

**DEPARTMENT OF HOUSING AND  
URBAN DEVELOPMENT**

**Office of Federal Housing Enterprise  
Oversight**

**12 CFR Part 1710**

**RIN 2550-AA24**

**Corporate Governance**

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

**ACTION:** Proposed amendments.

**SUMMARY:** The Office of Federal Housing Enterprise Oversight (OFHEO) is proposing for comment amendments to its corporate governance regulation to enhance the minimum corporate governance standards applicable to the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation.

**DATES:** Written comments on the proposed amendments must be received by June 11, 2004.

**ADDRESSES:** You may submit your comments, identified by regulatory information number (RIN) 2550-AA24, by any of the following methods:

- U.S. Mail, United Parcel Post, Federal Express, or Other Mail Service: The mailing address for comments is: Alfred M. Pollard, General Counsel, Attention: Comments/RIN 2550-AA24, Office of Federal Housing Enterprise Oversight, Fourth Floor, 1700 G Street, NW., Washington, DC 20552.
- Hand Delivered/Courier: The hand delivery address is: Alfred M. Pollard, General Counsel, Attention: Comments/RIN 2550-AA24, Office of Federal Housing Enterprise Oversight, Fourth Floor, 1700 G Street, NW., Washington, DC 20552. The package should be logged at the Guard Desk, First Floor, on business days between 9 a.m. and 5 p.m.
- E-mail: [RegComments@OFHEO.gov](mailto:RegComments@OFHEO.gov). Comments to Alfred M. Pollard, General Counsel, may be sent by e-mail at [RegComments@OFHEO.gov](mailto:RegComments@OFHEO.gov). Please include RIN 2550-AA24 in the subject line of the message.

**Instructions:** OFHEO requests that comments to the proposed amendments include the reference RIN 2550-AA24. OFHEO further requests that comments submitted in hard copy also be accompanied by the electronic version in Microsoft(®) Word or in portable document format (PDF) on 3.5" disk. Please see the section, **SUPPLEMENTARY INFORMATION**, below, for additional information on the posting and viewing of comments.

**FOR FURTHER INFORMATION CONTACT:**

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 amendments, including legal and policy considerations, and will take all comments into consideration before issuing the final amendments.

All comments received will be posted without change to <http://www.ofheo.gov>, including any personal information provided. Copies of all comments received will be available for examination by the public on business days between the hours of 10 a.m. and 3 p.m., at the Office of Federal Housing Enterprise Oversight, Fourth Floor, 1700 G Street NW., Washington, DC 20552. To make an appointment to inspect comments, please call the Office of General Counsel at (202) 414-6924.

**Background**

Title XIII of the Housing and Community Development Act of 1992, Public Law 102-550, titled the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (Act) (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 (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) (collectively, the Enterprises or government sponsored enterprises) are adequately capitalized and operate safely and in compliance with applicable laws, rules, and regulations.

In furtherance of its supervisory responsibilities, in 2002, OFHEO published the final corporate governance regulation, taking into consideration comments filed in response to an earlier proposed regulation.<sup>1</sup> The corporate governance regulation sets forth minimum standards with respect to corporate governance practices and procedures of the Enterprises. It establishes a framework for corporate governance addressing applicable law, requirements and responsibilities of the board of directors and board committees, conflict-of-interest standards, and indemnification.

As a result of findings and recommendations contained in the

*Report of the Special Examination of Freddie Mac*<sup>2</sup> (*Report of Special Examination*), as well as developments in law, supervision, and industry standards, OFHEO is undertaking to amend the corporate governance regulation within this framework. On June 7, 2003, the Director of OFHEO ordered a special examination of the events leading to the public announcement by Freddie Mac of an audit of prior year financial statements and the termination, resignation, and retirement of three principal executive officers of Freddie Mac.

The *Report of Special Examination* found that "[t]he accounting and management problems of Freddie Mac were largely the product of a corporate culture that demanded steady but rapid growth in profits and focused on management of credit and interest rate risks but neglected key elements of the infrastructure of the enterprise needed to support growth."<sup>3</sup> *The Report of Special Examination*, among other things, made specific recommendations with respect to best practices in corporate governance that Freddie Mac should follow and that OFHEO should require.<sup>4</sup> For example, included are recommendations that functions of the chief executive officer and the chairperson of the board of directors should be separated; board members should become more actively involved in the oversight of the Enterprise; adequate and appropriate information should be provided to the board of directors; financial incentives for board members, executive officers, and employees should be developed based on long-term goals, not short-term earnings; strict term limits should be placed on board members; firms that audit the Enterprises, not merely the audit partners, should be changed periodically; and formal compliance and risk management programs should be established. A Consent Order, issued by OFHEO to Freddie Mac on December 9, 2003, required Freddie Mac to implement certain corporate governance best practices that were recommended in the Report of Special Examination, as well as other remedial steps.<sup>5</sup>

The lessons learned by OFHEO through the special examination

<sup>2</sup> OFHEO, *Report of the Special Examination of Freddie Mac* (Dec. 2003) (Report of Special Examination), which may be found at <http://www.ofheo.gov/media/pdf/specialreport122003.pdf>.

