

CHAMBER OF COMMERCE  
OF THE  
UNITED STATES OF AMERICA

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June 10, 2004

Mr. Alfred M. Pollard, Esq.  
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Fourth Floor  
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Re: Proposed Corporate Governance Regulation (RIN 2550-AA24)  
69 Fed. Reg. 19,126 (Apr. 12, 2004)

Dear Mr. Pollard:

The United States Chamber of Commerce (the "Chamber"), the world's largest business federation with more than three million businesses and organizations of every size, sector, and region, is pleased to respond to the request for comments from the Office of Federal Housing Enterprise Oversight ("OFHEO") on its proposed corporate governance rule, 69 Fed. Reg. 19,126 (April 12, 2004). The proposed rule would amend 12 C.F.R. Part 1710.

The Chamber's constituents are a diverse group, consisting of businesses of every size, in every industry, and from every region in the United States. Although the proposed rules apply only to two companies that are regulated by OFHEO, the rules may affect other companies, particularly other regulated companies. Corporate governance, as applied to major public companies in the United States, has generally been the purview of state corporate law, the listing standards of the New York Stock Exchange (the "NYSE"), and the NASDAQ Stock Market, and the Securities and Exchange Commission (the "SEC"). OFHEO proposes additional corporate governance requirements for its regulated entities, some of which go beyond the stringent rules already adopted by the SEC and the NYSE.

We are particularly concerned about four issues:

- The requirement to separate the positions of Chairman of the Board and CEO is a matter that is best decided by the company's board of directors, may not be appropriate for all companies at all times, and may not be in the best interests of the company and its shareholders.
- The auditor rotation requirement will deprive companies of the firm-specific knowledge that auditors acquire through regular auditing of particularly complex companies, thereby raising the cost of audits and potentially decreasing audit quality, and may not improve on the requisite independence that auditors must maintain and which is afforded through other provisions in the Sarbanes-Oxley Act of 2002.

- Several of the proposed rules duplicate existing rules adopted by the SEC and the NYSE and, therefore, are unnecessary and could subject the companies to inconsistent enforcement or interpretation of the same standards. Adoption of the rules violates an executive branch policy against adopting regulations that are duplicative of regulations of other federal agencies.
- We believe proposed section 1710.30 violates the Administrative Procedures Act and will permit OFHEO to override the detailed rules adopted by the SEC and the NYSE.

We discuss these concerns in detail below.

### I. Separation of the Chairman of the Board and CEO Positions

OFHEO proposes to require that its regulated entities separate the positions of Chairman of the Board and CEO.<sup>1</sup> The Chamber respectfully opposes the proposed rule for several reasons.

First, the question of whether to separate the positions of Chairman and CEO should be judged on the merits by the company's board of directors, which has the information and experience with the company necessary to make such a determination. Mandatory separation of the positions by regulation forecloses any deliberation on the matter by the board.

Corporate governance reforms adopted in the wake of recent corporate scandals are designed to encourage strong, responsible boards that are accountable to shareholders. The proposed rule undermines those objectives by removing the board's ability to make a fundamental decision regarding the leadership of the company. Instead, the OFHEO rule would replace the proper role of the board with specific, unchangeable requirements.

The proposed requirements also do not reflect the approach to director responsibility uniformly followed by state corporate law, which sets forth broad standards of conduct. This flexible approach, rather than a checklist approach, to board responsibility is essential to encourage directors to exercise their informed business judgment in overseeing the management of a corporation. A rigid, rules-based approach to corporate governance does not strengthen the board and, on the contrary, may calcify behavior and encourage directors to avoid responsibility by relying on a checklist of duties instead of using their own best judgment in their actions as directors.

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<sup>1</sup> 12 C.F.R. § 1710.11(a)(1) (proposed).

Second, a one-size-fits-all approach as contemplated by the proposed rule may not be appropriate for all companies at all times. As of March 2004, more than seventy-five percent of S&P 500 companies are led by an individual serving as both Chairman and CEO.<sup>2</sup> Recent shareholder proposals to separate the positions have failed at companies including Coca-Cola, Merrill Lynch, and Verizon. Some companies, however, have separated the Chairman and CEO positions for varying reasons. Citigroup separated the roles for executive succession purposes, while Disney did so in response to pressure from shareholders. In each case, the decision was made by the board of directors based on its assessment of the needs of the company at the time the decision was being made.

