
CONSUMER MORTGAGE COALITION

June 14, 2004

Mr. Alfred M. Pollard
General Counsel
Office of Federal Housing Enterprise Oversight
1700 G Street, NW, Fourth Floor
Washington, D.C. 20552

RE: Comments/RIN 2550-AA24

Dear Mr. Pollard:

The Consumer Mortgage Coalition, a trade association of national mortgage lenders, servicers, and service providers, is pleased to provide comment to OFHEO on the proposed amendments to the corporate governance rule found at 12 CFR Part 1710 (69 *Federal Register* 19,126, April 12, 2004). As evidenced by OFHEO's *Report of Special Examination of Freddie Mac* (the "Report of Special Examination"), the current regulations need to be updated and improved.

Our comment letter has two parts. Part I discusses why the unique legal and financial structure of GSEs makes corporate governance rules and their enforcement by OFHEO important. Part II comments on certain proposed changes to the governance rule, and enhancements to OFHEO's examination function that will measure the effectiveness of corporate governance at each GSE.

The proposed rule in Part 1710 represents an important advance by enabling OFHEO to incorporate and enforce provisions in the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"), the SEC rules implementing Sarbanes-Oxley, and the New York Stock Exchange ("NYSE") listing requirements relating to corporate governance. Part 1710, however, is only a part of the comprehensive effort that OFHEO can and should make, through its examination and enforcement powers, to ensure that the management and the Boards of Directors of Fannie Mae and Freddie Mac meet their corporate and public mission commitments.

I. The Importance of the Proposed Rule

There are three reasons to support strong corporate governance regulations and improvements in OFHEO's examination authority to ensure that the GSEs have implemented effective corporate governance systems. First, sound governance is an essential part of assuring the safety and soundness of any major financial institution. Second, GSEs lack much of the market discipline that applies to other major financial institutions because of their implied guarantee. Improved corporate governance, including improved public disclosures, is important to promote corporate soundness. Third, unlike corporations chartered under state law, GSEs lack a statutory framework that clearly specifies the respective rights and responsibilities of directors, officers, and shareholders.

For these reasons, OFHEO should issue corporate governance regulations that, combined with its ongoing examinations of the GSEs, will assure that the corporate governance systems of the GSEs are effective.

The Importance of Sound Governance for Financial Safety and Soundness of Fannie Mae and Freddie Mac

Problems can arise when management takes undue risks in order to increase returns to shareholders and to managers whose compensation may be tied to short-term gains, and/or if management neglects basic responsibilities, such as the maintenance of sound internal controls and good accounting practices. The Board of Directors must play an essential role in ensuring that the governance system works effectively.

The OFHEO Special Examination Report made the following comments on the need for sound internal governance practices:

Beginning in the early 1990s, Freddie Mac promoted expectations of steady, rapid growth in profits. A corporate culture evolved that placed a very high priority on meeting the earnings estimates of Wall Street analysts but neglected key elements of the infrastructure of the Enterprise needed to support growth...The corporate culture fostered by that 'tone at the top' resulted in intense and sometimes improper efforts by the Enterprise to manage its reported earnings, compromised the integrity of many employees, and limited the effectiveness of its internal control structure. Freddie Mac created and maintained reserve accounts that did not comply with GAAP and entered into transactions with little or no economic substance, all for the express purposes of obtaining accounting results that would support the goal of reporting steady earnings growth and meeting analyst expectations.¹

¹ Office of Federal Housing Enterprise Oversight, *Report of the Special Examination of Freddie Mac*, December 2003, p. i.

[S]enior management and the Board failed to establish and maintain adequate internal control systems. The culture of Freddie Mac even allowed certain persons and business units to change or avoid established written policies and controls, in part because management of operations risk was not a priority.²

The Board of Directors was apprised of control weaknesses, the efforts of management to shift income into future periods and other issues that led to [Freddie Mac's \$5 billion] restatement, but did not recognize red flags, failed to make reasonable inquiries of management, or otherwise failed in its duty to follow up on matters brought to its attention.³

These findings highlight the need for OFHEO to require top-quality governance at both GSEs.

