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Alfred M. Pollard, Esq.
General Counsel
Office of Federal Housing Enterprise Oversight
Attention: Comments/RIN 2550-AA24
Fourth Floor
1700 G Street, NW
Washington, DC 20552

Re: RIN 2550-AA24: Proposed Amendments to Corporate Governance Regulation

Dear Mr. Pollard:

PricewaterhouseCoopers ("PwC") respectfully submits the following comments on the Office of Federal Housing Enterprise Oversight's ("OFHEO") proposed amendment to enhance the minimum corporate governance standards applicable to Government Sponsored Enterprises ("GSEs" or "Enterprises") regulated by OFHEO. Our comments are directed primarily to the provision requiring the Enterprises to change their external audit firm at least every ten years. For the reasons set forth below, we believe that the likely adverse impacts on audit quality will outweigh expectable benefits from any such requirement.

OFHEO has an important and unique responsibility as the primary regulator of the Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac") to ensure that they are adequately capitalized and operate safely and in compliance with applicable laws, rules, and regulations. As GSEs, Fannie Mae and Freddie Mac operate under federal charter and their shares are publicly held. They issue guaranteed mortgage-backed securities to the public. The Enterprises play a crucial role in the mortgage market as they raise money by borrowing in the nation's capital markets to buy mortgages from lending institutions, providing them with more capital for housing.

Given their important role, it is, of course, critically important that the GSEs have governance structures and financial statements that warrant and promote the public trust. To that end, we believe they should be subject to the robust corporate governance rules reflected in the Sarbanes-Oxley Act (the "Act"), specifically the Act's requirements and rules of the SEC relating to audit partner rotation, auditor independence, and audit committee oversight.

As the current auditors of Freddie Mac, and the auditors who were involved in the restatement of Freddie Mac's financial statements, we believe our experience is relevant to the proposed amendments.

SARBANES-OXLEY PROVIDES SAFEGUARDS TO ADDRESS THE ISSUES RAISED BY MANDATORY FIRM ROTATION, PROVIDING THE RIGHT BALANCE BETWEEN KNOWLEDGE OF INDUSTRY AND CLIENT, AND "FRESH LOOK."

The Sarbanes-Oxley Act is the most significant change in the securities laws since the 1933 and 1934 Securities Acts. It has brought about enhanced corporate governance rules and a sweeping new regulatory regime for registrants and their auditors. Fannie Mae, now having registered its shares with the SEC, is subject to the provisions of the Act, and its shareholders are currently afforded the safeguards of the Act. Freddie Mac has stated its intention to register with the SEC. However, we suggest in the interim that Freddie Mac be made subject to certain provisions of the Act so its shareholders can immediately receive the same benefits. As noted above, these provisions are audit partner rotation, auditor independence and audit committee oversight.

As part of the Sarbanes-Oxley legislation, Congress carefully considered whether to require mandatory rotation of audit firms. In the end, Congress rejected mandatory audit firm rotation in favor of earlier rotation of key audit engagement personnel and other restrictions to enhance audit independence and quality that were deemed to be more cost effective and quality enhancing. Those restrictions include, but are not limited to, the following:

- The lead audit engagement partner and concurring partner must be rotated every five years; other audit partners on the engagement team are limited to seven years;
- Auditors are hired by, fired by and report to the audit committee of the board of directors, not management;
- Public companies are precluded from hiring into a financial reporting oversight role a member of their audit firm's engagement team prior to a one-year "cooling off" period.

Additional and important safeguards are reflected in the provisions relating to: Public Company Accounting Oversight Board ("PCAOB") inspections, which provide oversight of judgments made during the audit; further restrictions on non-audit services to enhance auditor independence; and enhanced oversight by the audit committee which is in the best position to make a judgment about whether the auditor is independent, has the right skills and audit approach, and whether audit firm rotation is appropriate.

The change in mandatory rotation of engagement lead and concurring review partners from seven to five years has been a significant change in the way in which audits are staffed and conducted. We believe that these changes appropriately balance (i) the need for the lead partners to have industry knowledge and expertise, knowledge about the client, its people and its risks, and provide on the job training to partners and staff below the lead partner level with, (ii) the need for a periodic "fresh look." By mandating periodic changes in the audit firm, the audit firm may lose the training and institutional knowledge gained about the client and industry, and a "fresh look" will be obtained at the cost of perspectives and wisdom critical to a quality audit.