Third, having one individual serve as both Chairman and CEO may be in the best interests of the company and its shareholders. To be an effective Chairman, a person must be intimately familiar with the operations of a company. A management representative is often in the best position to carry out the responsibilities of a Chairman. The proposed rule prohibits such a structure.

Finally, there is no empirical data to show the proposed governance model is preferable or should be considered a best practice. The Sarbanes-Oxley Act, the NYSE and NASDAQ listing requirements, and the SEC rules do not require it. During passage of the Sarbanes-Oxley Act, Congress considered requiring a separate Chairman and CEO but did not adopt the requirement.<sup>3</sup> Absent a clear consensus on this point, there is no reason why this requirement should be made mandatory for some listed companies and not others.

As a general matter, government agencies should not impose specific governance rules that are based on a regulator's opinion of appropriate governance practices rather than studied analysis of such practices. The SEC and the stock exchanges developed the new corporate governance rules over a two-year period that included significant study and debate of the issues. OFHEO now proposes to create stricter corporate governance requirements without providing additional analysis of the need for, or appropriateness of, such requirements. Without study and analysis of the effects of proposed requirements, the proposed rules could have unintended consequences.

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<sup>2</sup> Governance Research, The Corporate Library, *available at* <<http://www.thecorporatelibrary.com/Governance-Research/spotlight-topics/spotlight/boardsanddirectors/SplitChairs2004.html>>. Of the S&P 500, 377 companies have combined Chairman/CEO positions.

<sup>3</sup> *See, e.g., Accounting and Investor Protection Issues Raised by Enron and Other Public Companies: Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 107th Cong. (2002) (statement of L. William Seidman, former chairman of the FDIC and the RTC, and statement of Ira M. Millstein, senior partner at Weil, Gotshal and Manges); 148 Cong. Rec. H4,866 (daily ed. July 25, 2002) (statement of Rep. Smith).

Accordingly, we respectfully request that OFHEO withdraw the proposed rule requiring separation of the Chairman and CEO positions.

## II. Audit Partner and Firm Rotation

Concurrent with the Sarbanes-Oxley Act, OFHEO proposes audit partner rotation every five years. We support OFHEO's efforts to improve the corporate governance framework of the enterprises through this provision, as it will provide a "fresh look" without sacrificing the institutional knowledge and experience garnered through years of auditing these complex entities. Since individual partners face legal and reputation risks resulting from unsuccessful audits, it is in the partners' best interests to perform the highest quality audits rather than protect clients or previous partners' errors that may exist within prior audits or financial reporting. Therefore, the audit partner rotation requirement is necessary and sufficient to provide the entities with a "fresh look" while not compromising knowledge and, as a result, audit quality.

OFHEO proposes to require its regulated entities to change their auditors on or before January 1, 2009, and at least every ten years thereafter.<sup>4</sup> The proposed rule will deprive companies of the firm-specific knowledge that auditors acquire through regular auditing of a particular company, thereby raising the cost of audits and potentially decreasing audit quality. During its deliberations on the Sarbanes-Oxley Act, Congress considered and rejected mandatory audit firm rotation provisions, leaving the decision to change audit firms to audit committees, which are empowered by Section 301 of the Sarbanes-Oxley Act to make those decisions and which, in practice, are in the best position to do so.<sup>5</sup> In addition, any regulation mandating auditor rotation should not be considered until after the SEC and the Public Company Accounting Oversight Board have gained sufficient experience with the effectiveness of the Sarbanes-Oxley reforms to evaluate such a requirement.

The proposed auditor rotation requirement threatens the quality of audits. Performing a quality audit requires that audit firms have a comprehensive understanding of a company's business and financial data. That body of knowledge is generally developed through experience auditing the company. By prohibiting audit firms from performing audit services for a company for more than ten consecutive years, the proposed rule may result in less informed and less effective audits. The American Institute of Certified Public Accountants studied the issue and

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<sup>4</sup> 12 C.F.R. § 1710.18(b) (proposed). The proposed rule states that Fannie Mae shall change its auditor no later than January 1, 2006; however, we understand that the correct date is January 1, 2009.