To assure safe and sound practices, it is important that the Rule create safeguards with respect to the quality, independence, and responsibilities of the Board of Directors, the incentive and compensation structure of Board members and company officials, audit practices, disclosure practices, and compliance and ethics. Moreover, the Rule should be state-of-the-art whenever possible and should provide flexibility for OFHEO, as the administrator of the Rule, to adjust these requirements to reflect changing corporate standards and other developments. The GSEs are one of the mainstays of the housing market; a sound governance rule is essential to protect them and the financial system from the dangers of concentrating corporate authority in the hands of a few GSE officials who may not have safety and soundness as their primary interest.

Sound governance is also important to promote capable supervision of safety and soundness. The Basel Committee on Banking Supervision makes this point:

Banking supervision cannot function as well if sound corporate governance is not in place and, consequently, banking supervisors have a strong interest in ensuring that there is effective corporate governance at every banking organization. Supervisory experience underscores the necessity of having the appropriate levels of accountability and checks and balances within each bank. Put plainly, sound corporate governance makes the work of supervisors infinitely easier.⁴

A tie exists between sound governance and supervision of financial safety and soundness. As the Basel Committee indicated, supervisors must pay close attention to assure proper governance at the supervised institutions.

² Ibid., p. ii.

³ Ibid., p. iv.

⁴ Basel Committee on Banking Supervision, "Enhancing Corporate Governance for Banking Organizations," September 1999, p. 1.

The Importance of Sound Governance to Help Compensate for Missing Market Discipline

Fannie Mae and Freddie Mac receive government subsidies that allow them to out-compete virtually any other firm in any line of business the GSEs choose to enter, as long as that activity falls within the very broad bounds of their charters. As a result of their government subsidies, there is a perception that the GSEs are backed by an implicit guarantee of the federal government. The government subsidies, along with an implicit guarantee, allow the GSEs to be more highly leveraged and thinly capitalized than other financial institutions. Without the perception of implicit government backing, investors would require that the GSEs maintain a much higher level of capital to protect against the consequences of financial risk.

The perception of government backing creates a lack of market discipline that can impact the operations of a GSE. As David M. Walker, Comptroller General of the United States recently testified:

In my view, it is all the more important that strong safeguards are established for the GSEs because such institutions are not subject to the same degree of market discipline as other privately run businesses. As a result of the perception of an implied guarantee of GSE obligations, customers and creditors may be less willing to monitor the companies' risk-taking, which could encourage managers to take on excessive risks.⁵

A sound governance rule will ensure that the GSEs are subject to the same state-of-the-art governance standards that apply to other publicly traded companies, including other federally regulated financial institutions. Accounting and disclosure requirements can ensure that investors are able to monitor the quality and practices and the financial condition of a GSE. Defining the roles and responsibilities of company directors and officers and application of officer certification and other requirements of the Sarbanes-Oxley Act will help to assure investors that the GSEs are complying with the highest corporate standards and also can provide increased opportunity for legal recourse if those standards are not met. While these elements of a sound governance rule cannot compensate for all of the distortions caused by the perception of implicit government backing, they will help to promote responsible actions by GSE officers and directors.

The Importance of Strong Governance Regulations to Fill Gaps in the GSE Legal Framework

Fannie Mae and Freddie Mac have a unique legal framework that distinguishes them from other companies in the United States. Private companies are chartered under the laws of a state. These state laws, which have developed over many years, define issues of governance, including the rights of shareholders vis-à-vis the company and its

⁵ David M. Walker, "Government Sponsored Enterprises: A Framework for Strengthening Governance and Oversight," testimony before the Senate Committee on Banking, Housing, and Urban Affairs, GAO-04-269T, February 10, 2004, p. 7.

managers, as well as the responsibilities of management under a wide variety of circumstances.

By contrast, there is no federal law of corporations that defines these issues for Fannie Mae and Freddie Mac. It is recognized that GSE shareholders and other stakeholders lack many of the articulated rights that are found in state corporation law.⁶ Thus, early in its life as a GSE, Fannie Mae turned to its regulator, at the time the Department of Housing and Urban Development, to issue regulations to help define matters of shareholder rights that the Fannie Mae charter act had failed to address.⁷ The current OFHEO governance regulations also seek to assist the two GSEs by requiring them to select a corporation law that will apply to their corporate governance practices and procedures. See 12 CFR § 1710.10 (b).

