

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

RIN 2550-AA20

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

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

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

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

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

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

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

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

**Background**

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

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

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

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

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

*Section 1710.2 Definitions*

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

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

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

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

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

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

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

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

Enterprise in an objective and impartial manner.

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

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

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

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

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

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

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

*NYSE* means the New York Stock Exchange.

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

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

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

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

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

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

#### Sections 1710.3–1710.9

Sections 1710.3 through 1710.9 are proposed to be reserved.

#### Subpart B—Corporate Practices and Procedures

##### Section 1710.10 Applicable Law

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

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

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

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

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

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

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

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

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

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

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

independence of board members of the compensation committee.

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

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

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

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

*Section 1710.14 Conflict-of-Interest Standards*

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

*Sections 1710.15–1710.19*

Sections 1710.15 through 1710.19 are proposed to be reserved.

*Subpart C—Responsibilities of Board of Directors*

*Section 1710.20 Conduct of Board Members*

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

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

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

*Section 1710.21 Responsibilities of Board of Directors*

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

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

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

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

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

(7) Ensuring the responsiveness of executive officers in providing accurate and timely reports to Federal regulators and in addressing the supervisory concerns of Federal regulators in a timely and appropriate manner.

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

*Sections 1710.22–1710.29*

Sections 1710.22 through 1710.29 are proposed to be reserved.

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

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

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

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

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

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

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

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

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

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

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

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

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

#### *Section 1710.31 Prohibited Indemnification Payments*

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

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

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

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

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

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

#### **Regulatory Impact**

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

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

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

#### *Regulatory Flexibility Act*

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

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

Administrative practice and procedure, Government Sponsored Enterprises.

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

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

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

##### **Subpart A—General**

Sec.

1710.1 Purpose.

1710.2 Definitions.

1710.3–1710.9 [Reserved]

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

1710.10 Applicable law.

1710.11 Committees of board of directors.

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

1710.13 Quorum of board of directors; proxies not permissible.

1710.14 Conflict-of-interest standards.

1710.15–1710.19 [Reserved]

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

1710.20 Conduct of board members.

1710.21 Responsibilities of board of directors.

1710.22–1710.29 [Reserved]

**Subpart D—Indemnification Payments**

1710.30 Permitted indemnification payments.

1710.31 Prohibited indemnification payments.

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

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

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

**§ 1710.2 Definitions.**

For purposes of this part, the term:

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

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

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

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

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

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

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

behalf of the Enterprise in an objective and impartial manner.

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

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

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

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

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

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

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

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

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

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

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

(2) Forgiveness of a debt or other obligation;

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

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

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

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

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

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

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

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

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

(3) Model Business Corporation Act, as amended.

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

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

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

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

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

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

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

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

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

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

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

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

**§§ 1710.15–1710.19 [Reserved]**

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

**§ 1710.20 Conduct of board members.**

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

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

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

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

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

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

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

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

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

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

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

(7) Ensuring the responsiveness of executive officers in providing accurate and timely reports to Federal regulators and in addressing the supervisory concerns of Federal regulators in a timely and appropriate manner.

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

**§§ 1710.22–1710.29 [Reserved]**

**Subpart D—Indemnification Payments**

**§ 1710.30 Permitted indemnification payments.**

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

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

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

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

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

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

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

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

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

materially adversely affect the safety and soundness of the Enterprise.

**§ 1710.31 Prohibited indemnification payments.**

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

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

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

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

Dated: September 4, 2001.

**Armando Falcon, Jr.,**

*Director, Office of Federal Housing Enterprise Oversight.*

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**DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT**

**Office of Federal Housing Enterprise Oversight**

**12 CFR Part 1773**

**RIN 2550-AA21**

**Flood Insurance**

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

**ACTION:** Proposed regulation.

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

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

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

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

**SUPPLEMENTARY INFORMATION:**

**Comments**

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

*I. Statutory Framework*

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

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

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

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

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

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

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

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

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

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

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

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

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