<sup>5</sup> The audit committee is directly responsible for the appointment, compensation, retention, and oversight of the company's registered public accounting firm. Rule 10A-3(b)(2) of the Securities Exchange Act of 1934, as amended.

concluded that mandatory auditor rotation would increase the likelihood of audit failure.<sup>6</sup> Problem audits occur much more frequently when the auditor lacks experience with the company's business, operations, and systems. An audit firm needs time to build such experience with a company, and once it has developed such experience, it should be allowed to use that experience for the benefit of the company and its shareholders.

Moreover, there is a higher incidence of fraud among companies with new auditors. According to the National Commission on Fraudulent Financial Reporting, fraud-related cases are more common in companies that recently have changed their independent public accountants.<sup>7</sup> Researchers and commentators argue that longer auditor tenure is associated with higher earnings quality, suggesting that auditors may place greater constraints on extreme management decisions in reporting financial performance.<sup>8</sup> Mandatory auditor rotation would weaken such beneficial constraints on fraudulent financial reporting.

In addition to threatening the quality of audits, the proposed rule will impose increased costs on companies and will create significant disruption for management with no comparable benefit to auditor independence. New audit firms will have to spend time learning the particulars of a company's business, which will inevitably drive up the cost of audits. Management will lose any benefits from the efficiencies gained through the previous auditor's knowledge, imparting a burden that will be particularly acute for companies in highly specialized industries where an audit firm may need to develop the requisite particularized knowledge at the expense of the companies and their shareholders. Furthermore, when management is forced to rotate to a new auditor, they face a limited number of firms to select from, several of which may be providing services that may impair the firms' independence, leaving an even more limited number of choices.

Rather than mandatory auditor rotation, the decision to hire or fire the audit firm should be left to the audit committee, which is composed of independent directors and is in the best position to assess the auditor's ability to provide independent and quality audits. The corporate governance rules and best practices are designed to encourage strong, responsible boards and board committees that are accountable to shareholders. The proposed rule undermines those objectives by removing the audit committee's ability to decide whether and when to engage a different audit firm.

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<sup>6</sup> American Institute of Certified Public Accountants, *Statement of Position Regarding Mandatory Rotation of Audit Firms of Publicly Held Companies* (1992). The Committee analyzed 406 cases of alleged audit failure between 1979 and 1991.

<sup>7</sup> *Id.*

<sup>8</sup> *See, e.g.,* Wanda A. Wallace, *Auditor Rotation: A Bad Governance Idea*, *Directors & Boards* (Spring 2004).

Finally, the issue of mandatory auditor rotation should not be considered until after the SEC and the Public Company Accounting Oversight Board have gained sufficient experience with the effectiveness of the Sarbanes-Oxley reforms. Congress did not require auditor rotation in the Sarbanes-Oxley Act, but instead directed the General Accounting Office (the “GAO”) to study the matter. In its November 2003 report, GAO concluded that “mandatory audit firm rotation may not be the most efficient way to strengthen auditor independence and improve audit quality considering the additional financial costs and the loss of institutional knowledge of the public company’s previous auditor of record, as well as the current reforms being implemented.”<sup>9</sup> The current reforms being implemented may accomplish the intended benefits of mandatory auditor rotation. The Sarbanes-Oxley Act contains significant reforms aimed at enhancing auditor independence and audit quality, including rotation of certain audit partners every five years, restrictions on providing non-audit or consulting services, and establishing the Public Company Accounting Oversight Board to oversee public company accounting firms. GAO concluded that the most prudent course of action is for the SEC and the Public Company Accounting Oversight Board to monitor and evaluate the effectiveness of these and other requirements for improving auditor independence and audit quality.

The preamble to the proposed rules contains no studied analysis of the auditor rotation requirement. The risk of audit failure discussed above is one potential negative consequence of adopting this requirement. There may be additional, unintended consequences. As the GAO recommended, the issue requires further study before any requirement is adopted.

Accordingly, we respectfully request that OFHEO withdraw the proposed rule requiring auditor rotation.

### III. Regulatory Overlap

Several of the proposed regulations incorporate requirements of the Sarbanes-Oxley Act and the NYSE corporate governance listing standards.<sup>10</sup> These regulations are unnecessary where companies are subject to the SEC rules and the NYSE rules as registrants under the Securities Exchange Act of 1934 which are listed on the NYSE.

