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**FOR IMMEDIATE RELEASE**

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## **OFHEO PUBLISHES EXAMINER GUIDANCES**

**Washington, DC** -- The Office of Federal Housing Enterprise Oversight today published three Examiner Guidances relating to supervision of Fannie Mae and Freddie Mac. The guidances provide greater specificity to agency regulations in the areas of corporate governance, accounting and compensation. They are effective immediately.

- A corporate governance guidance replaces existing guidance PG-05-02 and elaborates on the provisions of OFHEO's corporate governance rule at 12 CFR 1710.
- An accounting guidance addresses elements drawn from the earlier corporate governance guidance and provides a stand-alone set of standards for use by OFHEO's Office of Chief Accountant. This guidance reflects the increased emphasis by OFHEO on accounting practices at the Enterprises.
- A guidance on compensation practices sets forth OFHEO expectations regarding actions covered by OFHEO's executive compensation regulation at 12 CFR 1770 and corporate governance regulation at 12 CFR 1710.

"Many elements of the guidances are designed to prevent a recurrence of the serious problems found in OFHEO's special examinations of Fannie Mae and Freddie Mac," said OFHEO Director James B. Lockhart. "Key provisions of the guidances address the responsibilities and conduct of Enterprise boards and senior management in regard to compensation, risk management, internal controls and accounting. The guidances issued today further refine OFHEO's regulatory expectations and reflect our ongoing policy of transparent supervision," said Lockhart.

"The guidances reflect certain gaps in OFHEO's explicit authorities that need to be addressed. Pending legislation would provide stronger enforcement powers — including the ability to go after Enterprise-affiliated individuals, stronger tools to limit inappropriate

compensation and stronger language on removing directors and officers for misconduct,” Lockhart said. “I hope Congress acts on GSE reform quickly.”

Guidances provide direction to OFHEO examiners as to regulatory expectations about the policies, procedures and operations of the Enterprises. The examiners consider Enterprise actions in light of the guidances. If conduct does not align with a guidance, an Enterprise may be counseled; and, if the conduct is not then corrected, OFHEO could seek an enforcement action for an unsafe and unsound practice.

### **Summary of Key Guidance Provisions**

#### **Examination for Corporate Governance PG-06-001**

Replaces guidance Examination for Corporate Governance PG-05-002 (May 20, 2005).

Retains all provisions of earlier guidance, except for certain accounting standards addressed in Examination for Accounting Practices PG-06-003.

Defines and broadens relevant experience for board members, used to identify individuals for nomination for election to the board.

Updates provision to expand responsibilities of the head of the compliance office and of the internal investigation function.

Expands a provision on board of director responsibilities – that go beyond a short-term focus on maximizing shareholder value – to address internal controls and organization, staffing and budget planning and training.

Provides that the function of chairperson of the board is to be entrusted to an independent board member.

Adds a provision addressing the establishment of a management compliance control coordination committee to assure cross-enterprise coordination of legal, compliance and ethics programs.

Addresses need for separation between the risk management function and the control function of an Enterprise.

Requires establishment of policy and procedures relating to delegations of authority.

#### **Examination for Compensation Practices PG-06-002**

Provides standards for Enterprise compensation programs for board members, executive officers and employees, including appropriate structure and performance measures; also provides standards for employment agreements or contracts with executive officers, including provisions relating to termination benefits.

Standards address – for cases of misconduct – escrow of benefit payments, debarment

from future employment and claw-back provisions.

Provides for the certified submission of compensation comparability information for executive officers by the Enterprises to OFHEO, including the submission of a comprehensive comparability study every five years.

Addresses board of director responsibilities regarding the Compensation Committee.

Provides that each Enterprise board must provide OFHEO with a report describing compliance with the guidance within 150 days publication and annually thereafter.

### **Examination for Accounting Practices PG-06-003**

Requires the establishment and maintenance of accounting policies and procedures that properly reflect GAAP and provides for the periodic review of accounting policies and procedures.

Sets forth procedures for communications between the external auditor and OFHEO.

Provides for the changing of the lead and concurring/coordinating audit partner every five years and the rotation of the external audit firm, no less frequently than every ten years.

Describes the responsibilities of the Board Audit Committee and provides for the Committee's review of requirements of applicable laws and regulations relative to its activities.

Describes the Board Audit Committee responsibility, no less frequently than every two years, to cause an independent consultant to conduct a targeted evaluation of one or more accounting policy areas.

Calls for the assessment by management of the Enterprise's accounting functions no less frequently than every five years and for the maintenance of an independent internal audit function that is staffed by technically competent and appropriately trained auditors.

Calls for the creation of a system that assures accounting policies are continuously reviewed, updated, and fully disclosed to the Board Audit Committee.

**Three guidances follow:**

**Examination for Corporate Governance PG-06-001**

**Examination for Compensation Practices PG-06-002**

**Examination for Accounting Practices PG-06-003**

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*OFHEO's mission is to promote housing and a strong national housing finance system by ensuring the safety and soundness of Fannie Mae and Freddie Mac.*

# OFHEO

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## Examination Guidance

**Issuance Date: November 8, 2006**

**Doc. #: PG-06-001**

**Subject: Examination for Corporate Governance**

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

### **I. PURPOSE AND SCOPE.**

- a. This Guidance sets forth examination guidance and standards relating to the corporate governance of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) (collectively, the Enterprises) consistent with the safety and soundness responsibilities of the Office of Federal Housing Enterprise Oversight (OFHEO) under the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 and the OFHEO corporate governance regulation, 12 CFR Part 1710.
- b. This Guidance supersedes OFHEO Examination Guidance PG-05-002, Examination for Corporate Governance (May 20, 2005).

