEO reclassified an Enterprise from adequately capitalized to undercapitalized based on such conduct, and during the pendency of such conduct, the Enterprise's total capital declined below the risk based capital level (which, standing alone, would result in classification in the undercapitalized category), the resulting classification could be to the significantly undercapitalized category. In addition, as provided in § 1777.20(b), nothing in 12 U.S.C. 4614(b) prohibits OFHEO from subsequently reclassifying an Enterprise again if the action, inaction, or condition has not ceased or been eliminated and remedied to OFHEO's satisfaction within a reasonable time. The foregoing is also applicable for a discretionary reclassification based on other grounds under § 1777.20(a)(5) or § 1777.20(c)(5), such as a decline in collateral values.

Section 1777.21, implementing 12 U.S.C. 4618, sets out the procedure by which OFHEO classifies the Enterprises.<sup>20</sup> These procedures apply to routine classifications, which OFHEO issues for each Enterprise at least once a quarter, based on capital reports from the Enterprise and any other additional relevant information. These procedures would also be used if it became necessary for OFHEO to reclassify an Enterprise in accordance with OFHEO's discretionary authority to do so under subtitle B of the 1992 Act, or if OFHEO otherwise determined that a new classification would be appropriate for any reason, including a change in an Enterprise's condition that is not reflected in the Enterprise's capital report.

OFHEO may issue capital classifications using different "as of" dates for the Enterprise's risk-based capital level and minimum and critical capital levels. The respective "as of" dates will be stated in the proposed and final capital classifications. For example, OFHEO may assess compliance with the minimum capital level on a more frequent or rapid basis than the risk-based capital level.

As § 1777.21(a)(4) provides, OFHEO may initiate a capital classification at any time. If another capital

classification is pending at such time, OFHEO will advise the Enterprise whether the new classification supersedes the pending one. In addition, § 1777.21(b) requires the Enterprise to notify OFHEO of any material event that may reasonably be expected to cause the Enterprise's minimum, critical, or risk-based capital level to fall to a point that could result in a capital classification lower than the Enterprise's existing or proposed capital classifications.

Under the classification procedure, as set out in 12 U.S.C. 4618, OFHEO is to deliver written information to the Enterprise describing the proposed capital classification and the agency's basis for such classification. The Enterprise then has thirty days to submit any relevant information in response to the notice. OFHEO is authorized to extend the response period up to an additional thirty days or reduce the response period in appropriate circumstances; the Enterprise may also consent to an abbreviated response period. In exigent circumstances, the response period afforded to an Enterprise would likely be quite brief.

An Enterprise's failure to respond within the applicable period waives the opportunity to comment on the proposed classification. Once the response period has closed, OFHEO will make a final determination of the Enterprise's capital classification. OFHEO will take into consideration any relevant information submitted by the Enterprise during the response period in reaching the final decision. The final capital classification is to be provided to the Enterprise in writing, including a description of OFHEO's basis for the classification.

Section 1777.22 implements statutory capital distribution restrictions, including the above-cited provisions under each Enterprise's charter act, prohibiting, without regard to capital classification, each Enterprise from making any capital distribution that would decrease the capital of the Enterprise to an amount less than the risk-based capital level or the minimum capital level, except as explicitly approved by OFHEO. Section 1777.22(c) and (a) implement such provisions before and after the initial effective date of OFHEO's risk-based capital regulations, respectively. Section 1777.22(b)(1) implements 12 U.S.C. 4615(a)(2) and 4616(a)(2), prohibiting any Enterprise that is not classified as adequately capitalized from making any capital distributions that would result in classification into a lower capital classification. Section 1777.22(b)(2) also

implements 12 U.S.C. 4616(a)(2), prohibiting a significantly undercapitalized Enterprise from making any capital distributions absent OFHEO's prior approval. Section 1777.22(b)(2) also applies in the case of an Enterprise classified as critically undercapitalized. The proposed rule acknowledges, in a manner consistent with 12 U.S.C. 4617(b) through (c), OFHEO's authority to take actions authorized by 12 U.S.C. 4616 in the case of a critically undercapitalized Enterprise, including one in conservatorship. Under the same authority, § 1777.23 requires an Enterprise classified as critically undercapitalized to submit a complete and acceptable capital restoration plan to OFHEO.

Section 1777.23 addresses capital restoration plans. Under § 1777.23(a)(1), an Enterprise is required to file a complete capital restoration plan with OFHEO within ten days of receiving final notice of capital classification stating that the Enterprise is classified as undercapitalized, significantly undercapitalized, or critically undercapitalized, unless OFHEO extends the period.

Under § 1777.23(a)(2), an Enterprise that is already operating under an approved capital restoration plan will not be required to submit a new plan each time the Enterprise receives subsequent notices of capital classification, unless OFHEO notifies the Enterprise to the contrary. As a general matter, OFHEO would be likely to direct the Enterprise to submit a new or amended plan if subsequent notices of capital classification are on grounds different from or in addition to the grounds underlying previous notices, or if changes in circumstances underlying the original plan indicate that reevaluation is appropriate, or if the original plan is not achieving the desired effects within a reasonable period.

In order to be complete, the Enterprise's capital restoration plan must include all of the information required by 12 U.S.C. 4622(a) and all other information directed by OFHEO. If the Enterprise does not submit a complete plan by the specified deadline, OFHEO may in its discretion reclassify the Enterprise into a lower capital classification, as described in § 1777.23(c). OFHEO's original notice of proposed capital classification will notify the Enterprise that the Enterprise's failure to submit a complete and timely capital restoration plan may lead to additional reclassification, as provided in § 1777.21(a)(1)(ii). Consequently, if a complete and timely

<sup>20</sup> Part 1750 of OFHEO's regulations currently contain classification procedures at 12 CFR 1750.5. When this part 1777 is adopted as a final rule, OFHEO will amend part 1750 to remove the classification procedures from part 1750. At that time, all classification procedures will be located in part 1777, and procedures under which the Enterprises file periodic capital reports will remain in part 1750.

capital restoration plan is not received, OFHEO may issue such reclassification under § 1777.21(a)(3) immediately upon expiration of the filing deadline, without further notice. As further provided in § 1777.23(c), such reclassification may affect each subsequent capital classification of the Enterprise, until the Enterprise files a plan that obtains OFHEO's approval. If the Enterprise has not corrected its failure to file an acceptable plan after a reasonable period, OFHEO may issue additional reclassifications to the Enterprise, without additional notice.

OFHEO will review the Enterprise's capital plan and provide an order within thirty days specifying the plan is approved or disapproved, subject to extension for an additional thirty days as OFHEO deems necessary. If the plan is disapproved, OFHEO's order will address the reasons for disapproval. The Enterprise must then submit an amended plan acceptable to OFHEO within thirty days or such longer period as OFHEO approves. This thirty day period is longer than the ten day period for submission of the initial plan, in order to facilitate dialog with the Enterprise as to how the Enterprise may rehabilitate its disapproved plan. However, as provided in § 1777.23(c), OFHEO may elect to reclassify the Enterprise into a lower capital classification, without additional notice, until such time as the Enterprise files an amended capital plan and OFHEO approves it.

Once a capital plan is approved, it may be amended only with the prior written approval of OFHEO, as provided in § 1777.23(f). The Enterprise's obligations under the plan remain in place except to the extent the plan itself identifies dates, events, or conditions upon which the obligations terminate. To the extent the plan is silent in regard to any particular obligation, the obligation remains in place until OFHEO issues an order terminating such obligation. An Enterprise may seek such termination orders from OFHEO.

Section 1777.23(h) of the proposed rule requires the Enterprise to take all actions reasonably necessary to comply with the approved plan and fulfill the schedule thereunder. If an Enterprise fails to do so, § 1777.23(h) indicates OFHEO may exercise its authority under 12 U.S.C. 4615(b)(2) and 4616(b)(5), which authorizes OFHEO to reclassify an Enterprise if OFHEO finds it has failed to make, in good faith, reasonable efforts necessary to comply with the capital restoration plan. OFHEO interprets the requirement of good faith under the statutory language to mean that the Enterprise must make all efforts

reasonably necessary to implement the plan. As is provided in § 1777.23(h)(1)(ii) through (iii), the Enterprise's failure to implement the plan will be considered in the determination of each subsequent capital classification of the Enterprise until OFHEO determines the Enterprise is making such reasonable efforts. The Enterprise may face successive reclassifications for failure to make such efforts after a reasonable period.

In addition, a capital plan that has received an approval order by OFHEO is an order under the 1992 Act for purposes of 12 U.S.C. 4631, authorizing OFHEO to institute cease and desist proceedings if an Enterprise, executive officer, or director thereof engages in, or OFHEO has reasonable cause to believe is about to engage in, conduct that violates orders issued under the 1992 Act. Under certain circumstances, civil money penalties may also be imposed under 12 U.S.C. 4636 against an Enterprise, executive officer, or director thereof for violation of an order under the 1992 Act. As is noted in § 1777.23(h)(2), an Enterprise in any capital classification, its executive officers, and directors may be subject to action by OFHEO under 12 U.S.C. 4631, 4632, and 4636 and 12 CFR part 1780 for failure to comply with an approved plan.

Section 1777.24 of the proposed rule implements OFHEO's discretionary authority under 12 U.S.C. 4616(b)(1) through (4), to issue orders requiring a significantly undercapitalized Enterprise to take remedial and corrective actions such as reducing liabilities, limiting asset growth, obtaining new capital, or refraining from engaging in activities as specified by OFHEO. As indicated by § 1777.24, OFHEO may also issue such orders to an Enterprise that has been classified as critically undercapitalized, including one in conservatorship, under authority provided by 12 U.S.C. 4617(b) through (c).

The procedures under which these orders may be issued are similar to the procedures for issuance of capital classifications, and are set out in §§ 1777.24 through 1777.26 of the proposed rule. Similar to the treatment of approved capital plans discussed above, the provisions contained in these orders bind the Enterprise until such provisions terminate under the terms of the order or OFHEO modifies the order, as discussed in § 1777.26(b). As indicated in § 1777.26(c), these orders constitute orders under the 1992 Act, and an Enterprise in any capital classification, its executive officers, and directors may be subject to

administrative enforcement action by OFHEO under 12 U.S.C. 4631, 4632, and 4636 and 12 CFR part 1780 for failure to comply with such orders. Moreover, 12 U.S.C. 4635 provides jurisdiction in the United States District Court of the District of Columbia for direct enforcement of these orders.

Section 1777.27 summarizes 12 U.S.C. 4623, which provides that an Enterprise not classified as critically undercapitalized may seek judicial review of OFHEO's final notice of its capital classification, or a final notice of order issued under 12 U.S.C. 4616(b)(1) through (4). For any issue raised by such Enterprise in connection with such review, the Enterprise must have first exhausted its administrative remedies, by presenting all its objections, arguments, and information relating to such issue for OFHEO's consideration in the Enterprise's response to OFHEO's notice of capital classification or notice of intent to issue an order. The Enterprise's judicial action will not operate as a stay of OFHEO's final capital classification or order.

Section 1777.28 addresses appointment of a conservator for a significantly undercapitalized or critically undercapitalized Enterprise.<sup>21</sup> As is described in § 1777.12(a), 12 U.S.C. 4616 empowers OFHEO to appoint a conservator for a significantly undercapitalized Enterprise, if OFHEO determines the Enterprise's core capital is less than the minimum capital level and the alternative remedies available to OFHEO under the 1992 Act are not satisfactory. As is described in § 1777.12(b), 12 U.S.C. 4617 requires OFHEO to appoint a conservator for a critically undercapitalized Enterprise, unless OFHEO makes a written determination, and the Secretary of the Treasury concurs in writing, that the appointment of a conservator likely would have serious adverse effects on economic conditions of national financial markets or on the financial stability of the housing finance market, and the public interest would be better served by taking some other enforcement action authorized by the 1992 Act. Under 12 U.S.C. 4619(e)(2), either such appointment will be terminated by OFHEO upon the agency's determination that the Enterprise has maintained an amount of core capital that is equal to or exceeds the minimum capital level. OFHEO is also vested with discretion, under 12 U.S.C. 4619(e)(1), to terminate either

<sup>21</sup> OFHEO also has authority under 12 U.S.C. 4619(a)(1) through (2) to appoint conservators on various grounds, regardless of an Enterprise's capital classification.

type of conservatorship appointment based on the agency's determination that such termination is in the public interest and may safely be accomplished. These termination provisions are reflected in § 1777.28(d).