<sup>3</sup> *Id.*, at 4 (footnote omitted).

<sup>4</sup> *Id.*, at 163-171.

<sup>5</sup> OFHEO Order No. 2003-02, "Consent Order, In the Matter of the Federal Home Loan Mortgage Corporation" (Dec. 9, 2003) (Consent Order), which may be found at <http://www.ofheo.gov/media/pdf/consentorder12903.pdf>.

<sup>1</sup> 12 CFR part 1710, 67 FR 38361 (June 4, 2002).

provided new insights as to the appropriate best practices for both Enterprises. Thus, OFHEO is proposing to add prudential requirements that would have general applicability to its corporate governance regulation consistent with the practices recommended or required by the *Report of Special Examination* or the Consent Order.

OFHEO notes that the Enterprises are privately owned but federally chartered companies. Created by Congress to facilitate liquidity and stability in mortgage markets and to advance affordable housing, they receive in exchange special benefits from their Government sponsorship. Since their creation, the Enterprises have grown to become two of the largest financial companies in the world, yet the Enterprises are highly leveraged. Between them, Fannie Mae and Freddie Mac control a majority share of the conforming mortgage market. Given their Federal charters, public mission, and the size and significance of their operations in capital markets and the banking system, OFHEO has determined that Fannie Mae and Freddie Mac should adhere to certain policies that may not be applicable to all companies but should nevertheless apply to them.

With respect to recent developments, the New York Stock Exchange (NYSE) has issued amendments to its corporate governance rules that are applicable to companies listed on the NYSE, including the Enterprises.<sup>6</sup> In addition, Congress passed the Sarbanes-Oxley Act of 2002 (SOA),<sup>7</sup> which contains corporate governance requirements, and the U.S. Securities and Exchange Commission (Commission) has issued regulations to implement the SOA. Fannie Mae has voluntarily registered its common stock with the Commission effective March 31, 2003; Freddie Mac has announced its intention to register.<sup>8</sup>

Since registration, Fannie Mae files periodic financial disclosures with the Commission as required by the Securities Exchange Act of 1934 and is subject to the requirements of the SOA

and implementing rules and regulations of the Commission.<sup>9</sup> Upon registration, Freddie Mac will be subject to the same requirements. OFHEO intends to ensure that such requirements and implementing rules and regulations are or remain applicable to the Enterprises even if Freddie Mac does not register with the Commission or if one or both Enterprises deregister. In connection with any conduct regulated by the Commission, OFHEO would look to any rules, regulations, and interpretations issued by the Commission and its requirements. OFHEO may initiate an enforcement action in the area of the corporate governance in response to a violation of its corporate governance regulation, including behavior that violates laws or requirements set forth therein.

The proposed amendments to strengthen corporate governance of the Enterprises will support the supervisory program of OFHEO. Strengthened corporate governance will help to ensure the continued safe and sound operation of the Enterprises.

#### Section-by-Section Analysis

##### Section 1710.11 Board of Directors

OFHEO is proposing a section that would add requirements and consolidate existing requirements relating to the board of directors of an Enterprise. One requirement would require an Enterprise to prohibit the chairperson of the board from also serving as chief executive officer of the Enterprise. Separating the functions of chairperson and chief executive officer is prudent for safe and sound operations because it would strengthen board independence and oversight of management on behalf of shareholders consistent with the public mission of the Enterprises. Separating the role of chief executive officer would similarly clarify the role and responsibility of the individual charged with leading the management team.<sup>10</sup> OFHEO recognizes that this is a different standard than is

required of many other private corporations but it is appropriate for the Enterprises, not only because of their government sponsorship and dominance within their market, but also in light of the recent experience at Freddie Mac. In that case, separation of the two roles could have caused the board to provide stronger independent guidance to management and identify problems sooner. A separation of the chairperson and chief executive officer functions would be in the best interest of the companies and would enhance the effectiveness of changes being proposed for the board of directors to meet its obligations. This reasonable step will assist both in the perception and reality that these specialized institutions maintain the highest standards of corporate governance. The effective date of this requirement would be January 1, 2007.