### **II. REFERENCES.**

- a. Federal Housing Enterprises Financial Safety and Soundness Act of 1992.
- b. Corporate Governance Regulation, 12 CFR Part 1710.
- c. OFHEO Examination Guidance PG-06-002, Examination for Compensation Practices (Nov. 8, 2006).
- d. OFHEO Examination Guidance PG-06-003, Examination for Accounting Practices (Nov. 8, 2006).
- e. Stipulation and Consent to the Issuance of a Consent Order, between OFHEO and Freddie Mac, December 9, 2003.
- f. Stipulation and Consent to the Issuance of a Consent Order, between OFHEO and Fannie Mae, May 23, 2006.
- g. New York Stock Exchange, Listed Company Manual, Corporate Governance Rules, as modified Nov. 3, 2004, Section 303A of the NYSE Listed Company Manual, as modified from time to time (NYSE rules).
- h. Sarbanes-Oxley Act of 2002 (SOX).

### III. GUIDANCE.

#### a. **Board of directors.**

##### 1. Independence and service.

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

B. Directors – Absence of Conflicts/Qualifications for Service. Each board member should have no actual or apparent conflict of interest or other circumstance that makes it inappropriate for him or her to serve on the Enterprise board of directors. Each board member should meet the qualifications set by the Enterprise and maintain high ethical standards.

C. Factors to Be Considered. In assuring qualification of directors for service in paragraph a.1.A. and B, including for the formal procedure provided below in paragraph a.1.E of this section, the board of directors should consider carefully specific conduct as well as factors of reputation risk, appearance of a lack of independence or impropriety and the ability to perform responsibilities. Examples of situations where concerns may arise regarding qualification for service include, but are not limited to:

- i. Outside employment of a board member or immediate family members with a business engaging in significant business or competition with the Enterprise;
- ii. Significant real estate transactions or significant other transactions with a business having substantial business relationships with the Enterprise;
- iii. Receipt of charitable funds, from an Enterprise or its foundations, by an organization for which the individual or a member of their immediate family serves as a member of the board of directors, as a trustee or as an employee;

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

- iv. Receipt of benefits from a company doing business with the Enterprise that would not be available to the public;
- v. Significant adverse legal determinations against an individual; or of an individual to sign or otherwise comply with the Enterprise's code of conduct; and
- vi. An inability of an individual to sign or otherwise comply with the Enterprise's code of conduct.

D. Qualifications. The board of directors should comprehensively define independence and other qualifications for service for all board members, and provide such definitions and any subsequent changes to the definitions to the appropriate Examiner in Charge (EIC).<sup>2</sup> At a minimum, criteria contained in such definitions must be consistent with the NYSE rules and must address current and past personal and family member employment and business relationships with the Enterprise, as well as relationships with entities and individuals that received compensation from the Enterprise.

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

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

## 2. Board member qualifications.

A. Expertise. In identifying individuals for nomination for election to the board of directors, the board should consider, among other factors relevant to the nomination process, the knowledge of such individuals, as a group, in the areas of business, finance, accounting, risk management, public policy, mortgage lending, real estate, low-income housing, homebuilding, regulation of financial institutions, and such other areas as are relevant to the safe and sound operation of the Enterprise.

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<sup>2</sup> As used in this Guidance, the term "EIC" includes the designee(s) of the EIC.

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

3. Limits on service of board members.

A. Length of Service. A board member may not serve on the board for more than 10 years or past the age of 72, whichever comes first; a board member, however, may serve his or her full term if he or she has served less than 10 years or is 72 years on the date of his or her election or appointment to the board; 12 CFR § 1710.11(a)(1)(i).

B. Waiver. The Director, in his or her sole discretion, may waive the term limits for good cause, if such waiver is requested in writing; 12 CFR § 1710.11(a)(1)(ii). Waiver requests should provide a justification for the request and be submitted as soon as possible before the term limit is reached. The Director's decision to grant or disapprove a waiver request shall be final.

4. Board operations.

A. Policies and Procedures. The board of directors should maintain written policies and procedures for its operation, consistent with legal and regulatory standards and industry best practices.

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

C. Minutes of Meetings. The board of directors should provide written guidance to management regarding the preparation and maintenance of minutes to reflect accurately deliberations of the board of directors and its committees.

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

E. Quorum; Proxies. A quorum of the board of directors of an Enterprise is at least a majority of the seated board of directors. A board member may not vote by proxy; 12 CFR § 1710.11(b)(3).

5. Information to board members by management.

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

6. Committees of the board of directors.

A. Required Committees.

i. A board of directors of an Enterprise shall have an audit committee, a compensation committee, and a nominating/corporate governance committee. Each of these committees must be in compliance with the charter, independence, composition, expertise, duties, responsibilities, and other requirements set forth under the NYSE rules,<sup>3</sup> and, with respect to the audit committee, with section 301 of the SOX;<sup>4</sup> 12 CFR § 1710.12( c).

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<sup>3</sup> The NYSE rules provide that a listed company's nominating committee charter must at least address the qualifications of a prospective board member, the selection of nominees, corporate governance guidelines, and the charter must also address an annual performance evaluation of the committee. The compensation committee charter must list its responsibilities which are at least to review and approve corporate goals and objectives relevant to CEO compensation, to evaluate CEO performance, to make recommendations with respect to non-executive officer compensation, incentive compensation and equity-based plans, and to produce a compensation committee report on executive officer compensation as required by the SEC. Finally, the compensation committee charter must address its annual performance evaluation.

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

<sup>4</sup> Section 301 of the SOX provides that each member of the audit committee shall be a member of the board of directors, and shall be independent. To be considered "independent," the member of the audit committee may not receive, other than for service on the board, any consulting, advisory, or other compensatory fee from the issuer (in this case the Enterprise), and may not be an affiliated person of the issuer (Enterprise). The audit committee shall be directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by the issuer (Enterprise). The audit committee shall establish procedures for the "receipt, retention, and treatment of complaints" regarding accounting, internal controls, and



ii. Responsibility for oversight of risk management and for compliance should each be delegated to a specific committee of the board of directors of an Enterprise. The chair of the committee with compliance responsibilities should be an independent board member.