### Regulatory Impact

*Executive Order 12866, Regulatory Planning and Review*

The proposed regulation is not classified as a significant rule under Executive Order 12866 because it will not result in an annual effect on the economy of \$100 million or more or a major increase in costs or prices for consumers, individual industries, Federal, State, or local government agencies, or geographic regions; or have significant adverse effects on competition, employment, investment, productivity, innovation, or on the ability of United States-based enterprises to compete with foreign-based enterprises in domestic or foreign markets. Accordingly, no regulatory impact assessment is required and this proposed regulation has not been submitted to the Office of Management and Budget for review.

*Unfunded Mandates Reform Act of 1995*

This proposed rule does not include a Federal mandate that could result in the expenditure by State, local, and tribal governments, in the aggregate, or by the private sector, of \$100,000,000 or more (adjusted annually for inflation) in any one year. As a result, the proposed rule does not warrant the preparation of an assessment statement in accordance with the Unfunded Mandates Reform Act of 1995.

*Regulatory Flexibility Act*

The Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*) requires that a regulation that has a significant economic impact on a substantial number of small entities, small businesses, or small organizations must include an initial regulatory flexibility analysis describing the regulation's impact on small entities. Such an analysis need not be undertaken if the agency has certified that the regulation will not have a significant economic impact on a substantial number of small entities. 5 U.S.C. 605(b). OFHEO has considered the impact of the proposed regulation under the Regulatory Flexibility Act. The General Counsel of OFHEO certifies that the proposed regulation, if adopted, is not likely to have a significant economic impact on a substantial number of small business entities because the regulation only

affects the Enterprises, their executive officers, and their directors.

*Paperwork Reduction Act of 1995*

This proposed rules contain no information collection requirements that require the approval of the Office of Management and Budget pursuant to the Paperwork Reduction Act, 44 U.S.C. 3501–3520.

### List of Subjects in 12 CFR Part 1777

Administrative practice and procedure, Capital classification, Mortgages.

Accordingly, for the reasons set out in the preamble, OFHEO proposes to add part 1777 to subchapter C of 12 CFR chapter XVII to read as follows:

### PART 1777—PROMPT CORRECTIVE ACTION

Sec.

1777.1 Authority, purpose, scope, and implementation dates.

1777.2 Preservation of other authority.

1777.3 Definitions.

#### Subpart A—Prompt Supervisory Response

1777.10 Developments prompting supervisory response.

1777.11 Supervisory response.

1777.12 Other supervisory action.

#### Subpart B—Capital Classifications and Orders Under Section 1366 of the 1992 Act

1777.20 Capital classifications.

1777.21 Notice of capital category, and adjustments.

1777.22 Limitation on capital distributions.

1777.23 Capital restoration plans.

1777.24 Notice of intent to issue an order.

1777.25 Response to notice.

1777.26 Final notice of order.

1777.27 Exhaustion and review.

1777.28 Appointment of conservator for significantly undercapitalized or critically undercapitalized Enterprise.

**Authority:** 12 U.S.C. 1452(b)(2), 1456(c), 1718(c)(2), 1723a(k), 4513(a), 4513(b), 4514, 4517, 4611–4619, 4622, 4623, 4631, 4635.

#### § 1777.1 Authority, purpose, scope, and implementation dates.

(a) **Authority.** This part is issued by the Office of Federal Housing Enterprise Oversight (OFHEO) pursuant to sections 1313, 1371, 1372, and 1376 of the Federal Housing Enterprises Financial Safety and Soundness Act (1992 Act) (12 U.S.C. 4513, 4631, 4632, and 4636). These provisions broadly authorize OFHEO to take such actions as are deemed appropriate by the Director of OFHEO to ensure that the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation (collectively, the Enterprises) maintain adequate capital and operate in a safe and sound manner.

(b) **Authority, purpose and scope of subpart A.** In addition to the authority

set forth in paragraph (a) of this section, subpart A of this part is also issued pursuant to section 1314 of the 1992 Act (12 U.S.C. 4514), section 307(c) of the Federal Home Loan Mortgage Corporation Act (12 U.S.C. 1456(c)), and section 309(k) of the Federal National Mortgage Association Charter Act (12 U.S.C. 1723a(k)), requiring each Enterprise to submit such reports to OFHEO as the Director of OFHEO determines, in his or her judgment, are necessary to carry out the purposes of the 1992 Act. Subpart A is also issued in reliance on section 1317 of the 1992 Act (12 U.S.C. 4517) authorizing OFHEO to conduct examinations of the Enterprises. The purpose of subpart A is to set forth a framework of early intervention supervisory measures, other than formal enforcement actions, that OFHEO may take to address specified developments that merit supervisory review to ensure they do not pose a current or future threat to the safety and soundness of an Enterprise. OFHEO's initiation of procedures under subpart A does not necessarily indicate that any unsound condition exists or that any violation has taken place. The supervisory responses enumerated in § 1777.11 do not constitute orders under the 1992 Act for purposes of sections 1371, 1372, and 1376 thereof (12 U.S.C. 4631, 4632 and 4636).

(c) **Authority, purpose, and scope of subpart B.** In addition to the authority set forth in paragraph (a) of this section, subpart B of this part is also issued pursuant to subtitle B of the 1992 Act (12 U.S.C. 4611 through 4623), section 303(b)(2) of the Federal Home Loan Mortgage Corporation Act (12 U.S.C. 1452(b)(2)), and section 303(c)(2) of the Federal National Mortgage Association Charter Act (12 U.S.C. 1718(c)(2)). These provisions authorize OFHEO to administer certain capital requirements for the Enterprises, to classify the capital of the Enterprises based on capital levels specified in the 1992 Act, and, in appropriate circumstances, to exercise discretion to reclassify an Enterprise into a lower capital category. Under these provisions, there are also automatic consequences for an Enterprise that is not classified as adequately capitalized, as well as discretionary authority for OFHEO to require an Enterprise to take remedial actions. Subpart B implements the provisions of sections 1364 through 1368, 1369(b) through (e), 1369C, and 1369D of the 1992 Act as they apply to the Enterprises (12 U.S.C. 4614 through 4618, 4619(b) through (e), 4622 and 4623). The principal purposes of subpart B are to identify the capital

measures and capital levels that OFHEO uses in determining the capital classification of an Enterprise, to set out the procedures OFHEO uses in determining such capital classifications, to establish procedures for submission and review of capital restoration plans of an Enterprise that is not classified as adequately capitalized, and to establish procedures under which OFHEO issues orders pursuant to section 1366(b)(1) through (4) of the 1992 Act (12 U.S.C. 4616(b)(1) through (4)).

(d) *Effective dates of capital classifications.* Section 1364 of the 1992 Act (12 U.S.C. 4614(d)) directs OFHEO to determine capital classifications for the Enterprises by reference to two capital standards, consisting of the minimum or critical capital level on the one hand, and the risk-based capital level on the other. Section 1364(d) of the 1992 Act (12 U.S.C. 4614(d)) excludes consideration of whether the Enterprises meet the risk-based capital level in determining capital classifications or reclassifications under 1364, until one year after the effective date of OFHEO's regulation implementing OFHEO's risk-based capital test (issued under section 1361(e) of the 1992 Act (12 U.S.C. 4611(e))); until such time, section 1364(d) provides that an Enterprise is to be classified as adequately capitalized so long as it meets the minimum capital level. Subpart B contains a currently effective set of capital classifications omitting consideration of the risk-based capital level, as well as another set of capital classifications which will take effect, and displace the current set of capital classifications, one year after the effective date of OFHEO's risk-based capital rule.

#### § 1777.2 Preservation of other authority.

(a) *Supervisory standards.* Notwithstanding the identification of certain developments for supervisory response under subpart A of this part, nothing in this part in any way limits the authority of OFHEO otherwise to take such actions as are deemed appropriate by the Director of OFHEO to ensure that the Enterprises maintain adequate capital, operate in a safe and sound manner, and comply with the 1992 Act and regulations, orders, and agreements thereunder.

(b) *Capital floor.* Classification of an Enterprise as adequately capitalized in accordance with subtitle B of the 1992 Act and subpart B of this part indicates that the Enterprise meets the capital levels under sections 1361 and 1362 of the 1992 Act (12 U.S.C. 4611 and 4612) and regulations promulgated thereunder as of particular times stated in the

classification determination. Nothing in subpart B of this part or subtitle B of the 1992 Act limits OFHEO's authority otherwise to address circumstances that would require additional capital through regulations, orders, notices, guidance, or other actions.

(c) *Form of supervisory action or response.* In addition to the supervisory responses contemplated under subpart A of this part, and the authority to classify and reclassify the Enterprises, to issue orders, and to appoint conservators under subpart B of this part, the 1992 Act grants OFHEO broad discretion to take such other supervisory actions as may be deemed by OFHEO to be appropriate, including issuing temporary and permanent cease and desist orders, imposing civil money penalties, appointing a conservator under section 1369(a)(1) through (2) of the 1992 Act (12 U.S.C. 4619(a)(1) through (2)), entering into a written agreement the violation of which is actionable through enforcement proceedings, or entering into any other formal or informal agreement with an Enterprise. Neither the 1992 Act nor this part in any way limit OFHEO's discretion over the selection of the type of these actions, and the selection of one type of action under this part or under these other statutory authorities, or a combination thereof, does not foreclose OFHEO from pursuing any other action.

#### § 1777.3 Definitions.

For purposes of this part, the following definitions will apply:

*1992 Act* means the Federal Housing Enterprises Financial Safety and Soundness Act, 12 U.S.C. 4501 *et seq.*

*Affiliate* means an entity that controls an Enterprise, is controlled by an Enterprise, or is under common control with an Enterprise.

*Capital distribution* means:

(1) Any dividend or other distribution in cash or in kind made with respect to any shares of, or other ownership interest in, an Enterprise, except a dividend consisting only of shares of the Enterprise; and

(2) Any payment made by an Enterprise to repurchase, redeem, retire, or otherwise acquire any of its shares or other ownership interests, including any extension of credit made to finance an acquisition by the Enterprise of such shares or other ownership interests, except to the extent the Enterprise makes a payment to repurchase its shares for the purpose of fulfilling an obligation of the Enterprise under an employee stock ownership plan that is qualified under section 401 of the Internal Revenue Code of 1986 (26 U.S.C. 401 *et seq.*) or any substantially

equivalent plan and is approved in writing by OFHEO in advance.

*Core capital* has the same meaning as provided in 12 CFR 1750.2.

*Critical capital level* means the amount of core capital that is equal to the sum of one half of the amount determined under 12 CFR 1750.4(a)(1) and five-ninths of the amounts determined under 12 CFR 1750.4(a)(2) through 1750.4(a)(7).

*Enterprise* means the Federal National Mortgage Association and any affiliate thereof, and the Federal Home Loan Mortgage Corporation and any affiliate thereof.

*Minimum capital level* means the minimum amount of core capital specified for an Enterprise pursuant to section 1362 of the 1992 Act (12 U.S.C. 4612), as determined under 12 CFR 1750.4.

*OFHEO* means the Office of Federal Housing Enterprise Oversight.

*Risk-based capital level* means the amount of total capital specified for an Enterprise pursuant to section 1361 of the 1992 Act (12 U.S.C. 4611), as determined under OFHEO's regulations implementing section 1361.

*Total capital* has the same meaning as provided at 12 CFR 1750.11(n).