Another new requirement would limit the service of a board member to no more than 10 years or past the age of 72, whichever comes first. OFHEO believes that a limit on years of service and age would promote the highest level of functioning of the board of directors. This approach has been undertaken by the Enterprises in various forms and has acceptance in a number of corporate governance programs.<sup>11</sup> OFHEO invites comments on alternative age limits or term of service limits.

OFHEO requires conformance with certain rules of the NYSE in its current corporate governance regulation. OFHEO is proposing that a majority of the board members of an Enterprise be independent under the rules of the NYSE.<sup>12</sup> Notably, OFHEO makes no distinction between those board members who are elected by shareholders and those who are appointed by the President. Thus, if one or more vacancies exist on a board among either elected or appointed shareholders, a majority of seated board members is required. Under the final NYSE rule Section 303A.02:

(a) No board member qualifies as "independent" unless the board of directors affirmatively determines that the director has no material relationship with the listed company (either directly, or as a partner, shareholder, or officer of an organization that has a relationship with the company). Companies must disclose these determinations.

\* \* \* \* \*

(b) In addition:

<sup>11</sup> *Report of Special Examination*, supra, note 2, at 166. An age limit and term limit will work well in tandem and have been part of Enterprise bylaws in one form or another.

<sup>12</sup> Final NYSE rule Section 303A.

<sup>6</sup> Final NYSE Corporate Governance Rules (Nov. 4, 2003), Section 303A. The NYSE final Corporate Governance Rules may be found at <http://www.nyse.com>. Note that except for final NYSE rule Section 303A.08, which became effective June 30, 2003, listed companies have until the earliest of their first annual meeting after January 15, 2004, or October 31, 2004, to comply with the new rules. The Enterprises are companies listed on the NYSE. As listed companies, the rules of the NYSE, including those addressing corporate governance, are applicable to the Enterprises.

<sup>7</sup> Pub. L. 107-204 (Jul. 30, 2002).

<sup>8</sup> See <http://www.fanniemae.com/ir/sec/index.html?s=SEC+filings> for Fannie Mae and [http://www.freddie.mac.com/news/archives/investors/2003/restatement\\_112103.html](http://www.freddie.mac.com/news/archives/investors/2003/restatement_112103.html) for Freddie Mac.

<sup>9</sup> The existing corporate governance regulation provides that the corporate governance practices and procedures of the Enterprises must comply with their respective chartering act and other Federal law, rules, and regulations, and that they must be consistent with the safe and sound operations of the Enterprise. 12 CFR 1710.10(a), 67 FR 38361, 38370 (Jun. 4, 2002).

<sup>10</sup> See *Report of Special Examination*, supra, note 2, at 164. The concept of a non-executive chairman has support in recent discussions on improvements to corporate governance. For example, see General Accounting Office, Testimony of Comptroller General Walker before Senate Banking Committee, *Government-Sponsored Enterprises: A Framework for Strengthening GSE Governance and Oversight*, GAO-04-269T (February 10, 2004) (calling for separation of Chairman and CEO positions at Fannie Mae and Freddie Mac).

(i) A director who is an employee, or whose immediate family member is an executive officer, of the company is not independent until three years after the end of such employment relationship.

\* \* \* \* \*

(ii) A director who receives, or whose immediate family member receives, more than \$100,000 per year in direct compensation from the listed company, other than director and committee fees and pension or other forms of deferred compensation for prior service (provided such compensation is not contingent in any way on continued service), is not independent until three years after he or she ceases to receive more than \$100,000 per year in such compensation.

\* \* \* \* \*

(iii) A director who is affiliated with or employed by, or whose immediate family member is affiliated with or employed in a professional capacity by, a present or former internal or external auditor of the listed company is not "independent" until three years after the end of affiliation or the employment or auditing relationship.

(iv) A director who is employed, or whose immediate family member is employed, as an executive officer of another company where any of the listed company's present executives serve on that company's compensation committee is not "independent" until three years after the end of such service or the employment relationship.

(v) A director who is an executive officer or an employee, or whose immediate family member is an executive officer, of a company that makes payments to, or receives payments from, the listed company for property or services in an amount which, in any single fiscal year, exceeds the greater of \$1 million, or 2% of such other company's consolidated gross revenues, is not "independent" until three years after falling below such threshold.

OFHEO is proposing to incorporate the NYSE rule by reference because the rule adequately covers what constitutes independence. As expressly provided by proposed § 1710.30, discussed below, OFHEO would have the authority to provide for a different definition of the term "independent board member" or to provide additional guidance covering general or specific circumstances, if necessary in light of the special characteristics of the two Enterprises, including but not limited to circumstances where a board member has prior affiliation with an accounting firm currently serving as auditor of the Enterprise.