C. Frequency of Meetings. Committees of the board of directors of an Enterprise shall meet with sufficient frequency to carry out their obligations and duties under applicable laws, rules, regulations, and guidelines; 12 CFR § 1710.12(b).

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

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

1. General board responsibilities.

A. Conduct and Responsibilities. The board of directors is responsible for overseeing the conduct and affairs of the Enterprise in furtherance of the safe and sound operation of the Enterprise and must remain reasonably informed of the condition, activities, and operations of the Enterprise; 12 CFR § 1710.15(b). The board should affirmatively investigate questionable practices or uncertainties regarding operations by questioning management and actively participating in board presentations and information gathering. The responsibilities of the board of directors include having in place adequate policies and procedures to assure its oversight of, among other matters, the following:

- i. Corporate strategy, major plans of action, risk policy, programs for legal and regulatory compliance and corporate performance, including but not limited to prudent plans for growth and allocation of adequate resources to manage operations risk;
- ii. Hiring and retention of qualified senior executive officers;
- iii. Compensation programs of the Enterprise;
- iv. Integrity of accounting and financial reporting systems of the Enterprise, including independent audits and systems of internal control and the engagement of external auditors;
- v. Process and adequacy of reporting, disclosures, and communications to shareholders, investors, and potential investors;

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auditing. The audit committee has the authority to engage independent counsel and other advisors, and to provide for appropriate funding for payment to those advisors.

vi. Extensions of credit to board members and executive officers; and

vii. Responsiveness of executive officers in providing accurate and timely reports to federal regulators and in addressing the supervisory concerns of federal regulators in a timely and appropriate manner; 12 CFR § 1710.15(b)(7).

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

C. Internal Controls. The board of directors should prepare a statement setting forth the respective roles of the board and management for meeting corporate goals and legal requirements, including the appropriate extent of reliance on outside consultants and experts and the responsibility of the company. In addition, the board of directors should assure that the Enterprise develops an effective internal control program that includes:

i. Regular and, where appropriate in consultation with the EIC, external testing of internal controls including blind testing; such testing should include tests and review of critical financial models;

ii. A system to assure that a control environment exists to address tone at the top, assignment of authority, consistency of policies and practices and adherence to code of conduct; and

iii. Adequate policies, procedures and internal controls surrounding the preparing, revising, validating, authorizing and recording of journal entries and data base changes or modifications.

## 2. Annual review.

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

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

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

A. General. The board of directors is responsible for directing the conduct and affairs of the Enterprise in furtherance of the safe and sound operation of the Enterprise; 12 CFR § 1710.15(b). In meeting its oversight responsibilities, the board should –

- i. Assure that management prepares a plan for succession for senior officers as well as other levels of officers for which such planning would be prudent, to include development of candidates;
- ii. Assure that management develops a budget and staffing plan for each unit in the Enterprise with attention to the number of personnel and the appropriate skills and expertise required. Such plan or alternative approach for meeting this paragraph, agreed to by the EIC, shall be submitted to the appropriate EIC on an annual basis; and
- iii. Assure that management develops training plans for each unit of the Enterprise as needed to assure that staff has the skills to perform jobs as well as familiarity with requirements of the Enterprise (including but not limited to bylaws, codes of conduct, compliance, employment policies) and legal and regulatory requirements.

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

C. Separation of Functions. The board of directors should:

- i. Assure that the functions of the chairperson of the board and chief executive officer, once separated, remain separated until such time that the Director of OFHEO, upon request of the board of directors, determines to terminate, either on a temporary or permanent basis, such separation, and that the function of chairperson of the board is entrusted to an independent board member;<sup>5</sup> and
- ii. Oversee internal organization and staffing adequacy to provide appropriate separation between the risk management function (oversight of risk taking) and the control function (oversight of accounting and financial reporting) of the Enterprise.

D. Executive officers. Prior to the board of directors initiating a search for the positions of chief executive officer, chief financial officer, chief risk officer, or chief compliance officer as well as other officers designated by OFHEO in writing, the board should provide the appropriate EIC with its written search criteria and should keep the EIC informed of the status of the search.

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<sup>5</sup> As used in this Guidance, the term “Director of OFHEO,” includes the designee(s) of the Director.

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

F. Compensation. The board of directors shall assure that the Enterprise establishes a compensation system that comports with the provisions of 12 CFR § 1710.13, and should assure that such compensation system is consistent with the OFHEO Examination Guidance PG-08-002, Examination for Compensation Practices (Nov. 8, 2006).

G. Extensions of Credit. The board of directors shall assure that adequate policies and procedures are in place that prohibit the Enterprise, directly or indirectly, including through any subsidiary, from extending or maintaining credit, or arranging for the extension of credit in the form of a personal loan, to or for any board member or executive officer of the Enterprises as provided by section 402 of the SOX; 12 CFR § 1710.16.<sup>6</sup>

H. Indemnification; Dismissal; Restitution. The board of directors shall assure that adequate policies and procedures are in place regarding indemnification of current and former board members and current and former executive officers. Such policies and procedures should address, among other matters:

- i. Standards relating to indemnification, investigation by the board of directors, and review by independent counsel; 12 CFR § 1710.20; and standards for denying indemnification where misconduct or failure to obey laws or regulations is involved;
- ii. Procedure and standards for dismissal of employees for failure to obey laws, rules, and regulations or other possible misconduct that relates to or may affect the Enterprise that is not of an inconsequential nature; and
- iii. Policies for seeking restitution or for obtaining reimbursement, indemnification or guarantee against loss from employees where the employee's misconduct or failure to obey a law or regulation has resulted in a loss to the Enterprise.