### Subpart A—Prompt Supervisory Response

#### § 1777.10 Developments prompting supervisory response.

In the event of any of the following developments, OFHEO shall undertake one of the supervisory responses enumerated in § 1777.11, or a combination thereof:

(a) OFHEO's national House Price Index (HPI) for the most recent quarter is more than two percent less than the national HPI four quarters previously, or for any Census Division or Divisions in which are located properties securing more than 25 percent of single-family mortgages owned or securing securities guaranteed by an Enterprise, the HPI for the most recent quarter for such Division or Divisions is more than five percent less than the HPI for that Division or Divisions four quarters previously;

(b) An Enterprise's interest rate risk, as assessed by any internal measure, exceeds the limit at which the Enterprise's policies and procedures require a report of such exception to its board of directors;

(c) An Enterprise's net income for the most recent calendar quarter is less than one-half of its average quarterly net income for any four-quarter period during the prior eight quarters;

(d) An Enterprise's net interest margin (NIM) for the most recent quarter is less

than one-half of its average NIM for any four-quarter period during the prior eight quarters;

(e) For single-family mortgage loans owned or securitized by an Enterprise that are delinquent ninety days or more or in foreclosure, the proportion of such loans in the most recent quarter has increased more than one-half of a percentage point compared to the lowest proportion of such loans in any of the prior four quarters;

(f) An Enterprise's equity, as measured on its Consolidated Fair Value Balance Sheet as of the end of a calendar year, is ten percent less than the Enterprise's equity so measured as of the end of the previous calendar year, and is ten percent or more below the amount of its core capital;

(g) An Enterprise experiences material and sustained disruptions to its data processing or operational systems;

(h) An Enterprise changes its external auditor without cause;

(i) The board of directors of an Enterprise fails to hold a scheduled meeting without cause; or

(j) Any other development, including conduct of an activity by an Enterprise, that OFHEO determines in its discretion presents a risk to the safety and soundness of the Enterprise or a possible violation of applicable law, regulation, or order.

#### § 1777.11 Supervisory response.

(a) *Level I supervisory response.*—(1) *Supervisory letter.* Not later than five business days after OFHEO determines that a development enumerated in § 1777.10 has transpired, OFHEO shall deliver a supervisory letter alerting the chief executive officer or to the board of directors, of the Enterprise to OFHEO's determination that the development has occurred.

(2) *Contents of supervisory letter.* The supervisory letter shall notify the Enterprise that OFHEO is commencing review of the development pursuant to this subpart. As is appropriate under the particular circumstances and the nature of the development, the letter may direct the Enterprise to undertake one or more of the following, as of such time OFHEO directs:

(i) Provide OFHEO with any relevant information known to the Enterprise about the development, in such format as OFHEO directs;

(ii) Respond to specific questions and concerns OFHEO has about the development; and

(iii) Take appropriate action.

(3) *Review; further action.* Based on the Enterprise's response to the supervisory letter and consideration of other appropriate factors, OFHEO shall

promptly determine whether the Level I supervisory response is adequate to resolve any supervisory issues implicated by the development, or whether additional supervisory response under this section is warranted.

(b) *Level II supervisory response.*—(1) *Special review.* In addition to any other supervisory response described in this section, OFHEO may conduct a special review of the Enterprise in order to assess the impact of the development on the Enterprise.

(2) *Review; further action.* Based on the results of the special review and consideration of other appropriate factors, OFHEO shall promptly determine whether additional supervisory response under this section is warranted.

(c) *Level III supervisory response.*—(1) *Action plan.* In addition to any other supervisory response described in this section, OFHEO may direct the Enterprise to prepare and submit an action plan to OFHEO, in such format and at such time as OFHEO directs.

(2) *Contents of action plan.* Such action plan shall include, subject to additional direction by OFHEO, the following:

(i) In the case of developments, activities, or investments described in § 1777.10(b) through (j), any relevant information known to the Enterprise about the circumstances that led to such development, activity, or investment;

(ii) An assessment of likely consequences that the development, activity, or investment may have for the Enterprise; and

(iii) The proposed course of action the Enterprise will undertake in response to the development, in conducting the activity, or making the investment, including an explanation as to why such approach is preferred to any other alternative actions by the Enterprise and how such approach will address the concerns of OFHEO.

(3) *Review; further action.* If OFHEO in its discretion determines that the information, assessment, or proposed course of action contained in the action plan is incomplete or inadequate, OFHEO shall promptly direct the Enterprise to correct such deficiencies to the extent OFHEO determines such corrections will aid in resolving supervisory issues implicated by the development, and will promptly determine whether additional supervisory response under this section is warranted.

(d) *Level IV supervisory response.*—(1) *Notice to show cause.* In addition to any other supervisory response described in this section, OFHEO may issue written

notice to the board of directors of the Enterprise directing the Enterprise to show cause, on or before the date specified in the notice, why OFHEO should not issue one or more of the following:

(i) A notice of charges to the Enterprise under section 1371 of the 1992 Act (12 U.S.C. 4631) and the procedures in 12 CFR part 1780 commencing an action to order the Enterprise to cease and desist conduct, conditions, or violations specified in the notice to show cause;

(ii) A temporary order to the Enterprise under section 1372 of the 1992 Act (12 U.S.C. 4632) and the procedures in 12 CFR part 1780 to cease and desist from, and take affirmative actions to prevent or remedy harm from, conduct, conditions, or violations specified in the notice to show cause;

(iii) A notice of charges under section 1376 of the 1992 Act (12 U.S.C. 4636) and the procedures in 12 CFR part 1780 commencing imposition of a civil money penalty against the Enterprise; and

(iv) A notice of discretionary reclassification of the Enterprise's capital classification under section 1364(b) of the 1992 Act (12 U.S.C. 4614(b)) and subpart B of this part.

(2) *Review; further action.* Based on the Enterprise's response to the notice to show cause and consideration of other appropriate factors, OFHEO shall determine promptly whether to commence the actions described in the notice, and whether additional supervisory response under this section is warranted.

#### § 1777.12 Other supervisory action.

Notwithstanding the pendency or completion of one or more supervisory responses described in § 1777.11, OFHEO may at any time undertake additional supervisory steps and actions in the form of any informal or formal supervisory tool available to OFHEO under the 1992 Act, including but not limited to the issuance of guidance or directives under section 1313 (12 U.S.C. 4513), the requiring of reports under section 1314 (12 U.S.C. 4514), the conduct of other examinations under section 1317 (12 U.S.C. 4517), discretionary reclassification under section 1364 (12 U.S.C. 4614), discretionary action under section 1366(b) (12 U.S.C. 4616(b)), appointment of a conservator under section 1369(a) (12 U.S.C. 4619(a)), or administrative enforcement action under sections 1371, 1372, and 1376 (12 U.S.C. 4631, 4632 and 4636). In addition, OFHEO may take any such steps or actions with respect to an

Enterprise that fails to make a submission or comply with a directive as required by § 1777.11, or to address an Enterprise's failure to implement an appropriate action in response to a supervisory letter or under an action plan under § 1777.11.

### Subpart B—Capital Classifications and Orders Under Section 1366 of the 1992 Act

#### § 1777.20 Capital classifications.

(a) *Capital classifications after the effective date of section 1365 of the 1992 Act.* The capital classification of an Enterprise for purposes of subpart B of this part is as follows:

(1) *Adequately capitalized.* Except as otherwise provided under paragraph (a)(5) of this section, an Enterprise will be classified as adequately capitalized if the Enterprise:

(i) As of the date specified in the notice of proposed capital classification, held total capital equaling or exceeding the risk-based capital level; and

(ii) As of the date specified in the notice of proposed capital classification, held core capital equaling or exceeding the minimum capital level.

(2) *Undercapitalized.* Except as otherwise provided under paragraph (a)(5) of this section or § 1777.23(c) or § 1777.23(h), an Enterprise will be classified as undercapitalized if the Enterprise:

(i) As of the date specified in the notice of proposed capital classification, held total capital less than the risk-based capital level; and

(ii) As of the date specified in the notice of proposed capital classification, held core capital equaling or exceeding the minimum capital level.

(3) *Significantly undercapitalized.* Except as otherwise provided under paragraph (a)(5) of this section or § 1777.23(c) or § 1777.23(h), an Enterprise will be classified as significantly undercapitalized if the Enterprise:

(i) As of the date specified in the notice of proposed capital classification, held core capital less than the minimum capital level; and

(ii) As of the date specified in the notice of proposed capital classification, held core capital equaling or exceeding the critical capital level.

(4) *Critically undercapitalized.* An Enterprise will be classified as critically undercapitalized if, as of the date specified in the notice of proposed capital classification, the Enterprise held core capital less than the critical capital level.

(5) *Discretionary reclassification.—(i) Determination to reclassify.* If OFHEO

determines in writing that an Enterprise is engaging in action or inaction (including a failure to respond appropriately to changes in circumstances or unforeseen events) that could result a rapid depletion of core capital, or that the value of the property subject to mortgages held or securitized by the Enterprise has decreased significantly, or that reclassification is otherwise deemed necessary to ensure that the Enterprise holds adequate capital and operates safely, OFHEO may reclassify the Enterprise as:

(A) Undercapitalized if the Enterprise is otherwise classified as adequately capitalized;

(B) Significantly undercapitalized if the Enterprise is otherwise classified as undercapitalized;

(C) Critically undercapitalized if the Enterprise is otherwise classified as significantly undercapitalized.

(ii) *Prior approvals.* In making any determination to reclassify an Enterprise under paragraph (a)(5)(i) of this section, OFHEO will not base its decision to reclassify solely on action or inaction that previously was given specific approval by the Director of OFHEO in connection with the Director's approval of the Enterprise's capital restoration plan under section 1369C of the 1992 Act (12 U.S.C. 4622), or of a written agreement with the Enterprise that is enforceable in accordance with section 1371 of the 1992 Act (12 U.S.C. 4631).

(b) *Duration of reclassification; successive reclassifications.—(1) Any reclassification of an Enterprise based on action, inaction, or conditions under paragraph (a)(5) or (c)(5) of this section shall be considered in the determination of each subsequent capital classification of the Enterprise, and shall only cease being considered in the determination of the Enterprise's capital classification after OFHEO determines that the action, inaction or condition upon which the reclassification was based has ceased or been eliminated and remedied to OFHEO's satisfaction.*

(2) If the action, inaction, or condition upon which a reclassification was based under paragraph (a)(5) or (c)(5) of this section has not ceased or been eliminated and remedied to OFHEO's satisfaction within such reasonable period as is determined by OFHEO to be appropriate, OFHEO may consider such failure to be the basis for additional reclassification under such paragraph (a)(5) or (c)(5) of this section into lower capital classifications.

(c) *Capital classifications before the effective date of section 1365 of the 1992 Act.* Notwithstanding paragraph (a) of this section, until the expiration of one

year following the initial effective date of OFHEO's regulations establishing the risk-based capital test (issued under section 1361(e) of the 1992 Act (12 U.S.C. 4611(e)), the capital classification of an Enterprise for purposes of subpart B of this part is as follows:

(1) *Adequately capitalized.* Except as otherwise provided in paragraph (c)(5) of this section, an Enterprise will be classified as adequately capitalized if the Enterprise, as of the date specified in the notice of proposed capital classification, held core capital equaling or exceeding the minimum capital level.

(2) *Undercapitalized.* An Enterprise will be classified as undercapitalized if the Enterprise:

(i) As of the date specified in the notice of proposed capital classification, held core capital equaling or exceeding the minimum capital level; and (ii) Is reclassified as undercapitalized by OFHEO under paragraph (c)(5) of this section.

(3) *Significantly undercapitalized.* Except as otherwise provided under paragraph (c)(5) of this section or § 1777.23(c) or § 1777.23(h), an Enterprise will be classified as significantly undercapitalized if the Enterprise:

(i) As of the date specified in the notice of proposed capital classification, held core capital less than the minimum capital level; and (ii) As of the date specified in the notice of proposed capital classification, held core capital equaling or exceeding the critical capital level.