In addition, the proposed section would address board meetings. It would require that the board of directors of an Enterprise meet at least twice a quarter to carry out its obligations and duties under applicable laws, rules, regulations, and guidelines. Meetings must be frequent enough to ensure that

the board of directors can exercise adequate oversight of management. OFHEO determined in its review that the meetings of the board of directors of Freddie Mac were too infrequent to address the issues presented by a company of its size and complexity and also were less frequent than those of other public companies. To meet the responsibilities of directors in their oversight of a major financial firm, additional meetings are merited.<sup>13</sup>

The proposed section would also require that the non-management directors of an Enterprise meet at regularly scheduled executive sessions without management participation in order to promote open discussion.<sup>14</sup> The proposed section would consolidate without substantive change the existing requirement of the current corporate governance regulation with respect to the constitution of a quorum of the board of directors and the prohibition against a board member voting by proxy.

Furthermore, the proposed section would require that management of an Enterprise must provide board members with such adequate and appropriate information that a reasonable board member would find important to the fulfillment of his or her fiduciary duties and obligations.<sup>15</sup>

Finally, the proposed section would require, at least annually, the board of directors to review, with appropriate professional assistance, requirements of laws, regulations, rules, and guidelines that are applicable to its activities and duties.<sup>16</sup>

#### *Section 1710.12 Committees of Board of Directors*

OFHEO is proposing to add a requirement to § 1710.11, redesignated as § 1710.12, that a committee of the board of directors of an Enterprise meet as frequently as necessary to carry out its obligations and duties and to exercise adequate oversight of management.<sup>17</sup>

The current corporate governance regulation requires that an Enterprise establish audit and compensation committees of the board of directors. OFHEO is proposing to add the requirement that an Enterprise establish a nominating/corporate governance

committee consistent with the final NYSE rules.<sup>18</sup>

The amended section would continue to require that committees of the board of directors comply with NYSE rules.<sup>19</sup> The NYSE rules address, among other things, the independence of audit committee members; the audit committee's responsibility to select and oversee the issuer's independent accountant; procedures for handling complaints regarding the issuer's accounting practices; the authority of the audit committee to engage advisors; and, funding for the independent auditor and any outside advisors engaged by the audit committee.

The amended section would also require that audit committees comply with the requirements set forth in section 301 of the SOA, which address, among other things, audit committee responsibilities, independence, establishment of complaint procedures, and authority to engage advisers, as well as adequate funding of the committee. The reference to the SOA and the final NYSE rules would not restrict the authority of OFHEO to mandate additional requirements by regulation, guideline, or order.

#### *Section 1710.13 Compensation of Board Members, Executive Officers, and Employees*

OFHEO is proposing to amend § 1710.12, redesignated as § 1710.13, by adding language that would prohibit compensation in excess of what is appropriate for these government sponsored enterprises, in addition to what is reasonable (as the section currently reads) and consistent with their long-term goals. The addition of this language is intended to underscore the impropriety of compensation incentives that excessively focus the attention of management and employees on short-term earnings performance. Incentives focused primarily on short-term earnings may lead to improper conduct at an Enterprise, as OFHEO discovered in its investigation of Freddie Mac.<sup>20</sup> Financial incentives at the Enterprises should foster a management culture in which effective consideration is given to operational stability and legal and regulatory compliance.<sup>21</sup> As noted above, OFHEO

<sup>18</sup> Final NYSE rule Section 303A.04.

<sup>19</sup> See final NYSE rules Section 303A.06 and .07. The final NYSE rule Section 303A.06 requires with respect to the audit committee that listed companies must have an audit committee that satisfies the requirements of Rule 10A-3 under the Securities Exchange Act of 1934.

<sup>20</sup> See *Report of Special Examination, supra*, note 2, at 164.

<sup>21</sup> Consent Order, *supra*, note 5, at Art. 2, Para. 14.

<sup>13</sup> See *Report of Special Examination, supra*, note 2, at 166.

<sup>14</sup> See final NYSE rule Section 303A.03.

<sup>15</sup> See *Report of Special Examination, supra*, note 2, at 166.

<sup>16</sup> See Consent Order, *supra*, note 5, at Art. II, Para. 10.