#### 4. Delegations of authority.

A. Establishment of Policy and Procedure. The board of directors should oversee the establishment and implementation of a policy and procedure that requires written documentation and retention of such documentation of delegations of authorities of the board, board members, officers, and employees of the Enterprise. Management should develop, in consultation with the EIC, and the board should adopt, appropriate delegations of authority in

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<sup>6</sup> Section 402 of the SOX prohibits personal loans, or extensions of credit, to any board member or executive officer.

connection with reports, information, certifications, or other documentation provided to OFHEO. Any delegation of authority must be consistent with applicable law, rule, or regulation and should be consistent with OFHEO guidance. Management should develop, in consultation with the EIC, a list of employees subject to this paragraph.

B. Submission to EIC. The policy and procedure set forth in paragraph b.4.A. shall be submitted to the EIC within 90 business days of the effective date of this Guidance, and within 30 business days after any subsequent, substantial revision.

C. Consultation by EIC. The EIC shall consult with OFHEO office staff, as appropriate, concerning such proposed delegations developed by Enterprise management.

**c. Code of conduct and ethics.**

1. Establishment of code.

An Enterprise shall establish and administer a written code of conduct and ethics. The code must be reasonably designed to assure the ability of board members, executive officers, and employees of the Enterprise to discharge their duties and responsibilities, on behalf of the Enterprise, in an objective and impartial manner; 12 CFR § 1710.14 (a). The code shall include standards required under section 406 of the SOX and such standards as are necessary to promote honest and ethical conduct.<sup>7</sup> The standards should include, but are not limited to, the ethical handling of actual or apparent conflicts of interest between personal and professional relationships; full, fair accurate and timely disclosure of material information to shareholders and regulators; and compliance with applicable rules and regulations.

2. Review of code.

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

3. Reporting misconduct.

The board of directors should direct the General Counsel, Chief Compliance Officer, or other designated officer of the Enterprise to report directly to the board any information relating to actual or possible misconduct that relates to or may affect the Enterprise by an executive officer or board member, or actual or possible misconduct by an employee of the Enterprise

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<sup>7</sup> The standards for a code of ethics applicable to senior officers under Section 406 are such standards as necessary to promote honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest; full, fair, accurate, timely, and understandable disclosure in periodic reports; and compliance with applicable rules and regulations.

that is not of an inconsequential nature. The board should inform the Director of OFHEO of the substance of any such misconduct in a timely manner. The General Counsel, Chief Compliance Officer, or other designated officer of the Enterprise should notify the Director of OFHEO of the alleged misconduct if the board does not notify the Director in a timely manner.

**d. Compliance program.**

1. Establishment and reporting.

Each Enterprise shall establish a compliance program in accordance with the provisions of 12 CFR § 1710.19(a) and any applicable written agreement or order. The head of the compliance office may be employed or removed from employment only upon approval of the board of directors. He or she shall report directly to the chief executive officer and independently to the audit and compliance committees of the board. He or she should have no other responsibilities at the Enterprise, and should be able to communicate directly with OFHEO and the board.

2. Internal investigation function.

The compliance program should include an internal investigation function, which should review internal complaints, whistleblowers reports, ethics matters, and related topics. Investigations may be conducted by appropriate units of the Enterprises such as the legal or internal audit unit. The head of the compliance program or other appropriate unit and his or her staff must have access to adequate resources to perform the internal investigation function. Actual or possible misconduct by an employee of the Enterprise that is not of an inconsequential nature should be reported to the EIC in a prompt manner.

**e. Risk management program.**

1. Establishment and reporting.

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

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

The chief risk officer should, at a minimum:

A. Leadership. Provide overall leadership, vision, and direction for enterprise risk management including implementing a framework to manage all aspects of risk, ensuring

that risk management activities are appropriate to the level of risk assumed, and developing risk management policies.

B. Training Programs. Maintain risk management readiness by establishing or reviewing communication and training programs, risk-based performance measurement and incentives, and other programs.

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

D. Accountability. Assure the establishment of systems which are reasonably designed to assure that business units are fully engaged in managing their portion of the risk and are accountable.

E. Technologies. In support of the risk management program, assure the development of risk technologies and of analytical, systems, and data management capabilities; and the implementation of risk metrics and reports, including losses and incidents, key risk exposures, and early warning indicators.

**f. Compliance control coordination committee.**

Each Enterprise should establish a management compliance control coordination committee composed of the head of the compliance program, the chief risk officer, the head of the audit unit, and the general counsel to assure cross-enterprise coordination of legal, compliance, and ethics programs and activities. An Enterprise may submit to the EIC for his or her review and consent an alternative structure consistent with the purposes of this paragraph.

**g. Certification of disclosures by chief executive officer and chief financial officer.**

The chief executive officer and the chief financial officer of an Enterprise shall review each quarterly report and annual report issued by the Enterprise and such reports shall include certifications by such officers as required by section 302 of the SOX.<sup>8</sup>

**h. External auditing standards.**

Each Enterprise should establish policies and procedures with respect to external auditing standards that comport with OFHEO Examination Guidance PG-08003, Examination for Accounting Practices (Nov. 8, 2006).

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<sup>8</sup> Section 302 of the SOX addresses corporate responsibility for reports and requires the CEO and CFO of each issuer to certify the appropriateness of the financial statements and disclosures contained in periodic reports, and to certify that those financial statements and disclosures fairly present, in all material respects, the operations and financial condition of the issuer. The provision of the regulation and guidance will apply to Freddie Mac once it has filed documents that are covered by the provisions of section 302 of the SOX.