(4) *Critically undercapitalized.* An Enterprise will be classified as critically undercapitalized if, as of the date specified in the notice of proposed capital classification, the Enterprise held core capital less than the critical capital level.

(5) *Discretionary reclassification.—(i) Determination to reclassify.* If OFHEO determines in writing that an Enterprise is engaging in action or inaction (including a failure to respond appropriately to changes in circumstances or unforeseen events) that could result a rapid depletion of core capital, or that the value of the property subject to mortgages held or securitized by the Enterprise has decreased significantly, or that reclassification is deemed necessary to ensure that the Enterprise holds adequate capital and operates safely, OFHEO may reclassify the Enterprise as:

(A) Undercapitalized if the Enterprise is otherwise classified as adequately capitalized;

(B) Significantly undercapitalized if the Enterprise is otherwise classified as undercapitalized;

(C) Critically undercapitalized if the Enterprise is otherwise classified as significantly undercapitalized.

(ii) *Prior approvals.* In making any determination to reclassify an Enterprise under paragraph (c)(5)(i) of this section, OFHEO will not base its decision to reclassify solely on action or inaction that previously was given specific approval by the Director of OFHEO in connection with the Director's approval of the Enterprise's capital restoration plan under section 1369C of the 1992 Act (12 U.S.C. 4622), or of a written agreement with the Enterprise that is enforceable in accordance with section 1371 of the 1992 Act (12 U.S.C. 4631).

**§ 1777.21 Notice of capital category, and adjustments.**

(a) *Notice of capital classification.* OFHEO will classify each Enterprise according to the capital classifications in § 1777.20(a) or § 1777.20(c) on at least a quarterly basis. OFHEO may classify an Enterprise according to the capital classifications in § 1777.20(a) or § 1777.20(c), or reclassify an Enterprise as set out in § 1777.20(a)(5), § 1777.20(c)(5), § 1777.23(c), or § 1777.23(h), at such other times as OFHEO deems appropriate.

(1) *Notice of proposed capital classification.* (i) Before OFHEO classifies or reclassifies an Enterprise, OFHEO will provide the Enterprise with written notice containing the proposed capital classification, the information upon which the proposed classification is based, and the reason for the proposed classification, as appropriate.

(ii) Notices proposing to classify or reclassify an Enterprise as undercapitalized or significantly undercapitalized may be combined with a notice that OFHEO may further reclassify the Enterprise under § 1777.23(c), without additional notice.

(iii) Notices proposing to classify or reclassify an Enterprise as significantly undercapitalized or critically undercapitalized may be combined with a notice under § 1777.24 that OFHEO intends to issue an order under section 1366 of the 1992 Act (12 U.S.C. 4616).

(iv) Notices proposing to classify an Enterprise as undercapitalized or significantly undercapitalized may be combined with a notice proposing to simultaneously reclassify the Enterprise under § 1777.20(a)(5) or § 1777.20(c)(5).

(2) *Response by the Enterprise.* The Enterprise may submit a response to OFHEO containing information for OFHEO's consideration in classifying or reclassifying the Enterprise.

(i) The Enterprise has thirty calendar days from receipt the notice of proposed capital classification to submit its

response to OFHEO, unless OFHEO determines a shorter period to be appropriate or the Enterprise consents to a shorter period.

(ii) The Enterprise's response period may be extended for up to an additional thirty calendar days if OFHEO determines there is good cause for such extension.

(iii) The Enterprise's failure to submit a response during the response period (as extended or shortened, if applicable) shall waive any right of the Enterprise to comment on or object to the proposed capital classification.

(3) *Classification determination and written notice of capital classification.* After the Enterprise has submitted its response under paragraph (a)(2) of this section or the response period (as extended or shortened, if applicable) has expired, whichever occurs first, OFHEO will make its determination of the Enterprise's capital classification, taking into consideration such relevant information as is provided by the Enterprise in its response, if any, under paragraph (a)(2) of this section. OFHEO will provide the Enterprise with a written notice of capital classification, which shall include a description of the basis for OFHEO's determination.

(4) *Timing.* OFHEO may, in its discretion, issue a notice of proposed capital classification to an Enterprise at any time. If a notice of proposed classification is pending (under the process set out in paragraphs (a)(1) through (3) of this section) at that time, OFHEO may, in its discretion, specify whether the subsequent notice of proposed capital classification supersedes the pending notice.

(b) *Developments indicating possible change to capital classification—(1) Notice to OFHEO.* An Enterprise shall promptly provide OFHEO with written notice of any material development that may reasonably be expected to cause the Enterprise's core or total capital to fall to a point that could result in assignment of the Enterprise to a lower capital classification than the capital classification assigned to the Enterprise in its most recent notice of capital classification from OFHEO, or proposed to be assigned in the Enterprise's most recent notice of proposed capital classification from OFHEO. The Enterprise shall deliver such notice to OFHEO no later than 10 calendar days after the Enterprise becomes aware of or reasonably should have become aware of such development.

(2) OFHEO, in its discretion, will determine whether to issue a new notice of proposed capital classification under paragraph (a) of this section, based on OFHEO's review of the notice under

paragraph (a)(1) of this section from the Enterprise and any other information deemed relevant by OFHEO.

**§ 1777.22 Limitation on capital distributions.**

(a) *Capital distributions on or after the effective date of the risk-based capital level.* On or after the effective date of OFHEO's regulations establishing the risk-based capital level (issued under section 1361(e) of the 1992 Act (12 U.S.C. 4611(e)), an Enterprise shall make no capital distribution that would decrease the total capital of the Enterprise to an amount less than the risk-based capital level or the core capital of the Enterprise to an amount less than the minimum capital level without the prior written approval of OFHEO.

(b) *Capital distributions by an Enterprise that is not adequately capitalized—(1) Prohibited distributions.* An Enterprise that is not classified as adequately capitalized shall make no capital distribution that would result in the Enterprise being classified into a lower capital classification than the one to which it is classified at the time of such distribution.

(2) *Restricted distributions.* An Enterprise classified as significantly or critically undercapitalized shall make no capital distribution without the prior written approval of OFHEO. OFHEO may grant a request for such a capital distribution only if OFHEO determines, in its discretion, that the distribution:

(i) Will enhance the ability of the Enterprise to meet the risk-based capital level and the minimum capital level promptly;

(ii) Will contribute to the long-term financial safety and soundness of the Enterprise; or

(iii) Is otherwise in the public interest.

(c) *Capital distributions before the effective date of the risk-based capital level.* Until the effective date of OFHEO's regulations establishing the risk-based capital level (issued under section 1361(e) of the 1992 Act)(12 U.S.C. 4611(e)), an Enterprise may make no capital distribution that would decrease the core capital of the Enterprise to an amount less than the minimum capital level without the prior written approval of OFHEO.

**§ 1777.23 Capital restoration plans.**

(a) *Schedule for filing plans.—(1) In general.* An Enterprise shall file a capital restoration plan in writing with OFHEO within ten days of receiving a notice of capital classification under § 1777.21(a)(3) stating that the Enterprise is classified as undercapitalized, significantly

undercapitalized, or critically undercapitalized, unless OFHEO in its discretion determines an extension of the ten day period is necessary and provides the Enterprise with written notice of the date the plan is due.

(2) *Successive capital classifications.* Notwithstanding paragraph (a)(1) of this section, an Enterprise that has already submitted and is operating under a capital restoration plan approved by OFHEO under this part is not required to submit an additional capital restoration plan based on a subsequent notice of capital classification, unless OFHEO notifies the Enterprise that it must submit a new or amended capital restoration plan. An Enterprise that receives such a notice to submit a new or amended capital restoration plan shall file in writing with OFHEO a complete plan that is responsive to the terms of and within the deadline specified in such notice.

(b) *Contents of capital restoration plan.*—(1) The capital restoration plan submitted under paragraph (a)(1) or (2) of this section shall:

- (i) Specify the level of capital the Enterprise will achieve and maintain;
- (ii) Describe the actions that the Enterprise will take to become classified as adequately capitalized;
- (iii) Establish a schedule for completing the actions set forth in the plan;
- (iv) Specify the types and levels of activities (including existing and new programs) in which the Enterprise will engage during the term of the plan;
- (v) Describe the actions that the Enterprise will take to comply with any mandatory and discretionary requirements to be imposed under Subtitle B of the 1992 Act (12 U.S.C. 4611 through 4623) or subpart B of this part;

(vi) To the extent the Enterprise is required to submit (or revise) a capital restoration plan as the result of a reclassification of the Enterprise under § 1777.20(a)(5) or § 1777.20(c)(5), describe the steps the Enterprise will take to cease or eliminate and remedy the action, inaction, or conditions that caused the reclassification; and

(vii) Provide any other information or discuss any other issues as instructed by OFHEO.

(2) The plan shall include a declaration by the president, vice president, treasurer, or other officer designated by the Board of Directors of the Enterprise to make such declaration, that the material contained in the plan is true and correct to the best of such officer's knowledge and belief.

(c) *Failure to submit.*—(1) *Failure to submit; submission of unacceptable*

*plan.* If, upon the expiration of the period provided in paragraph (c)(1) or (2) of this section for an Enterprise to submit a capital restoration plan, an Enterprise fails to comply with the requirement to file a complete capital restoration plan, or if the capital restoration plan is disapproved after review under paragraph (d) of this section, OFHEO may, in accordance with § 1777.21(a)(1)(ii) without additional notice, reclassify the Enterprise:

- (i) As significantly undercapitalized if it is otherwise classified as undercapitalized; or
- (ii) As critically undercapitalized if it is otherwise classified as significantly undercapitalized.

(2) *Duration of reclassification.* An Enterprise's failure to submit an approved capital restoration plan as described in paragraph (c)(1) of this section shall continue to be grounds for reclassification at each subsequent capital classification of the Enterprise, and shall only cease being considered grounds for reclassification after the Enterprise files a capital restoration plan that receives OFHEO's approval under paragraph (d) of this section.

(3) *Successive reclassifications.* If an Enterprise has not remedied its failure to file a complete capital restoration plan or an acceptable capital restoration plan within such reasonable period as is determined by OFHEO to be appropriate, OFHEO may consider such failure to be the basis for additional reclassification under paragraph (c)(1) of this section into a lower capital classification. Such reclassification may be made without additional notice in accordance with § 1777.21(a)(1)(ii).

(d) *Order approving or disapproving plan.* Not later than thirty calendar days after receipt of the Enterprise's complete or amended capital restoration plan under this section (subject to extension upon written notice to the Enterprise for an additional thirty calendar days as OFHEO deems necessary), OFHEO shall issue an order to the Enterprise approving or disapproving the plan. An order disapproving a plan shall include the reasons therefore.

(e) *Resubmission.* An Enterprise that receives an order disapproving its capital restoration plan shall submit an amended capital plan acceptable to OFHEO within thirty calendar days of the date of such order, or a longer period if OFHEO determines an extension is in the public interest.

(f) *Amendment.* An Enterprise that has received an order approving its capital restoration plan may amend the capital restoration plan only after written notice to OFHEO and OFHEO's

issuance of an order approving the modification. Pending OFHEO's review and approval of the amendment in OFHEO's discretion, the Enterprise shall continue to implement the capital restoration plan under the original approval order.

(g) *Termination*—(1) *Termination under the terms of the plan.* An Enterprise that has received an order approving its capital restoration plan remains bound by each of its obligations under the plan until each such obligation terminates under express terms of the plan itself identifying a date, event, or condition upon which such obligation shall terminate.

(2) *Termination orders.* To the extent the plan does not include such express terms for any obligation thereunder, the Enterprise's obligation continues until OFHEO issues an order terminating such obligation under the plan. The Enterprise may also submit a written request to OFHEO seeking termination of such obligations. OFHEO will approve termination of such obligation to the extent that OFHEO determines, in its discretion, that the obligation's purpose under the plan has been fulfilled and that termination of the obligation is consistent with the overall safety and soundness of the Enterprise.