<sup>17</sup> See *Report of Special Examination, supra*, note 2, at 166.

has determined, in light of its experience with Freddie Mac and given the Federal charters, public mission, and size and role in capital markets of the Enterprises, that Fannie Mae and Freddie Mac should be required to adhere to certain policies that may not be applicable to all companies but should nevertheless apply to them. The proposed compensation requirement in no way detracts from the obligations of board members and management to meet their responsibilities shareholders, but reflects the attention that needs to be paid as well to other important considerations in directing the course and conduct of an Enterprise.

A new paragraph would require the chief executive officer and chief financial officer to reimburse the Enterprise if the Enterprise is required to prepare an accounting restatement due to the material noncompliance of the Enterprise, as a result of misconduct, with any financial reporting requirement. Reimbursement would be made in accordance with section 304 of the SOA. Section 304 would require reimbursement of (1) any bonus or other incentive-based, equity or option-based compensation received by such person from the Enterprise during the 12-month period following the first public issuance of the financial document embodying such financial reporting requirement; and (2) any profits realized from the sale or disposition of securities of the Enterprise that such person owned or controlled during that 12-month period.

The provisions of the proposed paragraph would in no manner limit the authority of OFHEO to take any appropriate enforcement action against an Enterprise or any of its board members or executive officers.

#### *Section 1710.14 Code of Conduct and Ethics*

OFHEO is proposing to amend § 1710.14 by revising the section heading to read "Code of Conduct and Ethics," and by referencing the standards set forth under section 406 of the SOA. Section 406 would provide that the code of conduct and ethics include standards as are reasonably necessary to promote (1) honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships; (2) full, fair, accurate, timely, and understandable disclosure in the periodic reports required to be filed by the issuer of the report, and (3) compliance with applicable governmental rules and regulations. In conducting its supervisory examination process,

OFHEO would ensure the adequacy of the code of conduct and ethics of an Enterprise.

In addition, the proposal would require that, at least every three years, an Enterprise must review the adequacy of its code of conduct and ethics to ensure that it is consistent with best practices.

#### *Section 1710.15 Conduct and Responsibilities of Board of Directors*

Section 1710.15 of the current corporate governance regulation establishes minimum standards for the conduct and responsibilities of the board of directors of an Enterprise. OFHEO is proposing to amend § 1710.15 to add a requirement with respect to the conduct and responsibilities of the board of directors. The proposal would require that the board of directors must remain reasonably informed of the condition, activities, and operations of the Enterprise. The proposal would also describe the responsibility of the board of directors to have in place policies and procedures to assure its oversight of corporate strategy, major plans of action, risk policy, programs for legal and regulatory compliance, and corporate performance to include prudent plans for growth and allocation of adequate resources to manage operations risk.<sup>22</sup>

Finally, the proposal would add a paragraph expressly addressing the oversight responsibility related to extensions of credit to board members and executive officers, consistent with the proposed § 1710.16, discussed below. In conducting its supervisory examination process, OFHEO would ensure that adequate policies and procedures are in place.

#### *Section 1710.16 Prohibition of Extensions of Credit to Board Members and Executive Officers*

OFHEO is proposing to add § 1710.16, which would limit extensions of credit to board members and other insiders as provided by section 402 of the SOA. Section 402 of the SOA would prohibit an Enterprise from directly or indirectly, including through any subsidiary, extending credit or arranging for the extension of credit in the form of a personal loan to or for any board member or executive officer of the Enterprise. The proposed section would conform OFHEO's regulation to that of other financial service regulators in addressing extensions of credit by companies they supervise.

<sup>22</sup> See *Special Report of Examination, supra*, note 2, at 165-168.

#### *Section 1710.17 Certification of Disclosures by Chief Executive Officer and Chief Financial Officer*

OFHEO is proposing to add § 1710.17, which would require compliance with sections 302 of the SOA that mandates certain certifications of quarterly and annual reports by the chief executive officer and chief financial officer of an Enterprise. The proposed section would conform OFHEO's supervisory regime to those of other financial regulators. The proposal would assure review, endorsement, and undertaking of responsibility by individuals required to certify public disclosures. It would not limit OFHEO from requiring certifications by additional parties or additional disclosures.

#### *Section 1710.18 Change of External Audit Partner and Audit Firm*

OFHEO is proposing to add § 1710.18, which would prohibit an Enterprise from accepting audit services from an external auditor if either the lead (or coordinating) external audit partner, who has primary responsibility for the external audit of the Enterprise, or the external audit partner, who has primary responsibility for reviewing the external audit, has performed audit services for the Enterprise in each of the five previous fiscal years. This prohibition is consistent with Section 203 of the SOA that makes it unlawful for a registered public accounting firm to provide audit services to a public company by such audit partners in excess of five previous fiscal years.