This issue is made more difficult by the fact that the GSEs are not subject to the same rules and regulations that govern other publicly traded companies, including other federally regulated financial institutions. For example, Fannie Mae and Freddie Mac are not subject to jurisdiction of the Securities and Exchange Commission (“SEC”) with respect to their responsibilities to make disclosures and provide other protections for investors. The two GSEs have agreed to voluntarily register their companies, but not their securities, with the SEC. Unless OFHEO makes protective provisions of the Sarbanes-Oxley Act expressly applicable to the GSEs, their governance, certification, and disclosure responsibilities will lag those of other companies.

II. The Proposed Rule

Applicability of Sarbanes-Oxley, SEC rules, and listing requirements of the NYSE

First and foremost, it is essential that Fannie Mae and Freddie Mac be subject to the corporate governance and financial disclosure rules of the New York Stock Exchange (Section 303A of the NYSE’s Listed Company Manual), the Sarbanes-Oxley Act, and the SEC, whether or not their stock is listed on the New York Stock Exchange or whether they are reporting companies subject to the public disclosure requirements of a public company. By incorporating the rules of the NYSE and the SEC, and statutory provisions of Sarbanes-Oxley into its rules, OFHEO will be empowered to enforce those provisions against Fannie Mae and Freddie Mac through OFHEO’s independent enforcement powers.

Although the proposed rule refers to certain sections of Sarbanes-Oxley, it does not refer to all of the provisions that should be applicable to the GSEs. For example, there is no reference to Sections 201 and 202 of Sarbanes-Oxley. These provisions set forth the non-audit services that outside auditors are prohibited from performing, and the procedural steps necessary for the Audit Committee of a company to take in approving non-audit services not prohibited under Section 201. These rules go to the very heart of

⁶ Note, “FNMA and the Rights of Private Investors: Her Heart Still Belongs to Daddy,” *Georgetown Law Journal*, Vol. 59 (November 1970), pp. 369-392.

⁷ U.S. Department of Housing and Urban Development, “Regulations Governing Operations of the Federal National Mortgage Association, Common Stock,” *Federal Register*, Vol. 36, No. 60, March 27, 1971, pp. 5784-5 (amending 24 CFR Sec. 81.2)

Sarbanes-Oxley because they address the fundamental relationship between the outside auditors and a public company.

The proposed rule refers to provisions of Section 302 of Sarbanes-Oxley governing certification by the CEO and CFO of internal controls of the company on a quarterly basis, but does not refer to Section 404, which requires an annual certification on internal controls, and an attestation by the outside accounting firm of the certification.

The proposed rule also does not refer to SEC rules that implement the relevant sections of Sarbanes-Oxley. The SEC rules should be incorporated by reference. Otherwise, the OHFEO corporate governance rules will not be as broad as the rules applicable to publicly reporting companies. For example, the SEC rules address possible circumvention of the five-year rule limitation applicable to lead and review auditing partners. Sarbanes-Oxley does not address possible circumvention. Other examples include the SEC rules requiring the CEO to be subject to the Codes of Conduct specified in Section 406 of Sarbanes-Oxley, although Section 406 does not specify the CEO.

The proposed rule refers only to the NYSE rules relating to the audit, compensation, and nominating/corporate governance committees, but omits any reference to other essential provisions such as (1) the details on holding regularly scheduled executive sessions without management, and, at least once a year, holding an executive session which includes only independent directors; (2) adoption and disclosure of corporate governance guidelines; (3) director qualification standards; (4) director access to management and, as necessary and appropriate, independent advisors; (5) director compensation; (6) director orientation and continuing education; (7) management succession; (8) annual performance evaluation of the Board; (8) adoption and disclosure of a code of business conduct and ethics for directors, officers and employees, and disclosure of any waivers of the code for directors or executive officers; and (9) elements of the code of business conduct and ethics.

The proposed rule leaves open the possibility that Freddie Mac will not register its common stock with the SEC. See Section 1710.19(c)(1). Whether through an OFHEO rule or directive, both GSEs should be subject to all of the reporting and proxy requirements of the SEC. Otherwise, they will lack the transparency expected and required of major American corporations.

Auditing, internal controls, compliance

The proposed rule requires that the compliance and risk management function to report to the CEO in an effort to make those functions “independent.” The proposed rule is silent, however, as to the reporting requirements of the internal auditor.