By simply duplicating the SEC and NYSE standards, OFHEO’s rules could subject the companies to inconsistent enforcement or interpretation of the same standard by different bodies.

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<sup>9</sup> United States General Accounting Office, 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 (Nov. 2003).

<sup>10</sup> *See, e.g.*, 12 C.F.R. §§ 1710.12(c), 1710.14 (proposed).

Adoption of the rules violates an executive branch policy against adopting regulations that are duplicative of regulations of other federal agencies.<sup>11</sup>

A primary purpose of the SEC and stock exchange rules is to protect investors, and the SEC and the stock exchanges are the appropriate bodies to adopt rules aimed at investor protection. The interpretation and enforcement of such rules fall outside of OFHEO's expertise as OFHEO was established to ensure the safety and soundness of the enterprises and is not charged with investor protection.<sup>12</sup> The SEC and the stock exchanges should remain responsible for interpreting and enforcing these corporate governance rules, which are aimed at investor protection.

The Chamber believes that the rules could be modified to address these concerns. The rules could be amended to state that the SEC and the NYSE will have primary regulatory and enforcement authority with respect to these rules and that OFHEO will interpret these standards in accordance with the rules, regulations, interpretations, and other guidance of the SEC and the NYSE.

#### IV. Section 1710.30

Proposed section 1710.30 states that the Director of OFHEO, in his or her sole discretion, may modify the standards of federal or state law or the NYSE rules made applicable to the enterprises under the regulation simply upon written notice to the enterprises.<sup>13</sup> The rule would permit OFHEO to override the detailed rules that were painstakingly adopted by the SEC and the NYSE after passage of the Sarbanes-Oxley Act. Over a two-year period, the SEC and the stock exchanges developed the detailed new rules that now govern public company governance and disclosure in the United States. Throughout the process, companies affected by the rules were given full opportunity to comment on the rules, as required under administrative law and general standards of due process. In the end, agencies determined that the final rules were sufficient to protect the public interests and the interests of investors. The proposed rules would allow OFHEO to modify the SEC and NYSE rules without any such deliberative process.

The proposed rule violates the Administrative Procedure Act ("APA"). Proposed section 1710.30 authorizes OFHEO effectively to amend certain provisions of the proposed rules

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<sup>11</sup> Exec. Order No. 12866, 58 Fed. Reg. 51735 (Sept. 30, 1993) (stating that agencies should avoid regulations that are inconsistent, incompatible, or duplicative with its other regulations or those of other Federal agencies).

<sup>12</sup> 12 U.S.C. § 4513(a).

<sup>13</sup> 12 C.F.R. § 1710.30 (proposed).

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without the notice-and-comment procedures required by the APA.<sup>14</sup> The APA has been interpreted broadly to require notice-and-comment procedures for any amendment or other type of change to a rule, including imposing additional burdens or obligations on regulated entities.<sup>15</sup> The proposed rule permits OFHEO to impose such burdens and obligations on the enterprises without following the APA notice-and-comment procedures, which allow the enterprises and others to comment on the proposed changes.

Accordingly, we respectfully request that OFHEO withdraw proposed section 1710.30.

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In conclusion, we are concerned that OFHEO's proposed rules go beyond the rules that were adopted by the SEC, the NYSE, and NASDAQ after studied analysis and, in many cases, impose additional costs on businesses without corresponding benefits. Accordingly, we respectfully urge OFHEO to revise its proposed rules and amend or withdraw the provisions as discussed above.

Sincerely,



David Hirschmann

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<sup>14</sup> 5 U.S.C. § 553. The APA notice-and-comment procedures are required for any "rule making," is defined to include amending a rule. 5 U.S.C. § 551(5).

<sup>15</sup> See, e.g., *Sprint Corp. v. FCC*, 315 F.3d 369 (D.C. Cir. 2003) (finding that the FCC's imposition of additional obligations on a party through an order effectively changed the FCC's rules and required the APA notice-and-comment procedure); *Alaska Prof. Hunters Ass'n v. FAA*, 177 F.3d 1030 (D.C. Cir. 1999) (finding that the FAA's change in interpreting a rule effectively amended the rule and required APA notice and comment).