OFHEO is also proposing a requirement that, at least every ten years, an Enterprise must change its external audit firm. Public companies are currently required to rotate their audit partners, but not the audit firm. In light of its experience with Freddie Mac, OFHEO has determined that Fannie Mae and Freddie Mac should be required to adhere to certain policies that may not be applicable to all companies but should nevertheless apply to them. Given the importance of having the most impartial oversight and review of accounting and other matters, OFHEO is proposing that the Enterprises should secure a different external audit firm on a periodic basis.

To allow a transition, OFHEO would require that Fannie Mae change its external auditor no later than January 1, 2006, and thereafter no less frequently than every ten years; and that Freddie Mac change its external auditor no later than January 1, 2009, and thereafter no less frequently than every ten years.

### *Section 1710.19 Compliance and Risk Management Programs*

Proposed § 1710.19 would require an Enterprise to establish and maintain a compliance program headed by a person who reports directly to the chief executive officer. The program would be required to ensure compliance with all applicable laws, rules, regulations, and guidelines, and adherence to best practices; establish written internal controls and disclosure controls and procedures; and provide for periodic meetings of the board of directors to ensure the board is able to assess adherence to and adequacy of current policies and procedures of the Enterprise regarding compliance and adjust such policies and procedures, as required.

In addition, the proposed section would require an Enterprise to establish and maintain a risk management program, headed by a person who would manage the overall risk oversight function of the Enterprise. The program would also be required to provide for periodic meetings of the board of directors to ensure the board is able to assess adherence to and adequacy of current policies and procedures of the Enterprise regarding risk management and adjust such policies and procedures, as required. For example, in order to assure that the board of directors may assess adherence to compliance and risk management policies, periodic meetings may be established between management personnel heading such programs and the audit committee and other relevant committees of the board of directors of the Enterprise.

The establishment and maintenance of compliance and risk management programs are essential for the continued safe and sound operations of the Enterprises.<sup>23</sup> The establishment of such programs will assist the board of directors in managing their responsibilities to oversee the adequacy of policies and procedures for compliance and risk management.

Finally, the proposed section would provide that if an Enterprise deregisters or does not register its common stock with the Commission, the Enterprise must continue to comply with sections 301, 302, 404, 402, and 406 of the SOA, subject to such additional requirements as provided by § 1710.30. It would also require that a registered Enterprise maintain its registered status, unless it provides 60 days prior written notice to the Director stating its intent to

deregister and its understanding that it will remain subject to certain requirements of the SOA, as provided above.

### **Subpart D—Modification of Certain Provisions**

#### *Section 1710.30 Modification of Certain Provisions*

OFHEO is proposing to move provisions of its existing regulation and to maintain similar treatment for new provisions in § 1710.30 to make clear that OFHEO, in referencing other sources for corporate governance standards, may modify such standards to meet its statutory responsibilities. References to standards of Federal or state law (including the Revised Model Corporation Act), or NYSE rules in §§ 1710.10,<sup>24</sup> 1710.11, 1710.12, 1710.17, and 1710.19 do not limit the ability of OFHEO to modify such standards as necessary with notice to the Enterprises.

#### **Regulatory Impact**

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

The proposed amendments to the corporate governance regulation are not classified as an economically significant rule under Executive Order 12866 because they 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. This proposed regulation, however, has been submitted to the Office of Management and Budget for review under other provisions of Executive Order 12866 as a significant regulatory action.

##### *Executive Order 13132, Federalism*

Executive Order 13132 requires that Executive departments and agencies identify regulatory actions that have significant federalism implications. A regulation has federalism implications if it has substantial direct effects on the states, on the relationship or

distribution of power between the Federal Government and the states, or on the distribution of power and responsibilities among various levels of government. The Enterprises are federally chartered corporations supervised by OFHEO. The corporate governance regulation and the proposed amendments thereto set forth minimum corporate governance standards with which the Enterprises must comply for Federal supervisory purposes. The corporate governance regulation requires that an Enterprise elect a body of state corporate law or the Revised Model Corporation Act to follow in terms of its corporate practices and procedures. The corporate governance regulation and the proposed amendments thereto do not affect in any manner the powers and authorities of any state with respect to the Enterprises or alter the distribution of power and responsibilities between Federal and state levels of government. Therefore, OFHEO has determined that the corporate governance regulation and the proposed amendments thereto, if adopted, have no federalism implications that warrant the preparation of a Federalism Assessment in accordance with Executive Order 13132.