(h) *Implementation.*—(1) An Enterprise that has received an order approving its capital restoration plan is required to implement the plan.

(i) If OFHEO determines, in its discretion, that an Enterprise has failed to make efforts reasonably necessary to comply with the capital restoration plan and fulfill the schedule thereunder, OFHEO may reclassify the Enterprise:

- (A) As significantly undercapitalized if it is otherwise classified as undercapitalized; or
- (B) As critically undercapitalized if it is otherwise classified as significantly undercapitalized.

(ii) *Duration of reclassification.* An Enterprise's failure to implement an approved capital restoration plan as described in paragraph (h)(1)(i) of this section shall continue to be grounds for reclassification at each subsequent capital classification of the Enterprise, and shall only cease being considered grounds for reclassification after OFHEO determines, in its discretion, that the Enterprise is making such efforts as are reasonably necessary to comply with the capital restoration plan and fulfill the schedule thereunder.

(iii) *Successive reclassifications.* If an Enterprise has not remedied its failure to implement an approved capital restoration plan within such reasonable period as is determined by OFHEO to be appropriate, OFHEO may consider such



failure to be the basis for additional reclassification under paragraph (h)(1)(i) of this section into a lower capital classification.

(2) *Administrative enforcement action.* A capital plan that has received an approval order from OFHEO under this section constitutes an order under the 1992 Act. An Enterprise, regardless of its capital classification, as well as its executive officers, and directors may be subject to action by OFHEO under sections 1371, 1372, and 1376 of the 1992 Act (12 U.S.C. 4631, 4632, and 4636) and 12 CFR part 1780 for failure to comply with such plan.

**§ 1777.24 Notice of intent to issue an order.**

(a) *Orders under section 1366 of the 1992 Act (12 U.S.C. 4616).* In addition to any other action taken under this part, part 1780 of this chapter, or any other applicable authority, OFHEO may, in its discretion, issue an order to an Enterprise that is classified as significantly undercapitalized or critically undercapitalized, or is in conservatorship, directing the Enterprise to take one or more of the following actions:

- (1) Limit any increase in, or reduce, any obligations of the Enterprise, including off-balance sheet obligations;
- (2) Limit or eliminate growth of the Enterprise's assets or reduce the amount of the Enterprise's assets;
- (3) Acquire new capital, in such form and amount as determined by OFHEO; and
- (4) Terminate, reduce, or modify any activity of the Enterprise that OFHEO determines creates excessive risk to the Enterprise.

(b) *Notice of intent to issue an order.* Before OFHEO issues an order to an Enterprise pursuant to section 1366 of the 1992 Act (12 U.S.C. 4616), OFHEO will provide the Enterprise with written notice containing the proposed order.

(c) *Contents of notice.* A notice of intent to issue an order under this subpart shall include:

- (1) A statement of the Enterprise's capital classification and its minimum capital level or critical capital level, and its risk-based capital level;
- (2) A description of the restrictions, prohibitions, or affirmative actions that OFHEO proposes to impose or require; and
- (3) The proposed date when such restrictions or prohibitions would become effective or the proposed date for the commencement and/or completion of the affirmative actions.

**§ 1777.25 Response to notice.**

(a) *Content of response.* The Enterprise may submit a response to

OFHEO containing information for OFHEO's consideration in connection with the proposed order. The response should include, but is in no way limited to, the following:

(1) Any relevant information, mitigating circumstances, documentation, or other information the Enterprise wishes OFHEO to consider in support of the Enterprise's position regarding the proposed order; and

(2) Any recommended modification of the proposed order, and justification thereof.

(b) *Time to respond.* The Enterprise has thirty calendar days from receipt the notice of proposed order to submit its response to OFHEO, unless OFHEO determines a shorter period to be appropriate or the Enterprise consents to a shorter period. OFHEO may extend the Enterprise's response period for up to an additional thirty calendar days if OFHEO determines, in its discretion, that there is good cause for such extension.

(c) *Waiver and consent.* The Enterprise's failure to submit a response during the response period (as extended or shortened, if applicable) shall waive any right of the Enterprise to comment on or object to the proposed order.

**§ 1777.26 Final notice of order.**

(a) *Determination and notice.* After the Enterprise has submitted its response under § 1777.25 or the response period (as extended or shortened, if applicable) has expired, whichever occurs first, OFHEO will make its determination regarding the order in its discretion, taking into consideration such relevant information as is provided by the Enterprise in its response, if any, under § 1777.25. OFHEO will provide the Enterprise with a written final notice of any order issued by OFHEO under this subpart, which shall include a description of the basis for OFHEO's determination.

(b) *Termination or modification.* An Enterprise that has received an order under paragraph (a) of this section remains subject to each provision of the order until each such provision terminates under the express terms of the order. The Enterprise may submit a written request to OFHEO seeking modification or termination of one or more provisions of the order. Pending OFHEO's review and approval of the Enterprise's request in OFHEO's discretion, the Enterprise shall remain subject to the provisions of the order.

(c) *Enforcement of order—(1) Judicial enforcement.* An order issued under paragraph (a) of this section is an order for purposes of section 1375 of the 1992 Act (12 U.S.C. 4635). An Enterprise in

any capital classification may be subject to enforcement of such order in the United States District Court for the District of Columbia pursuant to such section.

(2) *Administrative enforcement.* An order issued under paragraph (a) of this section constitutes an order under the 1992 Act. An Enterprise, regardless of its capital classification, as well as its executive officers, and directors may be subject to action by OFHEO under sections 1371, 1372, and 1376 of the 1992 Act (12 U.S.C. 4631, 4632, and 4636) and 12 CFR part 1780 for failure to comply with such order.

**§ 1777.27 Exhaustion and review.**

(a) *Judicial review.—(1) Review of certain actions.* An Enterprise that is not classified as critically undercapitalized may seek judicial review of a final notice of capital classification issued pursuant to § 1777.21(a)(3) or a final notice of order issued pursuant to § 1777.26(a) in accordance with section 1369D of the 1992 Act (12 U.S.C. 4623).

(2) *Other review barred.* Except as set out in paragraph (a)(1) of this section, or review of conservatorship appointments to the limited extent provided in section 1369(b) of the 1992 Act (12 U.S.C. 4619(b)) and § 1777.28(c), no court shall have jurisdiction to affect, by injunction or otherwise, the issuance or effectiveness of a capital classification or any other action of OFHEO pursuant to this subpart B, as provided in section 1369D of the 1992 Act (12 U.S.C. 4623).

(b) *Exhaustion of administrative remedies.* In connection with any issue for which an Enterprise seeks judicial review in connection with an action described in paragraph (a)(1) of this section, the Enterprise must have first exhausted its administrative remedies, by presenting all its objections, arguments, and information relating to such issue for OFHEO's consideration pursuant to § 1777.21(a)(2), as part of the Enterprise's response to OFHEO's notice of capital classification, or pursuant to § 1777.25, as part of the Enterprise's response to OFHEO's notice of intent to issue an order.

(c) *No stay pending review.* The commencement of proceedings for judicial review of a final capital classification or order as described in paragraph (a)(1) of this section shall not operate as a stay thereof.

**§ 1777.28 Appointment of conservator for a significantly undercapitalized or critically undercapitalized Enterprise.**

(a) *Significantly undercapitalized enterprise.* At any time after an Enterprise is classified as significantly undercapitalized, OFHEO may issue an

order appointing a conservator for the Enterprise upon determining that:

(1) The amount of core capital of the Enterprise is less than the minimum capital level; and

(2) The alternative remedies available to OFHEO under the 1992 Act are not satisfactory.

(b) *Critically undercapitalized Enterprise.*—(1) *Appointment upon classification.* Not later than thirty days after issuing a final notice of capital classification pursuant to § 1777.21(a)(3) classifying an Enterprise as significantly undercapitalized, OFHEO shall issue an order appointing a conservator for the Enterprise.

(2) *Exception.* Notwithstanding paragraph (b)(1) of this section, the Director of OFHEO may make a written finding, with the written concurrence of the Secretary of the Treasury, that:

(i) The appointment of a conservator would have serious adverse effects on economic conditions of national financial markets or on the financial stability of the housing finance market; and

(ii) The public interest would be better served by taking some other enforcement action authorized under this title.

(c) *Judicial review.* An Enterprise for which a conservator has been appointed pursuant to paragraph (a) or (b) of this section may seek judicial review of the appointment in accordance with section 1369(b) of the 1992 Act (12 U.S.C. 4619(b)). Except as provided therein, no court may take any action regarding the removal of a conservator or otherwise restrain or affect the exercise of the powers or functions of a conservator.

(d) *Termination.*—(1) *Upon reaching the minimum capital level.* OFHEO will issue an order terminating a conservatorship appointment under paragraph (a) or (b) of this section upon a determination that the Enterprise has maintained an amount of core capital that is equal to or exceeds the minimum capital level.

(2) *In OFHEO's discretion.* OFHEO may, in its discretion, issue an order terminating a conservatorship appointment under paragraph (a) or (b) of this section upon a determination that such termination order is in the public interest and may safely be accomplished.

Dated: April 4, 2001.

**Armando Falcon, Jr.,**  
*Director, Office of Federal Housing Enterprise Oversight.*

[FR Doc. 01-8671 Filed 4-9-01; 8:45 am]

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**DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT****Office of Federal Housing Enterprise Oversight****12 CFR Part 1710**

RIN 2550-AA20

**Corporate Governance****AGENCY:** Office of Federal Housing Enterprise Oversight, HUD.**ACTION:** Proposed regulation.

**SUMMARY:** The Office of Federal Housing Enterprise Oversight (OFHEO) is responsible for ensuring the safety and soundness of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation (Enterprises). In furtherance of that responsibility, OFHEO is proposing a regulation to set forth minimum requirements with respect to corporate governance practices and procedures of the Enterprises.

**DATES:** Written comments on the proposed regulation must be received by November 13, 2001.

**ADDRESSES:** Send written comments concerning the proposed regulation to Alfred M. Pollard, General Counsel, Office of Federal Housing Enterprise Oversight, Fourth Floor, 1700 G Street, NW., Washington, DC 20552. Written comments may also be sent to Mr. Pollard by electronic mail at [RegComments@OFHEO.gov](mailto:RegComments@OFHEO.gov). OFHEO requests that written comments submitted in hard copy also be accompanied by the electronic version in MS Word© or in portable document format (PDF) on 3.5" disk.

**FOR FURTHER INFORMATION CONTACT:** David W. Roderer, Deputy General Counsel, telephone (202) 414-3804 (not a toll-free number); or Isabella W. Sammons, Associate General Counsel, telephone (202) 414-3790 (not a toll-free number); Office of Federal Housing Enterprise Oversight, Fourth Floor, 1700 G Street, NW., Washington, DC 20552. The telephone number for the Telecommunications Device for the Deaf is (800) 877-8339.

**SUPPLEMENTARY INFORMATION:****Comments**

OFHEO invites comments on all aspects of the proposed regulation, including legal and policy considerations, and will take all comments into consideration before issuing the final regulation. Copies of all comments will be posted on the OFHEO Internet web site at <http://www.ofheo.gov>. In addition, copies of

all comments received will be available for examination by the public at the Office of Federal Housing Enterprise Oversight, Fourth Floor, 1700 G Street, NW., Washington, DC 20552.

**Background**

Title XIII of the Housing and Community Development Act of 1992, Pub. L. 102-550, titled the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (12 U.S.C. 4501 *et seq.*), established OFHEO as an independent office within the Department of Housing and Urban Development to ensure that the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation (collectively, the Enterprises) are adequately capitalized and operate safely and in compliance with applicable laws, rules, and regulations.

Corporate governance involves the relationships between an Enterprise, its management, board of directors, shareholders, regulators, and other stakeholders. It provides the structure through which the business objectives and strategies of the Enterprises are set as well as the means of attaining those objectives and monitoring performance. In recent years, regulators, investor organizations, stock exchanges, and corporations themselves have increased their focus on the importance of good corporate governance practices and procedures to ensure the long-term success of corporations.