#### **IV. ADDITIONAL MATTERS.**

##### **a. Guidance compliance report.**

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

##### **b. Safety and soundness.**

Any failure of the Enterprise to meet the terms of the OFHEO corporate governance regulation, 12 CFR Part 1710, or to meet the terms of the NYSE rules may raise safety and soundness concerns and may be determined to constitute an unsafe and unsound practice.

##### **c. Preservation of existing authority.**

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

##### **d. Designation.**

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



## **Examination Guidance**

**Issuance Date: November 8, 2006**

**PG-06-002**

**Subject: Examination for Compensation Practices**

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

### **I. PURPOSE AND SCOPE.**

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

### **II. REFERENCES.**

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

### **III. GUIDANCE.**

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

##### **1. General standard.**

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

##### **2. Additional standards relating to compensation programs.**

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

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

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

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

3. Additional standards relating to employment agreements or contracts.

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

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

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

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

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

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

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

## H. Contingent Benefits.

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

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

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

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

4. Standards relating to termination benefits of executive officers.

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

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

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

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

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

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

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

5. Termination benefits – general.

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

6. Contracts for consulting services.

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

**b. Submission of comparability information.**

1. Comparability study for covered executive officers.

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

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

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

3. Certifications.

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

4. Review of comparability information.

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

**c. Board of directors responsibilities.**

1. Compensation committee.

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

2. Compensation committee reports.

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

3. Independent consultant.

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

**IV. ADDITIONAL MATTERS.**

**a. Guidance compliance report.**

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

**b. Safety and soundness.**

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

**c. Preservation of existing authority.**

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



# OFHEO

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## Examination Guidance

**Issuance Date: November 8, 2006**

**Doc. #: PG-06-003**

**Subject: Examination for Accounting Practices**

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

### I. PURPOSE AND SCOPE.

This Guidance sets forth examination guidance and standards relating to the accounting practices of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation (collectively, the Enterprises) consistent with the safety and soundness responsibilities of the Office of Federal Housing Enterprise Oversight (OFHEO) under the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 and the OFHEO corporate governance regulation, 12 CFR Part 1710.

### II. REFERENCES.

- a. Federal Housing Enterprises Financial Safety and Soundness Act of 1992.
- b. Corporate Governance Regulation, 12 CFR Part 1710.
- c. Stipulation and Consent to the Issuance of a Consent Order, between OFHEO and Freddie Mac, December 9, 2003.
- e. Stipulation and Consent to the Issuance of a Consent Order, between OFHEO and Fannie Mae, May 23, 2006.
- f. OFHEO Examination Guidance PG- 06-001, Examination for Corporate Governance (Nov. 8, 2006).
- g. OFHEO Examination Guidance PG-06-002, Examination for Compensation Practices (Nov. 8, 2006).
- h. New York Stock Exchange, Listed Company Manual, Corporate Governance Rules, as modified Nov. 3, 2004, Section 303A of the NYSE Listed Company Manual, as modified from time to time (NYSE rules).
- i. Sarbanes-Oxley Act of 2002 (SOX).
- j. Securities and Exchange Commission (SEC) Staff Accounting Bulletin 99 – Materiality
- k. Securities and Exchange Commission Rule 13a-15, Controls and Procedures

- l. Securities Exchange Act of 1934 Rule 10A-3, Standards Relating To Listed Company Audit Committees.
- m. Securities and Exchange Commission Rule 2-01 of Regulation S-X, Qualifications of Accountants.
- n. Public Company Accounting Oversight Board (PCAOB) Release No. 2003-006 Establishment of Interim Professional Auditing Standards.

### **III. DEFINITIONS.**

For purposes of this Guidance:

#### **a. Chief Accountant; OCA.**

Chief Accountant means OFHEO's Chief Accountant or designee(s) of the Chief Accountant; OCA means the OFHEO Office of Chief Accountant.

#### **b. Item of Regulatory Concern (IRC).**

An Item of Regulatory Concern (IRC) is an item that may affect accounting policies and procedures, systems, controls, or reporting of an Enterprise, such as a new Financial Accounting Standards Board (FASB) standard or deficiencies in existing policies and procedures, systems, controls or reporting.

#### **c. Item of Significant or Critical Regulatory Concern (ISCRC).**

An Item of Significant or Critical Regulatory Concern (ISCRC) is an item that affects accounting policies and procedures, systems, controls or reporting of an Enterprise. The designation of significant or critical is made by OFHEO and signifies the degree of importance and the need for and timing of the item being addressed by the Enterprise, including any necessary remediation.

#### **d. Material; materiality.**

OFHEO recognizes that for public disclosures filed with the SEC, the materiality guidelines of the SEC should be employed.<sup>1</sup> OFHEO is informed by the SEC definitions and may consider them or employ them as part of its ongoing review of Enterprise accounting. A determination that an accounting matter is material or presents a materiality issue may be a factor in OFHEO oversight of an Enterprise. An item not being "material" or not having "materiality," however, does not supplant OFHEO's regulatory concerns that are defined in paragraphs III.b. and c.

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<sup>1</sup> SEC Staff Accounting Bulletin 99 – Materiality.

## **IV. GUIDANCE.**

### **a. Office of Chief Accountant.**

#### 1. General.

OCA advises the Director and OFHEO staff on all accounting matters related to the Enterprises. OCA develops policies regarding accounting and financial reporting and monitors accounting standards that affect the Enterprises and works with the Enterprises at a policy level on emerging issues. OCA develops and interprets examination guidance concerning Enterprise accounting policy and procedures, systems, reporting, and disclosure. OCA supports and coordinates accounting resources within OFHEO to assure the best and most efficient use of those resources. OCA supports other offices in providing consistent accounting policy interpretation across OFHEO and works with external constituencies on accounting issues; 12 CFR § 1700.2 (d)(8). Finally, OCA oversees Enterprise efforts to address accounting and accounting related issues such as those identified as an IRC or ISCRC.