It is important that the risk management, compliance, and internal audit function report directly to the Audit Committee of both GSEs. The CEO is a member of senior management and should not be in the position of hiring, evaluating, and firing those whose responsibilities include evaluating the management of the GSE. Of course, it is also important that the Audit Committee work closely with the CEO and other members of senior management who need to sign off on the adequacy of the internal controls and

financial statements of the enterprise. The CEO, the CFO and other members of management will need the internal auditor, risk management officers, and the compliance personnel to help them ensure that the systems and controls within the institution are adequate.

Section 203 of Sarbanes-Oxley requires that the external auditor's lead partner and concurring partner be changed every five years. SEC regulations considerably amplify Section 203 of Sarbanes-Oxley and attempt to prevent a circumvention of the rotation requirements. OFHEO's corporate governance rules should also reflect these additional limitations and clarifications.

The proposed rule recommends that the GSEs change their auditors every ten years. Neither Sarbanes-Oxley nor the SEC rules require a periodic change in the auditing firm. The Congress studied this issue extensively and determined not to include such a change in the final legislation. The SEC has not adopted such a requirement in its rules. The National Public Company Accounting Board has the authority to adopt such a requirement, but has not yet done so.

We believe a better approach would be to empower OFHEO by establishing, in regulation, OFHEO's formal authority to remove an outside auditor if it has reason to believe that the outside auditor is not sufficiently independent of the company, has performed audits in the past that are inadequate, or is otherwise disqualified to serve as the enterprise's outside auditor. This is the approach followed by the federal banking agencies. See rules on Removal, Suspension, and Debarment of Accountants from Performing Audit Services (12 CFR Part 19, Part 263, Part 308, and Part 513, effective October 1, 2003).

The proposed rule requires that the GSEs meet the requirements of a number of sections of the Sarbanes-Oxley Act, but does not mention other important sections, including Sections 201 and 202. Section 201 prohibits outside auditors from performing certain listed non-audit services to the companies in which they perform the outside audit. Section 202 requires that before outside auditors perform non-prohibited non-audit services, the audit committee must review and approve such services. These sections, taken together, help to ensure that the outside auditors maintain independence from management. OFHEO should reflect these sections in its final regulations.

Board independence, terms, qualifications, and responsibilities

The proposed rule refers to a requirement for the majority of the "seated" members of the Board to be independent. The term "seated" is not defined. We recommend that the majority of the Board, including Presidential appointees, be independent, as that term is defined in the NYSE rules. We also recommend that the independence standard (the NYSE standard) apply to a majority of the Board, including Presidential appointees, and that the final rules clarify that requirement.

In addition, we support the proposed requirement that the Board meet at least twice a quarter. Quarterly meetings of the GSE boards may be insufficient at the present time to address major issues facing them. Quarterly meetings also empower the

Executive Committees of the GSEs to act in the behest of the Board between board meetings. Typically, senior management controls executive committees. Thus, infrequent quarterly board meetings can create opportunities for senior management to make decisions that are, by their nature, board decisions.

The proposed rule recommends that Board members terms be limited to ten years, and that a mandatory 72-year old retirement age be imposed. We believe that a better approach would be to bolster OFHEO's examination efforts to identify members of the Board who should no longer serve as Directors for lack of independence, lack of effort, or lack of ability. A more detailed explanation of our recommendations is described in the "Examination Issues" section below.

The proposed rule states that each Board is responsible for adopting policies and procedures to assure its oversight of a number of areas affecting the operation of the GSE. See Section 1710.15(b). The enumerated items, however, exclude crucial matters such as the achievement of the GSE's public mission, the maintenance of the highest ethical standards and avoidance of conflicts of interest. The Boards of the GSEs must be vigilant in identifying any diminution in the reputation and objectivity of their institutions, which were created by Congress to fulfill a public mission.

We also support the proposed requirements on Board meetings, quorum and proxies, information, and annual review. See Section 1710.11(b). The annual review by the Board in Section 1710.11(b)(5), however, should be expanded to include an annual review of the effectiveness of the corporate governance system by the Boards of both GSEs. Changes to the system should then be made to correct deficiencies and improve corporate governance.

Code of Conduct and Ethics

The proposed rule would require that the Boards of the GSEs review their Codes of Conduct every three years. Given the importance of and need for a strong ethical culture in the GSEs, we recommend that the corporate governance rule require an annual review, which the Board could delegate to the Audit Committee, subject to the Audit Committee filing an annual report with the Board for its review.