The General Accounting Office ("GAO") observed in its November 2003 report to the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services, "Public Accounting Firms: Required Study on the Potential Effects of Mandatory Audit Firm Rotation" ("GAO Study"), that, although it would take several years to assess the effectiveness of the Sarbanes-Oxley Act, it was as likely to sufficiently achieve the same intended benefits of enhanced auditor independence and audit quality as mandatory audit firm rotation when fully implemented.[1] The GAO believes that mandatory audit firm rotation may not be the most efficient way to enhance auditor independence and audit quality, considering the costs of changing the auditor of record and the loss of auditor knowledge that is not carried forward to the new auditor.[2]

In fact, although some foreign jurisdictions have required mandatory auditor rotation, the results have not been seen as uniformly satisfactory. With new requirements for strengthening audit reliability being implemented in the US, it does not seem wise to mandate audit firm rotation in the face of mixed results in jurisdictions where it is now required. Absent clear evidence of the benefits of mandatory firm rotation, the risks associated with changing audit firms and the associated costs outweigh the benefits, particularly when those same benefits can be achieved through mandatory audit partner rotation.

Industry/Client Knowledge

Audit quality is the result of many factors including integrity, independence, experience, knowledge, and training. As American companies have become more and more complex, so too have the audits of their respective financial statements. The Enterprises are particularly complex entities because of the extensive use of sophisticated financial instruments. Those transactions involve difficult interpretations of complex accounting rules and audit judgments. Accounting firms that audit such entities must invest and devote substantial time and expense to train and develop their people.

We believe that losing this knowledge of the client, its people, its transactions, and its risks every ten years will damage, not promote, audit quality. It is costly and time intensive to gain the cumulative audit knowledge necessary to audit complex financial statements. In addition to the incremental costs, we believe the quality of the work performed by the accounting firm would also suffer, thus increasing rather than decreasing the risks of an audit failure. The auditor's understanding of the underlying business is crucial to a successful audit. On-the-job training and the ensuing familiarity with the client –its strengths, weaknesses and perhaps most importantly, its year-to-year and over time changes – are indispensable in gaining that understanding and to ensuring audit quality.

[1] United States General Accounting Office November 2003 report, *Public Accounting Firms: Required Study on the Potential Effects of Mandatory Audit Firm Rotation*, GAO-04-216 (Washington, DC: November 21, 2003) at p.49.
[2] Id. at p. 50.

Fresh Look

The critical question is whether a "fresh look" can best be achieved not from another partner in the same accounting firm but from a partner at a different firm. Put another way, can another partner from the same firm be sufficiently independent to provide the independent "fresh look" of past audited accounts and new information affecting those prior accounts that may come to the new auditor's attention? We believe that a new partner from the same firm can and, in fact, does effectively provide a true "fresh look."

Given individual partners' responsibility for the opinions they issue, there are two reasons why there is a large disincentive for a partner in an accounting firm to protect another partner or a client from facing up to errors that may be subsequently discovered in previously issued financial statements. First, the discovery of new reliable information material to prior financial statements does not, in many cases, involve any notion of "fault" on the part of either management or the auditor. Sometimes the information is at very low levels of the organization—below any reasonable audit scope—which comes to light as a result of a whistleblower. Sometimes, the new information relates to a revised view by the regulator of accounting judgments. Sometimes, the issue is the result of an error or a mistake.

Even when it can be argued that the auditor missed something, it is not—especially in this "post-Enron" environment—in the interest of the audit engagement partner to do anything other than insist the issue be addressed. Otherwise, what was a prior mistake on the part of someone else now becomes an issue that may subject the current audit-partner to civil, criminal, or regulatory sanctions or penalties. From both an individual and institutional perspective, all of the incentives and personal legal penalties support the motivation on the part of the individual partner to detect and correct errors—whether in current or prior accounts.

Second, the public record of restatements by SEC registrants clearly demonstrates that these incentives are working. American businesses, and the accounting profession as a whole, have experienced more restatements than ever before, in both audited and unaudited financial statements. Most restatements are identified and reported with no change in audit firm. The high level of restatements is the result of sensitivity by the auditors, management, and the audit committee of the need to get it right (including by making prompt corrections) and to detect and disclose material errors to the public.