OFHEO recognizes that good corporate governance practices and procedures are essential to the safe and sound operations of the Enterprises and accomplishment of their public policy purposes. Thus, corporate governance is one category of risk and risk management that is examined by OFHEO under its annual risk-based examination program. The proposed regulation builds upon the annual risk-based examination program in that it sets forth basic safety and soundness standards for corporate governance with which the Enterprises are required to comply. The proposed corporate governance practices and procedures are substantively similar to those required by Federal banking agencies with respect to the regulated financial institutions. To a large extent, the corporate governance requirements set forth in the proposed regulation reflect the current practices of the Enterprises and the supervisory standards of OFHEO. The Enterprises must be able to continue to attract and retain the highest caliber of board members and executive officers.

**Section-by-Section Analysis***Subpart A—General**Section 1710.1 Purpose*

OFHEO is responsible under the Act for ensuring the safety and soundness of the Enterprises. In furtherance of that responsibility, proposed § 1710.1 provides that the purpose of the proposed regulation is to set forth minimum requirements with respect to the corporate governance practices and procedures of the Enterprises.

*Section 1710.2 Definitions*

Proposed § 1710.2 sets forth the definitions of terms used in the proposed regulation. The term:

*Act* is proposed to mean the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, Title XIII of the Housing and Community Development Act of 1992, Pub.L. 102-550, section 1301, Oct. 28, 1992, 106 Stat. 3672, 3941 through 4012 (1993) (12 U.S.C. 4501 *et seq.*).

*Agent* is proposed to mean any person, other than a board member, executive officer, or employee of an Enterprise, who acts on behalf or for the benefit of an Enterprise, such as representing an Enterprise in contacts with third parties or providing professional services to an Enterprise.

*Board member* is proposed to mean a member of the board of directors; and, for purposes of subpart D, "board member" is proposed to include a current or former board member.

*Board of directors* is proposed to mean the board of directors of an Enterprise.

*Chartering acts* is proposed to mean the Federal National Mortgage Association Charter Act and the Federal Home Loan Mortgage Corporation Act, which are codified at 12 U.S.C. 1716 through 1723i and 12 U.S.C. 1451 through 1459, respectively.

*Compensation* is proposed to mean any payment of money or the provision of any other thing of current or potential value in connection with employment. The term "compensation" is also proposed to include all direct and indirect payments of benefits, both cash and non-cash, including, but not limited to, payments and benefits derived from compensation or benefit agreements, fee arrangements, perquisites, stock option plans, post employment benefits, or other compensatory arrangements.

*Conflict of interest* is proposed to mean an interest in a transaction, relationship, or activity that might affect adversely, or appear to affect adversely, the ability to perform duties and responsibilities on behalf of the

Enterprise in an objective and impartial manner.

*Director* means the Director of OFHEO or his or her designee.

*Employee* is proposed to mean a salaried individual, other than an executive officer, who works part-time, full-time, or temporarily for an Enterprise.

*Enterprise* is proposed to mean the Federal National Mortgage Association or the Federal Home Loan Mortgage Corporation; and the term "Enterprises" is proposed to mean, collectively, the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation.

*Entity* is proposed to mean a corporation, company, association, firm, joint venture, general or limited partnership, society, joint stock company, fund, or other organization or institution.

*Executive officer* is proposed to mean any senior executive officer and any senior vice president or individual with similar responsibilities, without regard to title, who is in charge of a principal business unit, division, or function, or who reports directly to the chairperson, vice chairperson, chief operating officer, or president; and, for purposes of subpart D, "executive officer" is proposed to include a current or former executive officer.

*Independent board member* is proposed to mean a board member who meets the criteria for independence under the NYSE rules for audit committee members, regardless of the committee(s) on which the board member serves.

*Legal expenses* is proposed to mean, with respect to a claim, proceeding, or action, the amount of legal or other professional fees and expenses, and the amount of, and any cost incurred in connection with a penalty, fine, assessment, judgment, or settlement.

*NYSE* means the New York Stock Exchange.

*OFHEO* means the Office of Federal Housing Enterprise Oversight.

*Payment*, for purposes of subpart D of this part, is proposed to mean:

- (1) Direct or indirect transfer of funds or assets;
- (2) Forgiveness of a debt or other obligation;
- (3) Conferment of a benefit, including but not limited to stock options and stock appreciation rights; and
- (4) Segregation of funds or assets, establishment or funding of a trust, or purchase of or arrangement for a letter of credit or other instrument, for the purpose of making, or pursuant to an agreement to make, a payment on or after the date on which such funds or

assets are segregated, such trust is established, or such letter of credit or other instrument is made available, without regard to whether the obligation to make such payment is contingent on the determination, after such date, of the liability for the payment of such amount or the liquidation of the amount of such payment.

*Person* is proposed to mean an individual or entity.

*Senior executive officer* is proposed to mean the chairperson of the board of directors, chief executive officer, chief financial officer, chief operating officer, president, vice chairperson, any executive vice president of an Enterprise, and any individual, without regard to title, who has similar responsibilities.

#### *Sections 1710.3–1710.9*

Sections 1710.3 through 1710.9 are proposed to be reserved.

#### *Subpart B—Corporate Practices and Procedures*

##### *Section 1710.10 Applicable Law*

Congress established the Enterprises as privately owned corporations, imbued with private and public purposes, to be managed by their respective boards of directors. To 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, proposed § 1710.10 would require that each Enterprise elect to follow and be bound by a specified body of corporate governance law to the extent such law is not inconsistent with applicable Federal law, rules, or regulations, including the standards proposed here. Specifically, the proposal requires the Enterprise to elect either the law of the jurisdiction in which its principal office is located, Delaware General Corporation Law, or the Model Business Corporation Act. The Enterprise is required to specify its election in its bylaws.

The proposed approach provides the Enterprises with flexibility in structuring their corporate governance practices and procedures while at the same time providing shareholders and other interested parties with certainty as to the body of corporate law applicable to each Enterprise.

OFHEO requests comments as to whether the choice of law to be elected should be narrower or broader than proposed. More particularly, should the law of the jurisdiction where the principal office of the Enterprise is located be the applicable law? Should the Delaware General Corporation Law

and the Model Business Corporation Act be permissible alternatives? Should Federal law or agency-promulgated standards be the sole legal basis for corporate governance practices and procedures of the Enterprises?

##### *Section 1710.11 Committees of Board of Directors*

Proposed § 1710.11 provides that an Enterprise may establish committees of the board of directors, in addition to the minimally required audit and compensation committees. No committee is to have the authority of the board of directors to amend the bylaws and no committee is to operate to relieve the board of directors or any board member of any responsibility imposed by applicable laws, rules, and regulations. In addition, proposed § 1710.11 requires that each Enterprise provide in its bylaws for the establishment of audit and compensation committees, however styled.<sup>1</sup>

The proposed section requires that the audit committee comply with all NYSE rules with respect to the audit committee, including charter, independence, composition, and expertise requirements.<sup>2</sup> The NYSE rules are adequate to ensure an effective and independent audit committee without further supplementation by OFHEO. Furthermore, since both Enterprises are listed with the NYSE, the Enterprises should not need to make changes to their respective audit committees to comply with the requirements of proposed § 1710.11.

The compensation committee is proposed to be comprised of at least three independent board members. The proposed duties of the compensation committee include ensuring that compensation plans for executive officers and employees comply with applicable laws, rules, and regulations and approving the compensation of senior executive officers.

OFHEO specifically requests comments as to whether the definition of the term "independent board member" in proposed § 1710.2 is appropriate to use with respect to the

<sup>1</sup> The importance of an independent audit committee has received increased attention by recent publications, including the *Recommendation of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees*, sponsored by the NYSE and the National Association of Securities Dealers, which can be accessed at <http://www.nyse.com> or <http://www.nasd.com>.

<sup>2</sup> The NYSE rules applicable to audit committees are in sections 303.01 and 303.02 of the NYSE Listed Company Manual, which can be accessed at <http://www.nyse.com>.

independence of board members of the compensation committee.

*Section 1710.12 Compensation of Board Members, Executive Officers, and Employees*

Proposed § 1710.12 requires that the compensation of board members, executive officers, and employees be reasonable and commensurate with their duties and responsibilities and comply with applicable laws, rules, and regulations.<sup>3</sup>

*Section 1710.13 Quorum of Board of Directors; Proxies Not Permissible*

Proposed § 1710.13 requires that each Enterprise provide in its bylaws that, for the transaction of business, a quorum of the board of directors is a majority of the entire board of directors and that a board member may not vote by proxy.

*Section 1710.14 Conflict-of-Interest Standards*

Proposed § 1710.14 requires that each Enterprise establish and administer written conflict-of-interest standards that will provide reasonable assurance that the board members, executive officers, employees, and agents of the Enterprise discharge their responsibilities in an objective and impartial manner.

*Sections 1710.15–1710.19*

Sections 1710.15 through 1710.19 are proposed to be reserved.

*Subpart C—Responsibilities of Board of Directors*

*Section 1710.20 Conduct of Board Members*

Proposed § 1710.20 sets forth the standards that board members must follow in conducting the business of the Enterprise. In addition to devoting sufficient time to his or her duties and responsibilities, each board member is to act:

- (1) On a fully informed, impartial, objective, and independent basis;
- (2) In good faith and with due diligence, care, and loyalty;
- (3) In the best interests of the shareholders and the Enterprise; and
- (4) In compliance with the chartering acts of the Enterprises and other applicable laws, rules, and regulations.

This proposed section is based on current legal standards embodied in State law and the Model Business Corporation Act.

*Section 1710.21 Responsibilities of Board of Directors*

Proposed § 1710.21 sets forth the responsibilities of the board of directors. The board of directors is responsible for managing the conduct and affairs of the Enterprise to ensure that the Enterprise is operated in a safe and sound manner, including, at a minimum:

- (1) Reviewing and overseeing corporate strategy, major plans of action, and risk policy as well as monitoring corporate performance;
- (2) Hiring and retaining qualified senior executive officers and overseeing succession planning for such senior executive officers;
- (3) Ensuring that compensation plans for executive officers and employees comply with applicable law, rules, and regulations and approving the compensation of board members and senior executive officers.

(4) Ensuring the integrity of the accounting and financial reporting systems of the Enterprise, including independent audits, and that appropriate systems of control are in place to identify and monitor risk and compliance with the chartering acts of the Enterprises and other applicable laws, rules, and regulations;

(5) Remaining informed of the condition, activities, and operations of the Enterprise;

(6) Overseeing the process and adequacy of reporting, disclosures, and communications to shareholders, investors, and potential investors; and

(7) Ensuring the 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.

The proposed section also notes that the board of directors should refer to publications of and formal pronouncements by OFHEO for guidance on the responsibilities of the board of directors.<sup>4</sup> The proposed section is based on current OFHEO supervisory standards as well as State laws and the Model Business Corporation Act.

*Sections 1710.22–1710.29*

Sections 1710.22 through 1710.29 are proposed to be reserved.

*Subpart D—Indemnification Payments*  
*§ 1710.30 Permitted Indemnification Payments*

Proposed § 1710.30 delineates the circumstances under which an Enterprise may make or agree to make indemnification payments. In proposing this section, OFHEO has considered the likely effect of such delineation on the ability of the Enterprises to attract and retain competent board members, executive officers, employees, and agents, and defers to applicable law in connection with actions not initiated or undertaken by OFHEO.