#### 2. Designation of staff member to receive notification or reports.

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

#### 3. Additional accounting guidance.

Beyond the provisions of this Guidance, OCA will develop additional guidance, as needed, including but not limited to guidance to assure consistent application of Generally Accepted Accounting Principles (GAAP) by the Enterprises, where applicable and where the accounting change would be to a preferable method; and to provide additional examination guidance concerning Enterprise accounting policies, practices, procedures, and disclosures.

### **b. Enterprise accounting policies and procedures.**

#### 1. Development of policies and procedures.

Each Enterprise must establish a formal written procedure for development of accounting policy and create a system for full disclosure to the Audit Committee of the board of directors (Board Audit Committee) of these policies and the Enterprise's compliance with regulatory and GAAP requirements.

#### 2. Policies and procedures to reflect GAAP.

Each Enterprise must establish and maintain accounting policies and procedures that properly reflect GAAP.

3. Establishment of accounting guide.

Each Enterprise should establish and maintain a complete and current accounting guide that lists all of the Enterprise's accounting policies and procedures, including a procedure for documenting the business purpose of all significant transactions. The accounting guide should be provided to the Chief Accountant within 90 days of the effective date of this Guidance and notification of any subsequent revisions, when undertaken, should be submitted to the Chief Accountant on a monthly basis or, in either case, at such later time as determined by the Chief Accountant.

4. Enforcement of Enterprise policies and procedures.

Each Enterprise is responsible for designing and maintaining internal control over financial reporting.<sup>2</sup> Each should ensure that controls exist for internal control over financial reporting including activities of the internal audit function, the audit committee and self-assessment programs. Furthermore, each Enterprise should require that employees and consultants comply with the policies and procedures established by the Enterprise.

5. Periodic review.

Each Enterprise should have a system in place to assure that accounting policies and procedures are continuously reviewed and updated to reflect current GAAP requirements, and should have proper procedures and processes in place to assure compliance.

6. Board Audit Committee oversight.

The Board Audit Committee is responsible for overseeing that Enterprise management establishes, implements, and maintains accounting policies and procedures that are in compliance with applicable law, regulation, guidance, and industry standards, including GAAP and other applicable reporting and disclosure standards.

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<sup>2</sup> SEC Rule 13a-15 (f) defines the term “internal control over financial reporting”:

as a process designed by, or under the supervision of, the issuer's principal executive and principal financial officers, or persons performing similar functions, and effected by the issuer's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

(1) Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer;

(2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the issuer; and

(3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the issuer's assets that could have a material effect on the financial statements.

**c. Board Audit Committee.**

1. Establishment of the Board Audit Committee.

The board of directors of each Enterprise shall establish the Board Audit Committee. The Board Audit Committee shall be in compliance with the charter, independence, composition, expertise, duties, responsibilities, and other requirements set forth in section 301 of the SOX<sup>3</sup> and the NYSE rules;<sup>4</sup> 12 C.F.R 1710.12 (c).

2. Charter of the Board Audit Committee.

The charter of the Board Audit Committee shall, at a minimum, address the purpose of the Committee and the duties and responsibilities of the Committee as set forth in paragraphs IV.c.2.A. and B. below, and in compliance with the NSYE rules.

A. Purpose of the Board Audit Committee. The purpose of the Board Audit Committee, at a minimum, must be to:

- i. Assist the board of director's oversight of the integrity of the financial statements, compliance with legal and regulatory requirements, the external auditor's qualifications, and performance of the internal audit function.
- ii. Prepare a Board Audit Committee report as required by the SEC to be included in the annual proxy statement.

B. Duties and Responsibilities of the Board Audit Committee. The duties and responsibilities of the Board Audit Committee, shall, at a minimum, include:

- i. Duties and responsibilities relating to annual review of internal quality control procedures of the external auditor; discussion of annual audited financial statements, earnings releases, and policies with respect to risk assessment and risk management; periodic meetings with management and external auditors; and setting clear hiring policies for employees or former employees of the external auditor.
- ii. Responsibilities set forth in the Securities Exchange Act Rule 10A-3(b) relating to audit

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<sup>3</sup> Section 301 of SOX provides that each member of the audit committee shall be a member of the board of directors, and shall be independent. To be considered "independent", the member of the audit committee may not receive, other than for service on the board, any consulting, advisory, or other compensatory fee from the issuer (in this case the Enterprise), and may not be an affiliated person of the issuer (Enterprise). The audit committee shall be directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by the issuer (Enterprise). The audit committee shall establish procedures for the "receipt, retention, and treatment of complaints" regarding accounting, internal controls, and auditing. The audit committee has the authority to engage independent counsel and other advisors, and to provide for appropriate funding for payment to those advisors.

<sup>4</sup> The NYSE rules require that the audit committee have at least three members and satisfy Rule 10A-3 of the Securities Exchange Act of 1934.

committees, including establishing procedures for the receipt, retention, and treatment of complaints received by the Enterprise regarding accounting, internal accounting controls, or auditing matters; and confidential, anonymous submission by Enterprise staff members of concerns regarding questionable accounting or auditing matters.<sup>5</sup>

iii. Selecting, evaluating, and replacing the external auditor. The external auditor is ultimately accountable to the Board Audit Committee.

iv. Assuring that the external auditor submits a formal written statement regarding relationships and services which may adversely affect independence and for discussing with the external auditor any disclosed relationships that may impact objectivity and independence.

v. Overseeing internal audit activities, including decisions regarding the appointment or replacement of the chief audit executive who reports directly to the Board Audit Committee.

vi. Receiving, reviewing, and discussing reports from the external auditor on critical accounting policies and practices used, all alternative treatments of financial information within GAAP related to material items that have been discussed with management, ramifications of the use of such alternative treatments, and the treatment preferred by the external auditors.<sup>6</sup> The Board Audit Committee must review with the external auditor any difficulties the auditor encountered and management's response.

vii. Meeting periodically with management, internal auditors, and the external auditor.

viii. Providing for an annual evaluation of the Board Audit Committee.