The proposed rule does not require that the Code of Conduct address the public mission of the GSEs. Yet, the GSEs would not exist but for the centrality of their public mission. Their Codes of Conduct should recite their public mission in detail and explain how they will manage their institutions to meet their public mission responsibilities.

Section 1710.14 of the proposed rule refers to Section 406 of the Sarbanes-Oxley Act, but not to the listing requirements of the NYSE that require companies with listed securities to adopt codes of conduct for all directors, officers, and employees, on a broader array of subjects than are covered in Section 406. In addition, the NASDAQ listing rules require that all "related party transactions" as defined in Item 404 of Regulation S-K of the SEC must be reviewed and approved by the Audit Committee or other body of independent directors. We recommend that Section 1710.14 be expanded to include adoption of the Code of Conduct and ethics provisions of the NYSE listing

requirements, and NASDAQ rules relating to prior review and approval of related party transactions.

Examination issues

It is clear that the first line of defense against management misfeasance or malfeasance must rest with the Board of Directors. The proposed rule will encourage the Boards of both GSEs to meet their fiduciary duties. It is also essential, however, that OFHEO recommit itself to conduct examinations that will thoroughly evaluate the effectiveness of the corporate governance system in the GSEs, and to use its enforcement powers to require corrective action when warranted.

Unlike other companies listed on the NYSE, Fannie Mae and Freddie Mac are subject to examinations by OFHEO, an arm of the federal government. This examination process allows OFHEO to determine the effectiveness of their corporate governance systems on an ongoing and timely basis. Numerical, structural and “objective” measurements of good corporate governance alone do not speak to the effectiveness of corporate governance. OFHEO can assess the effectiveness of the corporate governance systems of Fannie Mae and Freddie Mac by conducting examinations that are fact-specific. These examinations can include review of the Board and committee agendas, minutes and Board and committee reports and packages, interviews with key independent members of the Board, evaluation of the effectiveness of the Board, the Board committees, and individual members of the Board, and review of the written charter, policies and procedures of the Board and its committees.

In 1998, OFHEO adopted an Examination Guidance (Doc. #: EG-98-01, December 31, 1998), which incorporated detailed Corporate Governance examination procedures. These procedures tested the effectiveness of corporate governance systems for audit, management information, management process, and Board governance.

We recommend that OFHEO revisit this Examination Guidance, which does not appear to have been updated since December 1998. The Examination Guidance needs to reflect many of the changes wrought by Sarbanes-Oxley, the SEC rules implementing Sarbanes-Oxley, the listing requirements of the national securities exchanges, and corporate practices being adopted by other financial institutions and public companies.

One area where the Examination Guidance might be expanded is the periodic review of the nomination process and its linkage to a review of each candidate’s competence, knowledge, and performance. Currently, the Examination Guidance does not refer to a review of the individual performance of Board members. It is important that the proposed rule in Part 1710 require the Board to conduct an annual review of the performance of individual Board members and to have that review considered as part of the annual nomination process.

The Examination Guidance should also require a review by OFHEO examiners of the Board of Directors’ annual review of its corporate governance policy and procedures. The GSEs’ annual review should be required by the rules in Part 1710, and the OFHEO examiners should review the annual review during examinations. In addition, Part 1710

should require that the Board adopt annually a corporate governance written manual consistent with the NYSE listing requirements.

Other recommendations

Section 1710.30 of the proposed rule would allow OFHEO to adjust the standards applied in this rule upon written notice to each GSE. Given the progress that is being made in improved standards of corporate governance in the United States, this regulatory flexibility is needed. Moreover, there is a need to apply and adjust such standards from time to time because of the unique legal framework of the GSEs.

Summary

In summary, we support the strengthening of safeguards against unsafe and unsound and unethical practices that can undermine the financial strength and reputation of the GSEs, and their ability to meet their public mission. Sound corporate governance practices, reflected in part in OFHEO's regulations, and supplemented by a thorough and robust OFHEO examination of the effectiveness of the GSEs' corporate governance systems, are an important component of any system that will maintain the safety and soundness of the GSEs and allow them to fulfill their public mission.

Sincerely,

A handwritten signature in black ink, appearing to read "Anne C. Canfield", enclosed within a thin rectangular border.

Anne C. Canfield
Executive Director