OFHEO considers an administrative proceeding to be initiated or undertaken by the issuance of a notice of charges. With respect to administrative proceedings initiated or undertaken by OFHEO, the proposed section permits an Enterprise to make or to agree to make indemnification payments, which are not prohibited under proposed § 1710.31, to a board member or executive officer, if the following two criteria are met:

(1) The board of directors of the Enterprise, in good faith, determines in writing after due investigation and consideration that the board member or executive officer acted in good faith and in a manner he or she believed to be in the best interests of the Enterprise and that the indemnification payment will not materially adversely affect the safety and soundness of the Enterprise; and

(2) The board member or executive officer agrees in writing to reimburse the Enterprise, to the extent the Enterprise is not covered by a commercial insurance policy or similar coverage, for that portion of any indemnification payment that subsequently becomes a prohibited indemnification payment under proposed § 1710.31.

In connection with an administrative proceeding initiated or undertaken by OFHEO, proposed § 1710.30 provides that the board member or executive officer requesting an indemnification payment is not to participate in any way in the discussion of the board of directors and approval of such payment. It does, however, provide that the board member or executive officer may present the request for indemnification to the board of directors and respond to any inquiries from the board of directors concerning his or her involvement in the circumstances giving rise to the administrative proceeding.

If a majority of board members are named as respondents in an administrative proceeding initiated or undertaken by OFHEO and request indemnification, proposed § 1710.30 provides that the remaining board

<sup>3</sup>OFHEO has issued a proposed regulation with respect to the compensation of executive officers at 65 FR 81771 (Dec. 27, 2000).

<sup>4</sup>For example, the *OFHEO Examination Handbook*, published at <http://www.ofheo.gov>, provides information and sets forth the examination criteria with respect to responsibilities of the board of directors.

members may authorize independent legal counsel to review the indemnification request and provide the remaining board members with a written opinion of counsel as to whether the two criteria for payment, noted above, are met. If the opinion of counsel concludes that the criteria have been met, the remaining board members may rely on the opinion in authorizing the requested indemnification.

Likewise, if all of the board members are named as respondents in an administrative proceeding and request indemnification, proposed § 1710.30 provides that the board of directors is to authorize independent legal counsel to review the indemnification request and provide the board of directors with a written opinion of counsel as to whether the two criteria have been met. If the opinion of counsel concludes that the criteria have been met, the board of directors may rely on such opinion in authorizing the requested indemnification.

These proposed procedures address the conflicts inherent in situations where the majority or all of the board members are subjects of an administrative proceeding. The use of independent legal counsel provides for an unbiased review of the two criteria necessary to approve indemnification and does not impose an undue hardship on the Enterprise. The board members may, of course, decline to approve the indemnification request despite a favorable opinion of legal counsel. OFHEO would consider legal counsel to be independent for purposes of the proposed section if the legal counsel is not a member of the legal staff of the Enterprise, does not have a recent or ongoing relationship with the Enterprise or any of its board members or senior executive officers, and has no other conflict of interest.

In a civil action or an administrative proceeding not initiated or undertaken by OFHEO, the proposed section authorizes an Enterprise to provide for payment to any board member, executive officer, employee, or agent of the Enterprise of legal expenses, in accordance with applicable law, provided that such payment is consistent with the safe and sound operations of the Enterprise.

#### *Section 1710.31 Prohibited Indemnification Payments*

Proposed § 1710.31 addresses when indemnification is prohibited in connection with an administrative proceeding that OFHEO initiates or undertakes. Thus, the proposed section does not permit an Enterprise or any affiliate of an Enterprise to make or

agree to make, with certain exceptions, any payment to indemnify a board member or executive officer for any legal expense incurred in connection with an administrative proceeding initiated or undertaken by OFHEO that results in a final order or settlement pursuant to which such board member or executive officer is assessed a civil money penalty or is required to cease and desist from or take any affirmative action with respect to the Enterprise.

The proposed exceptions to this prohibition are that an Enterprise may make a reasonable payment that:

(1) Is used to purchase a commercial insurance policy or similar coverage; provided, that such insurance policy or similar coverage is not used to indemnify a board member or executive officer for the cost of any civil money penalty assessed against him or her in an administrative proceeding initiated or undertaken by OFHEO, but may be used to pay other legal expenses incurred in connection with such administrative proceeding or the amount of any restitution to the Enterprise; or

(2) Represents partial indemnification for legal expenses specifically attributable to particular charges for which there has been a formal and final adjudication or finding in connection with a settlement that the board member or executive officer has not violated certain laws or regulations or has not engaged in certain unsafe or unsound practices or breaches of fiduciary duty.

With respect to the second exception noted above, OFHEO recognizes that the appropriate amount of any partial indemnification may be difficult to ascertain with certainty. OFHEO, nevertheless, is of the opinion that the permissibility of partial indemnification is more equitable than an all or nothing approach.

#### **Regulatory Impact**

##### *Executive Order 12866, Regulatory Planning and Review*

The proposed regulation is not classified as a significant rule under Executive Order 12866 because it would not result in an annual effect on the economy of \$100 million or more or a major increase in costs or prices for consumers, individual industries, Federal, State, or local government agencies, or geographic regions; or have significant adverse effects on competition, employment, investment, productivity, innovation, or on the ability of United States-based enterprises to compete with foreign-based enterprises in domestic or foreign markets. Accordingly, no regulatory

impact assessment is required and this proposed regulation has not been submitted to the Office of Management and Budget for review.

#### *Regulatory Flexibility Act*

The Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*) requires that a regulation that has a significant economic impact on a substantial number of small entities, small businesses, or small organizations must include an initial regulatory flexibility analysis describing the regulation's impact on small entities. Such an analysis need not be undertaken if the agency has certified that the regulation will not have a significant economic impact on a substantial number of small entities. 5 U.S.C. 605(b). OFHEO has considered the impact of the proposed regulation under the Regulatory Flexibility Act. The General Counsel of OFHEO certifies that the proposed regulation, if adopted, is not likely to have a significant economic impact on a substantial number of small business entities because the regulation is applicable only to the Enterprises, which are not small entities for purposes of the Regulatory Flexibility Act.

#### **List of Subjects in 12 CFR Part 1710**

Administrative practice and procedure, Government Sponsored Enterprises.

Accordingly, for the reasons stated in the preamble, OFHEO proposes to add subchapter B to 12 CFR chapter XVII as follows:

#### **Subchapter B—Corporate Governance**

#### **PART 1710—CORPORATE GOVERNANCE**

##### **Subpart A—General**

Sec.

1710.1 Purpose.

1710.2 Definitions.

1710.3–1710.9 [Reserved]

##### **Subpart B—Corporate Practices and Procedures**

1710.10 Applicable law.

1710.11 Committees of board of directors.

1710.12 Compensation of board members, executive officers, and employees.

1710.13 Quorum of board of directors; proxies not permissible.

1710.14 Conflict-of-interest standards.

1710.15–1710.19 [Reserved]

##### **Subpart C—Responsibilities of Board of Directors**

1710.20 Conduct of board members.

1710.21 Responsibilities of board of directors.

1710.22–1710.29 [Reserved]

**Subpart D—Indemnification Payments**

1710.30 Permitted indemnification payments.

1710.31 Prohibited indemnification payments.

**Authority:** 12 U.S.C. 4513(a) and 4513(b)(1).

**Subpart A—General****§ 1710.1 Purpose.**

OFHEO is responsible under the Act for ensuring the safety and soundness of the Enterprises. In furtherance of that responsibility, this part sets forth minimum requirements with respect to the corporate governance practices and procedures of the Enterprises.

**§ 1710.2 Definitions.**

For purposes of this part, the term:

(a) *Act* means the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, Title XIII of the Housing and Community Development Act of 1992, Pub. L. 102–550, section 1301, Oct. 28, 1992, 106 Stat. 3672, 3941 through 4012 (1993) (12 U.S.C. 4501 *et seq.*).

(b) *Agent* means any person, other than a board member, executive officer, or employee of an Enterprise, who acts on behalf or for the benefit of an Enterprise, such as representing an Enterprise in contacts with third parties or providing professional services to an Enterprise.

(c) *Board member* means a member of the board of directors; and, for purposes of subpart D of this part, the term “board member” includes a current or former board member.

(d) *Board of directors* means the board of directors of an Enterprise.

(e) *Chartering acts* mean the Federal National Mortgage Association Charter Act and the Federal Home Loan Mortgage Corporation Act, which are codified at 12 U.S.C. 1716 through 1723i and 12 U.S.C. 1451 through 1459, respectively.

(f) *Compensation* means any payment of money or the provision of any other thing of current or potential value in connection with employment. The term “compensation” includes all direct and indirect payments of benefits, both cash and non-cash, including, but not limited to, payments and benefits derived from compensation or benefit agreements, fee arrangements, perquisites, stock option plans, post employment benefits, or other compensatory arrangements.

(g) *Conflict of interest* means an interest in a transaction, relationship, or activity that might affect adversely, or appear to affect adversely, the ability to perform duties and responsibilities on

behalf of the Enterprise in an objective and impartial manner.

(h) *Director* means the Director of OFHEO or his or her designee.

(i) *Employee* means a salaried individual, other than an executive officer, who works part-time, full-time, or temporarily for an Enterprise.

(j) *Enterprise* means the Federal National Mortgage Association or the Federal Home Loan Mortgage Corporation; and the term “Enterprises” means, collectively, the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation.

(k) *Entity* means a corporation, company, association, firm, joint venture, general or limited partnership, society, joint stock company, fund, or other organization or institution.

(l) *Executive officer* means any senior executive officer and any senior vice president of an Enterprise and any individual with similar responsibilities, without regard to title, who is in charge of a principal business unit, division, or function of an Enterprise, or who reports directly to the chairperson, vice chairperson, chief operating officer, or president of an Enterprise; and, for purposes of subpart D of this part, the term “executive officer” includes a current or former executive officer.

(m) *Independent board member* means a board member who meets the criteria for independence under the NYSE rules for audit committee members, regardless of the committee(s) on which the board member serves.

(n) *Legal expenses* means, with respect to a claim, proceeding, or action, the amount of legal or other professional fees and expenses, and the amount of, and any cost incurred in connection with a penalty, fine, assessment, judgment, or settlement.

(o) *NYSE* means the New York Stock Exchange.

(p) *OFHEO* means the Office of Federal Housing Enterprise Oversight.

(q) *Payment*, for purposes of subpart D of this part, means:

(1) Direct or indirect transfer of funds or assets;

(2) Forgiveness of a debt or other obligation;

(3) Conferment of a benefit, including but not limited to stock options and stock appreciation rights; and

(4) Segregation of funds or assets, establishment or funding of a trust, or purchase of or arrangement for a letter of credit or other instrument, for the purpose of making, or pursuant to an agreement to make, a payment on or after the date such funds or assets are segregated, such trust is established, or such letter of credit or such other

instrument is made available, without regard to whether the obligation to make such payment is contingent on the determination, after such date, of the liability for such payment or the liquidation of the amount of such payment.

(r) *Person* means an individual or entity.

(s) *Senior executive officer* means the chairperson of the board of directors, chief executive officer, chief financial officer, chief operating officer, president, vice chairperson, any executive vice president of an Enterprise, and any individual, without regard to title, who has similar responsibilities.

**§§ 1710.3–1710.9 [Reserved]****Subpart B—Corporate Practices and Procedures****§ 1710.10 Applicable law.**

(a) *Election.* Each Enterprise shall elect to follow and be bound by the corporate governance practices and procedures of one of the following bodies of law, to the extent such procedures are not inconsistent with safety and soundness and applicable Federal law, rules, and regulations:

(1) Law of the jurisdiction in which the principal office of the Enterprise is located;

(2) Delaware General Corporation Law, Del. Code Ann. tit. 8, as amended; or

(3) Model Business Corporation Act, as amended.

(b) *Designation.* Each Enterprise shall designate in its bylaws the body of law elected pursuant to paragraph (a) of this section within 90 calendar days from the effective date of this part.

**§ 1710.11 Committees of board of directors.**

(a) *Committees.* An Enterprise may provide in its bylaws for the establishment of committees of the board of directors, in addition to the audit and compensation committees required under paragraph (b) of this section. No committee of the board of directors shall have the authority of the board of directors to amend the bylaws and no committee shall operate to relieve the board of directors or any board member of any responsibility imposed by applicable laws, rules, and regulations.