In this connection, we understand that there may be some concern about the role of the audit firm's National Office in consultations relating to accounting issues. To address that concern and demonstrate why engagement partner rotation alone is effective, it is important to understand the relationship between an engagement partner and the National Office of a firm. Engagement partners are responsible for consultation with the National Office when the issues are complex and when firm policies require such consultation to occur. This is an audit quality safeguard to better ensure that the appropriate conclusions are arrived at on complex and difficult issues. It is not a delegation of the engagement partner's authority. On any given audit engagement, the number of National Office consultations are few in comparison to the numerous independent judgments made by the engagement partner. As a matter of state licensing law, the engagement partner is, and must be, ultimately responsible for the conduct of the audit and the signing of the report. As the engagement partner is the person who is closest and most involved in the audit, it is the engagement partner (and not National Office or the firm) who is in the best position to provide the "fresh look" and to which rotation should be directed.

In short, engagement partners, especially when they take over from another partner, in their own self-interest and in the interests of their firms have every reason to surface newly discovered issues and appropriately resolve them. The "fresh look" by another partner protects against the potential loss of skepticism and objectivity without the detriment to audit quality of losing the knowledge of the client, its business, people, risks, and judgments made. We believe and recommend that the Act should be given a chance to work—before it is determined that even more disruption of the process is necessary or warranted.

MANDATORY AUDIT FIRM ROTATION UNDERMINES SARBANES-OXLEY REFORMS REGARDING ENHANCED AUDIT COMMITTEE AUTHORITY.

The Act charges audit committees with significant oversight responsibilities. Those responsibilities include the authority to hire and fire the auditors, which inherently involves an evaluation of whether audit firm rotation is appropriate in the client circumstances. By mandating audit firm rotation regardless of the audit committee's determination about what is in the best interests of the public and shareholders, the authority of the audit committee is effectively eroded.

In addition, a mandatory rule is likely to undercut the judgment of audit committees. The replacement of existing auditors and the selection of new auditors requires a balancing of considerations, including an evaluation of costs, the reach of the auditor's knowledge of the business, industry and applicable accounting rules, availability of the appropriate audit personnel, and other considerations. Mandatory firm rotation would have the effect of eliminating that balancing and removing from the audit committees the judgment to determine in each individual case what is in the best interests of the Enterprises.

The GSEs operate complex businesses that require their auditors to possess a wide array of resources and highly-specialized, industry-specific knowledge to perform audits. Only a limited number of firms are capable of performing these audits. The GSEs Audit Committee's choice may be further restricted by firms lacking independence from the Enterprises (e.g., provision of certain non-audit services). The remaining independent auditing firms may not include the optimal choice for that GSE. This further reduces the perceived benefits of mandatory firm rotation.

INCREASED REGULATORY OVERSIGHT CONTRIBUTES TO ENHANCED AUDIT QUALITY.

The Act also charges the PCAOB with regulatory authority over the auditing profession, which includes an annual inspection of the larger registered firms. Upon registration of Freddie Mac's common stock with the SEC, both GSEs' financial statements will become subject to SEC review, and the audits of the Enterprises' financial statements will be subject to PCAOB oversight and inspection. OFHEO's mandatory audit firm rotation proposal does not sufficiently consider the added investor protection and improvement in audit quality that will result from SEC and PCAOB oversight. Rather than mandating audit firm rotation, we recommend that OFHEO and the PCAOB perform periodic joint inspections of the audits of the GSEs' financial statements after both are registered with the SEC. This measure would be consistent with the provisions of the Act and the regulatory authority of OFHEO and the PCAOB. In this way, OFHEO can best be assured that audit quality and independence are maintained without the need to require additional regulatory burdens.

CONCLUSION

OFHEO should ensure that Fannie Mae and Freddie Mac are bound by the requirements of the Act and the rules of the SEC. Additionally, we recommend OFHEO and the PCAOB perform periodic joint inspections of the audits of the GSEs' financial statements. In so doing, OFHEO should give the carefully considered, studied, and weighted measures of the Act and the rules of the SEC time to be implemented and monitored by the PCAOB and the SEC. Mandatory audit firm rotation would disrupt the careful balance of risks and benefits for audit quality and auditor independence as determined by the Congress in enacting the Act. The checks and balances in place under Sarbanes-Oxley make mandatory audit firm rotation unnecessary and undesirable. Mandatory audit firm rotation for such large complex organizations as the GSEs—untested and unproven as an effective means to protect auditor independence—minimizes the role and reduces the effectiveness of audit committees, increases costs to the GSEs, and undermines an audit firm's ability to provide the highest audit quality. For these and the other reasons set forth above, we strongly urge OFHEO not to adopt the proposed rule requiring mandatory firm rotation.

We appreciate the opportunity to express our views. We will be pleased to discuss any comments or answer any questions that you may have. Please do not hesitate to contact Richard Kilgust at 646-471-6110 regarding our submission.

Very truly yours,

PricewaterhouseCoopers