C. Additional Responsibilities of the Board Audit Committee. The Board Audit Committee plays a critical role and, at a minimum, should:

i. Assure the development of policies and procedures for its approval and for notice to OFHEO of any accounting treatments or policies identified as having significant legal, reputation, or safety and soundness risk with a focus on accounting treatments or policies that do not employ GAAP or preferred methods.

ii. Approve and evaluate the staffing, budget, and audit plan of the internal audit function.

iii. Assure that management provides it with adequate information and reports to carry out its duties and responsibilities.

iv. Annually review the adequacy of its charter.

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<sup>5</sup> Compliance with SEC Rule 10A-3(b)(2), (3), (4), and (5) relating to audit committee responsibilities is a requirement set forth in the Sec. 303A.07 of the NYSE rules.

<sup>6</sup> The term "material" is used here as defined in the SEC guidance referenced in footnote 1, above.

**d. Independent internal audit function.**

1. Establishment of Enterprise internal audit function.

A. General. An Enterprise shall maintain an internal audit function that is independent and objective in performing its activities. The internal audit function should have a charter approved by the Board Audit Committee. Performance of the internal audit function should be evaluated not less than annually.

B. Compensation. Compensation for the internal auditor should comport with OFHEO Examination Guidance PG-006-02, Examination for Compensation Practices (Nov. 8, 2006).

C. Reporting. The head of the internal audit function should report directly to the Board Audit Committee and administratively to executive management.

D. Access to Records. The internal audit function should have independent access to all internal records and systems, including the general ledger, of the Enterprise.

2. Reporting by the internal audit function.

The board of directors should assure that the internal audit function maintains open and direct communication with management and the Board Audit Committee. The head of the internal audit function should report periodically to the Board Audit Committee and senior management on internal audit's activities and performance. Reporting should include internal audit's assessment of significant risk exposures and control issues, corporate governance issues, and other matters needed or requested by the Board Audit Committee and senior management.

3. Internal audit staff.

A. Qualifications and Training. Each Enterprise should have policies and procedures in place to assure that technically competent internal audit staff members are hired and appropriate training and professional development is provided to such staff members so that they remain professionally competent and current with professional standards. OFHEO shall review such training and professional development and may provide additional guidance.

B. Understanding of Duties. Each Enterprise should have policies and procedures to assure that internal audit staff members clearly understand their duties. Those duties should include that they report where noted non-compliance of GAAP to appropriate management and the Board Audit Committee.

C. Quality Control. Each Enterprise shall develop and implement internal control procedures to assure that internal audit staff members follow internal policies and procedures.

**e. Enterprise accounting staff.**

1. Qualifications and training.

Each Enterprise should have policies and procedures in place to assure that technically competent accounting staff members are hired and that they are provided appropriate training and development so that they remain professionally competent and current in professional standards.

2. Understanding of duties.

Each Enterprise should have policies and procedures to assure that accounting members clearly understand their duties. Those duties should include reporting non-compliance of GAAP to appropriate management.

3. Quality control.

Each Enterprise should develop and implement internal control procedures to assure that accounting staff members follow internal accounting policies and procedures.

**f. Financial statements.**

[reserved]

**g. Security of accounting information.**

[reserved]

**h. External auditor.**

1. Board Audit Committee responsibilities with respect to the external auditor.

The Board Audit committee is responsible for assuring that adequate policies and procedures are in place so that the Board Audit Committee may assess the expertise and capacity of the external auditor to fulfill its duties and obligations; selecting, evaluating, and replacing the external auditor; and assuring that the external auditor submits a formal written statement regarding its relationships and services which may affect objectivity and independence.

2. Audit partner engagement.

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



3. Auditing firm engagement.

A. Auditing Firm Change. Each Enterprise should change its external auditing firm no less frequently than every ten years to assure safe and sound operations of the Enterprise. The Director of OFHEO, or his or her designee, may waive or otherwise modify this requirement if he or she determines that the auditing firm change would be detrimental to safe and sound operations of the Enterprise.

B. Other Auditing Firm Change. Should an auditing firm change occur or be planned for other than the purposes of paragraph IV.h.3.A., the Enterprise should provide prompt notice to the Chief Accountant.

C. Auditing Firm Transition Plan. No later than one year prior to each auditing firm change required in paragraph IV.h.3.A., an Enterprise should submit to the Chief Accountant an accounting firm transition plan that addresses bidding and related processes, time schedules, operational problems, and other relevant facts, as may be requested by the Chief Accountant.

D. External Auditor Review. The Board Audit Committee should review the external auditor's engagement and other commitments of the auditing firm to the Enterprise to understand fully the work performed by the external auditor.

E. Communication with External Auditor. An Enterprise's audit engagement letter with the external auditor should provide that:

i. The external auditor may, upon the Chief Accountant's request, provide the Chief Accountant with access to senior audit partners on the engagement and any other personnel whom such partners deem necessary. The Chief Accountant also may have access to the external auditor's working papers prepared in the course of performing the services set forth in the engagement letter and the Chief Accountant may have such access to the external auditor without Enterprise personnel in attendance.

ii. The engagement letter should provide that the external auditor, without the approval of the Enterprise, may meet with the Chief Accountant with such frequency and about such matters as determined by the Chief Accountant, and may provide reports or other communications arising from the audit engagement directly to the Chief Accountant.

iii. The audit engagement letter should not contain provisions characterized as unsafe and unsound in the "Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions in External Audit Engagement Letter," 71 F.R. 6847 (February 9, 2006).