(b) *Audit and compensation committees.* Each Enterprise shall provide in its bylaws, within 90 calendar days after the effective date of this part, for the establishment of the following committees, however styled:

(1) An audit committee that is in compliance with the charter, independence, composition, expertise, and all other requirements of the audit committee rules of the NYSE.

(2) A compensation committee, comprised of at least three independent board members, whose duties include, at a minimum, ensuring that compensation plans for executive officers and employees comply with applicable laws, rules, and regulations and approving the compensation of senior executive officers.

**§ 1710.12 Compensation of board members, executive officers, and employees.**

Compensation of board members, executive officers, and employees shall not be in excess of that which is reasonable and commensurate with their duties and responsibilities and comply with applicable laws, rules, and regulations.

**§ 1710.13 Quorum of board of directors; proxies not permissible.**

Each Enterprise shall provide in its bylaws, within 90 calendar days from the effective date of this part, that, for the transaction of business, a quorum of the board of directors is a majority of the entire board of directors and that a board member may not vote by proxy.

**§ 1710.14 Conflict-of-interest standards.**

Each Enterprise shall establish and administer written conflict-of-interest standards that will provide reasonable assurance that the board members, executive officers, employees, and agents of the Enterprise discharge their responsibilities in an objective and impartial manner.

**§§ 1710.15–1710.19 [Reserved]**

**Subpart C—Responsibilities of Board of Directors**

**§ 1710.20 Conduct of board members.**

(a) *Actions.* Each member of the board of directors of an Enterprise, in conducting the business of the Enterprise, shall act:

- (1) On a fully informed, impartial, objective, and independent basis;
- (2) In good faith and with due diligence, care, and loyalty;
- (3) In the best interests of the shareholders and the Enterprise; and
- (4) In compliance with the chartering act of the Enterprise and other applicable laws, rules, and regulations.

(b) *Time.* Each board member of an Enterprise shall devote sufficient time and attention to his or her responsibilities in conducting the business of the Enterprise.

**§ 1710.21 Responsibilities of board of directors.**

(a) *Responsibilities.* The board of directors is responsible for managing the conduct and affairs of the Enterprise to ensure that the Enterprise is operated in a safe and sound manner, including, at a minimum:

(1) Reviewing and overseeing corporate strategy, major plans of action, risk policy, as well as monitoring corporate performance;

(2) Hiring and retaining qualified senior executive officers and overseeing succession planning for such senior executive officers;

(3) Ensuring that compensation plans for executive officers and employees comply with applicable law, rules, and regulations and approving the compensation of board members and senior executive officers;

(4) Ensuring the integrity of the accounting and financial reporting systems of the Enterprise, including independent audits, and that appropriate systems of control are in place to identify and monitor risk and compliance with the chartering act of the Enterprise and other applicable laws, rules, and regulations;

(5) Remaining informed of the condition, activities, and operations of the Enterprise;

(6) Overseeing the process and adequacy of reporting, disclosures, and communications to shareholders, investors, and potential investors; and

(7) Ensuring the 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.

(b) *Additional guidance.* The board of directors should refer to publications of and formal pronouncements of OFHEO for guidance on the responsibilities of the board of directors.

**§§ 1710.22–1710.29 [Reserved]**

**Subpart D—Indemnification Payments**

**§ 1710.30 Permitted indemnification payments.**

(a) *OFHEO administrative proceedings.* (1) Except as provided in § 1710.31, an Enterprise may make or agree to make indemnification payments to a board member or executive officer of the Enterprise with respect to legal expenses incurred in connection with an administrative proceeding initiated or undertaken by OFHEO, if:

(i) The board of directors of the Enterprise, in good faith, determines in writing after due investigation and consideration that the board member or executive officer acted in good faith and

in a manner he or she believed to be in the best interests of the Enterprise and that the indemnification payment will not materially adversely affect the safety and soundness of the Enterprise; and

(ii) The board member or executive officer agrees in writing to reimburse the Enterprise, to the extent the Enterprise is not covered by any commercial insurance policy or similar coverage, for that portion of an indemnification payment that subsequently becomes a prohibited indemnification payment under § 1710.31.

(2) In connection with an administrative proceeding initiated or undertaken by OFHEO:

(i) The board member or executive officer requesting an indemnification payment shall not participate in any way in the discussion of the board of directors and approval of such payment; provided, however, that such board member or executive officer may present the request for indemnification to the board of directors and respond to any inquiries from the board of directors concerning his or her involvement in the circumstances giving rise to the administrative proceeding.

(ii) In the event that a majority of the board members are named as respondents, the remaining board members may authorize independent legal counsel to review the indemnification request and provide the remaining board members with a written opinion of counsel as to whether the conditions delineated in paragraph (a)(1) of this section have been met. If the opinion of counsel concludes that such conditions have been met, the remaining members of the board of directors may rely on the opinion in authorizing the requested indemnification.

(iii) In the event that all of the board members are named as respondents, the board of directors shall authorize independent legal counsel to review the indemnification request and provide the board with a written opinion of counsel as to whether the conditions delineated in paragraph (a)(1) of this section have been met. If the opinion of counsel concludes that such conditions have been met, the board of directors may rely on the opinion in authorizing the requested indemnification.

(b) *Other civil actions or administrative proceedings.* In cases involving a civil action or an administrative proceeding not initiated or undertaken by OFHEO, an Enterprise may provide for payment to any board member, executive officer, employee, or agent of the Enterprise of legal expenses in accordance with applicable law, provided that such payment will not



materially adversely affect the safety and soundness of the Enterprise.

**§ 1710.31 Prohibited indemnification payments.**

(a) *Prohibited indemnification payments.* An Enterprise or any affiliate of an Enterprise may not make, except as provided in paragraph (b) of this section, any payment to indemnify any board member or executive officer for any legal expense incurred in connection with an administrative proceeding initiated or undertaken by OFHEO that results in a final order or settlement pursuant to which the board member or executive officer is assessed a civil money penalty or is required to cease and desist from or take any affirmative action with respect to the Enterprise.

(b) *Exceptions.* An Enterprise may make a reasonable payment that:

(1) Is used to purchase any commercial insurance policy or similar coverage; provided, however, that such insurance policy or similar coverage shall not be used to indemnify a board member or executive officer for the cost of any civil money penalty assessed against him or her in an administrative proceeding initiated or undertaken by OFHEO, but may be used to pay other legal expenses incurred in connection with such administrative proceeding or to pay the amount of any restitution to the Enterprise; or

(2) Represents partial indemnification for legal expenses specifically attributable to particular charges for which there has been a formal and final adjudication or a finding in connection with a settlement that the board member or executive officer has not violated certain laws or regulations or has not engaged in certain unsafe or unsound practices or breaches of fiduciary duty.

Dated: September 4, 2001.

**Armando Falcon, Jr.,**

*Director, Office of Federal Housing Enterprise Oversight.*

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**DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT**

**Office of Federal Housing Enterprise Oversight**

**12 CFR Part 1773**

**RIN 2550-AA21**

**Flood Insurance**

**AGENCY** Office of Federal Housing Enterprise Oversight, HUD.

**ACTION:** Proposed regulation.

**SUMMARY:** The Office of Federal Housing Enterprise Oversight (“OFHEO”) is proposing a regulation to codify the authority and responsibility of OFHEO to oversee and enforce the statutory requirements affecting the operations of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation under the National Flood Insurance Reform Act of 1994, and to effect congressionally mandated adjustments to the civil money penalties applicable to violations of that law.

**DATES:** Comments regarding this notice of proposed rulemaking must be received in writing on or before October 12, 2001.

**ADDRESSES:** Send written comments to Alfred M. Pollard, General Counsel, Office of General Counsel, Office of Federal Housing Enterprise Oversight, 1700 G Street, NW., Fourth Floor, Washington, DC 20552. Written comments may also be sent by electronic mail at [RegComments@ofheo.gov](mailto:RegComments@ofheo.gov). OFHEO requests that written comments submitted in hard copy also be accompanied by the electronic version in MS Word or in portable document format (pdf) on 3.5” disk.

**FOR FURTHER INFORMATION CONTACT:** David A. Felt, Associate General Counsel, Office of General Counsel, Office of Federal Housing Enterprise Oversight, 1700 G Street, NW., Fourth Floor, Washington, DC 20552, telephone (202) 414-3750 (not a toll-free number). The telephone number for the Telecommunications Device for the Deaf is (800) 877-8339.

**SUPPLEMENTARY INFORMATION:**

**Comments**

OFHEO invites comments on all aspects of the proposed regulation, including legal and policy considerations, and will take all comments into consideration before issuing the final regulation. Copies of all comments will be posted on the OFHEO Internet web site at <http://www.ofheo.gov>. In addition, copies of all comments received will be available for examination by the public at the Office of Federal Housing Enterprise Oversight, Fourth Floor, 1700 G Street, NW., Washington, DC 20552.

*I. Statutory Framework*

Title XIII of the Housing and Community Development Act of 1992, Pub. L. No. 102-550, entitled the “Federal Housing Enterprises Financial Safety and Soundness Act of 1992” (the

“Act”),<sup>1</sup> established the Office of Federal Housing Enterprise Oversight (“OFHEO”) as an independent office within the Department of Housing and Urban Development. OFHEO is the financial safety and soundness regulator of the nation’s two largest housing-related Government-sponsored enterprises: the Federal National Mortgage Association (“Fannie Mae”) and the Federal Home Loan Mortgage Corporation (“Freddie Mac”) (collectively, the “Enterprises”). In addition to establishing OFHEO, the Act made amendments to the Enterprises’ enabling statutes (collectively, “the Charter Acts”)<sup>2</sup> among other things, accommodate the restructured regulatory regime under the Act.

The National Flood Insurance Act of 1968 (“NFIA”)<sup>3</sup> and the Flood Disaster Protection Act of 1973 (“FDPA”),<sup>4</sup> as amended by the National Flood Insurance Reform Act of 1994 (“NFIRA”),<sup>5</sup> together create a comprehensive National Flood Insurance Program (“NFIP”) that includes various provisions designed to ensure that structures built in flood plains are covered by statutory minimum amounts of flood insurance. NFIRA added specific requirements explicitly applicable to the Enterprises,<sup>6</sup> designated OFHEO as the Federal agency responsible for determining compliance of the Enterprises’ flood insurance responsibilities, required OFHEO to report their compliance in the agency’s 1996, 1998 and 2000 annual reports,<sup>7</sup> and provided OFHEO with the authority to issue any regulations necessary to carry out the applicable provisions of NFIRA.<sup>8</sup> NFIRA also authorized OFHEO to impose civil money penalties upon an Enterprise that fails to implement procedures reasonably designed to ensure that the loans it purchases comply with the mandatory flood insurance purchase requirements.<sup>9</sup>

More specifically, NFIRA requires that the Enterprises each implement procedures reasonably designed to ensure that any mortgage loan that is purchased and is secured by property located in a designated flood hazard

<sup>1</sup> 12 U.S.C. 4501 *et seq.*

<sup>2</sup> Federal National Mortgage Association Charter Act (12 U.S.C. 1716-1723i) and Federal Home Loan Mortgage Corporation Act (12 U.S.C. 1451-1459).

<sup>3</sup> Codified at 42 U.S.C. 4001 *et seq.* and other scattered sections of 42 U.S.C.

<sup>4</sup> Codified at 42 U.S.C. 4002 *et seq.* and other scattered sections of 42 U.S.C.

<sup>5</sup> Pub. L. No. 103-325 (Sept. 23, 1994) (codified, as amended, at 42 U.S.C. 4001-4129).

<sup>6</sup> 42 U.S.C. 4012a(b)(3).

<sup>7</sup> 12 U.S.C. 4521(a)(4).

<sup>8</sup> 42 U.S.C. 4001 note.

<sup>9</sup> 42 U.S.C. 4012a(f)(c).