##### *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 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 amendments to the corporate governance regulation under the Regulatory Flexibility Act. The General Counsel of OFHEO certifies that the corporate governance regulation and the proposed amendments thereto, if adopted, are not likely to have a significant economic impact on a substantial number of small business entities because it 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.

<sup>23</sup> See *Special Report of Examination, Recommended Actions*, Nos. 9 and 10, *supra*, note 2, at 165–168, and *Consent Order*, *supra*, note 5.

<sup>24</sup> Section 1710.10 provides generally that an Enterprise must follow the corporate governance practices and procedures of the law of the jurisdiction in which the principal office of the Enterprise is located, Delaware General Corporation Law, or the Revised Model Business Corporation Act.

Accordingly, for the reasons stated in the preamble, OFHEO proposes to amend 12 CFR part 1710 to subchapter C of chapter XXVII to read as follows:

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

1. The authority citation for part 1710 continues to read as follows:

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

#### **§ 1710.13 [Removed]**

2. Remove § 1710.13.

#### **§§ 1710.11 and 1710.12 [Redesignated]**

3. Redesignate §§ 1710.11 and 1710.12 as new §§ 1710.12 and 1710.13, respectively;

4. Add a new § 1710.11 to read as follows:

#### **§ 1710.11 Board of directors.**

(a) *Membership.*

(1) *Chairperson and chief executive officer.* Effective January 1, 2007, the chairperson of the board of directors of an Enterprise may not also serve as the chief executive officer of the Enterprise.

(2) *Limits on service of board members.* No director of an Enterprise may serve on the board of directors for more than 10 years or past the age of 72, whichever comes first.

(3) *Independence of board members.* A majority of seated members of the board of directors of an Enterprise shall be independent board members, as defined under rules set forth by the NYSE.

(b) *Meetings, quorum and proxies, information, and annual review.*

(1) *Frequency of meetings.* The board of directors of an Enterprise shall meet at least twice a quarter to carry out its obligations and duties under applicable laws, rules, regulations, and guidelines.

(2) *Non-management board member meetings.* Non-management directors of an Enterprise shall meet at regularly scheduled executive sessions without management participation.

(3) *Quorum of board of directors; proxies not permissible.* For the transaction of business, a quorum of the board of directors of an Enterprise is at least a majority of the seated board of directors and a board member may not vote by proxy.

(4) *Information.* Management of an Enterprise shall provide a board member of the Enterprise with such adequate and appropriate information that a reasonable board member would find important to the fulfillment of his or her fiduciary duties and obligations.

(5) *Annual review.* At least annually, the board of directors of an Enterprise shall review, with appropriate

professional assistance, the requirements of laws, regulations, rules, and guidelines that are applicable to its activities and duties.

5. Amend newly designated § 1710.12 by revising paragraph (b) and by adding new paragraph (c) to read as follows:

#### **§ 1710.12 Committees of board of directors.**

\* \* \* \* \*

(b) *Frequency of meetings.* A committee of the board of directors of an Enterprise shall meet with sufficient frequency to carry out its obligations and duties under applicable laws, rules, regulations, and guidelines.

(c) *Required committees.* An Enterprise shall provide for the establishment of, however styled, the following committees of the board of directors, which committees shall be in compliance with the charter, independence, composition, expertise, duties, responsibilities, and other requirements set forth under section 301 of the Sarbanes-Oxley Act of 2002, Public Law 107–204 (Jul. 30, 2002), as from time to time amended (SOA), with respect to the audit committee, and under rules issued by the NYSE, as from time to time amended (NYSE rules):

- (1) Audit committee;
- (2) Compensation committee; and
- (3) Nominating/corporate governance committee.

6. Amend newly designated § 1710.13 by revising newly designated paragraph (a) and by adding a new paragraph (b) to read as follows:

#### **§ 1710.13 Compensation of board members, executive officers, and employees.**

(a) *General.* Compensation of board members, executive officers, and employees of an Enterprise shall not be in excess of that which is reasonable and appropriate, shall be commensurate with the duties and responsibilities of such persons, shall be consistent with the long-term goals of the Enterprise, shall not focus solely on earnings performance, but shall take into account operational stability and legal and regulatory compliance as well, and shall be undertaken in a manner that complies with applicable laws, rules, and regulations.

(b) *Disgorgement.* If an Enterprise is required to prepare an accounting restatement due to the material noncompliance of the Enterprise, as a result of misconduct, with any financial reporting requirement under law or regulation, the chief executive officer and chief financial officer of the Enterprise shall reimburse the Enterprise as provided under section 304 of the SOA.