F. Matters covered by Reports or Communications. The matters covered by external auditor reports or communications referenced above in paragraph IV.h.3.E.ii. may include, but are not limited to:

i. Fraud involving senior management, and fraud (whether caused by senior management or other employees) that causes a material misstatement of the financial statements.

- ii. Illegal acts that come to the external auditor's attention and has a significant impact on the financial statements or the external auditor's opinion on the financial statements.
- iii. Adjustments arising from the audit that have a significant effect on the financial statements, identified by either the external auditor or management.
- iv. Major issues that were discussed with management in connection with the initial or recurring retention of the external auditor including, and discussions regarding the application of accounting principles and auditing standards.
- v. Disagreements with management over the application of accounting principles to the Enterprise's specific transactions and events that could be significant to the Enterprise's financial statements or the auditor's report.
- vi. Processes used by management in formulating particularly sensitive accounting estimates and the basis for the auditor's conclusions regarding the reasonableness of those estimates.
- vii. Initial selection of and changes in accounting policies, including critical accounting policies, alternative treatments within generally accepted accounting principles and the auditor's judgment about the quality of the Enterprise's accounting policies.
- viii. Consultation by management with other accountants about auditing and accounting matters.
- ix. External auditor's responsibility under GAAP for matters of interest in internal control and degree of assurance obtained about the financial statements.
- x. Any serious difficulties encountered by the external auditor in dealing with management relating to the performance of the audit. Such difficulties may include significant matters involving, among other things, unreasonable delays by management in permitting the commencement of the audit or in providing needed information, whether the timetable set by management is unreasonable under the circumstances, unavailability of client personnel, and the failure of client personnel to complete schedules on a timely basis.
- xi. A report by the external auditor describing in detail the auditing firm's internal quality-control procedures; any issues raised by the most recent internal quality-control review, peer review, or PCAOB inspection of the firm and any steps taken to deal with any such issues, including the auditing firm's letters of response to the peer review and PCAOB inspection reports. The Chief Accountant may meet with senior partners or representatives of the auditing firm to discuss the report by the independent auditor, peer review report, or PCAOB inspection report and various letters of response in understanding the firm's quality control procedures.

G. Independence of External Auditor. In oversight of an Enterprise's efforts to assure independence and fitness for service of external auditors, the Chief Accountant will consider

carefully regulatory and professional independence requirements, including relevant facts and circumstances of specific conduct as well as factors of reputation risk, appearance of a lack of independence or impropriety, and the ability to perform responsibilities.<sup>7</sup>

#### H. Conflicts of Interest.

i. With respect to the auditing firm and in oversight of an Enterprise's efforts to assure fitness for service of external auditors, the Chief Accountant will consider carefully the responsibility and actions of a firm of external auditors to adopt and apply a system of quality control in conducting an audit practice consisting of policies, procedures, and code of conduct to address matters including, but not limited to outside employment, business relationships, confidentiality requirements, exchange of gifts and entertainment, contributions to charitable activities, community service, and state board licensing requirements addressing violations of professional standards of conduct, disciplinary action, or conviction of any felony and/or misdemeanor charge(s).

ii. With respect to the lead engagement team partner and concurring/coordinating partner, the Chief Accountant will consider and evaluate situations involving possible conflicts of interest with the Enterprise relative to professional and firm standards including, but not limited to outside employment, business relationships, exchange of gifts and entertainment, contributions to charitable activities and community service, and state board licensing requirements addressing violations of professional standards of conduct, disciplinary action, or conviction of any felony and/or misdemeanor charge(s).

#### **i. Review of audit and accounting functions.**

##### **1. Annual review by Board Audit Committee.**

At least annually, the Board Audit Committee should review, with appropriate professional assistance, the requirements of laws, rules, regulations and guidelines that are applicable to its activities and duties. The Board Audit Committee should provide the Chief Accountant with the materials and procedures employed in such review and should keep the Chief Accountant apprised of the progress of such review.

##### **2. General review.**

No less frequently than every five years, the Board Audit Committee should cause management to conduct an assessment of the Enterprise's accounting functions, including, but not limited to lines of reporting, independence of functions, segregation of duties, alignment of functions, roles and responsibilities, staff training and qualifications, key person dependencies, and adequacy of resources. Also, the Board Audit Committee should engage an external auditor to attest to and report on management's assessment. The external auditor should report its findings to the board of directors, senior management, and the Chief Accountant. The Chief

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<sup>7</sup> The external auditor must meet the requirements of independence set forth by the PCAOB Release No. 2003-006 and in SEC Rule 2-01 of Regulation S-X.

Accountant shall review the appointment of the firm, the work plan for the engagement, and should have access to the external auditor during the engagement.

3. Targeted independent review.

No less frequently than every two years, the Board Audit Committee should cause an independent consultant or accounting firm to conduct a targeted evaluation of one or more accounting policy areas, such as, but not limited to derivatives, securitizations, amortization of premium and discount, and report its findings to the board of directors, senior management, and the Chief Accountant. The Chief Accountant shall review the appointment of the firm, the work plan for the engagement, and shall have access to the firm during the engagement.

**V. ADDITIONAL MATTERS.**

**a. Guidance compliance report.**

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

**b. Safety and soundness.**

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

**c. Preservation of existing authority.**

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

\*Note: The FHFA Accounting Guidance updating the OFHEO Accounting Guidance presented in 2006 is available on FHFA.gov on FHFA Electronic Reading Room page (at: <http://www.fhfa.gov/Default.aspx?Page=43>)

**FHFA Examination Guidance: Examination for Accounting Practices - October 27, 2009**