7. Amend § 1710.14 by revising the section heading, revising newly designated paragraph (a) and adding new paragraphs (b) and (c) to read as follows:

#### **§ 1710.14 Code of conduct and ethics.**

(a) *General.* An Enterprise shall establish and administer a written code of conduct and ethics that is reasonably designed to assure the ability of board members, executive officers, and employees of the Enterprise to discharge their duties and responsibilities, on behalf of the Enterprise, in an objective and impartial manner, and that includes standards required under section 406 of the SOA.

(b) *Review.* Not less than once every three years, an Enterprise shall review the adequacy of its code of conduct and ethics to ensure that it is consistent with best practices.

8. Amend § 1710.15 by revising paragraph (b) to read as follows:

#### **§ 1710.15 Conduct and responsibilities of board of directors.**

\* \* \* \* \*

(b) *Conduct and responsibilities.* The board of directors of an Enterprise is responsible for directing the conduct and affairs of the Enterprise in furtherance of the safe and sound operation of the Enterprise and shall remain reasonably informed of the condition, activities, and operations of the Enterprise. The responsibilities of the board of directors include having in place adequate policies and procedures to assure its oversight of, among other matters, the following:

(1) Corporate strategy, major plans of action, risk policy, programs for legal and regulatory compliance and corporate performance, including but not limited to prudent plans for growth and allocation of adequate resources to manage operations risk;

(2) Hiring and retention of qualified senior executive officers and succession planning for such senior executive officers;

(3) Compensation programs of the Enterprise;

(4) Integrity of accounting and financial reporting systems of the Enterprise, including independent audits and systems of internal control;

(5) Process and adequacy of reporting, disclosures, and communications to shareholders, investors, and potential investors;

(6) Extensions of credit to board members and executive officers; and

(7) 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.

\* \* \* \* \*

9. Add new § 1710.16 to read as follows:

**§ 1710.16 Prohibition of extensions of credit to board members and executive officers.**

An Enterprise may not directly or indirectly, including through any subsidiary, extend or maintain credit, arrange for the extension of credit, or renew an extension of credit, in the form of a personal loan to or for any board member or executive officer of the Enterprise, as provided by section 402 of the SOA.

10. Add new § 1710.17 to read as follows:

**§ 1710.17 Certification of disclosures by chief executive officer and chief financial officer.**

The chief executive officer and the chief financial officer of an Enterprise shall read each quarterly report and annual report issued by the Enterprise and such reports shall include certifications by such officers as required by section 302 of the SOA.

11. Add new § 1710.18 to read as follows:

**§ 1710.18 Change of external audit partner and audit firm.**

(a) *Change of external audit partner.* An Enterprise may not accept audit services from an external auditor if either the lead (or coordinating) external audit partner who has primary responsibility for the external audit of the Enterprise or the external audit partner who has primary responsibility for reviewing the external audit has performed audit services for the Enterprise in each of the five previous fiscal years.

(b) *Change of external audit firm.* The Federal National Mortgage Association shall change its external auditor no later than January 1, 2006, and thereafter no less frequently than every ten years; and the Federal Home Loan Mortgage Corporation shall change its external auditor no later than January 1, 2009, and thereafter no less frequently than every ten years.

12. Add new § 1710.19 to read as follows:

**§ 1710.19 Compliance and risk management programs; compliance with other laws.**

(a) *Compliance program.* An Enterprise shall establish and maintain a compliance program, headed by a person who reports directly to the chief executive officer of the Enterprise, that shall—

(1) Ensure that the Enterprise complies with all applicable laws, rules, regulations, and guidelines, and adheres to best practices;

(2) Establish written internal controls and disclosure controls and procedures;

(3) Provide for periodic meetings of the board of directors to ensure the board is able to assess adherence to and adequacy of current policies and procedures of the Enterprise regarding compliance and adjust such policies and procedures, as required.

(b) *Risk management program.* An Enterprise shall establish and maintain a risk management program, headed by a person who reports directly to the chief executive officer of the Enterprise, that shall—

(1) Manage the overall risk oversight function of the Enterprise;

(2) Provide for periodic meetings of the board of directors to ensure the board is able to assess adherence to and adequacy of current policies and procedures of the Enterprise regarding risk management and adjust such policies and procedures, as required.

(c) *Compliance with other laws.*

(1) If an Enterprise deregisters or does not register its common stock with the U.S. Securities and Exchange Commission (Commission) under the Securities Exchange Act of 1934, the Enterprise shall continue to comply with sections 301, 302, 304, 402, and 406 of the SOA, subject to such requirements as provided by § 1710.30 of this part.

(2) An Enterprise that has its common stock registered with the Commission shall maintain such registered status, unless it provides 60 days prior written notice to the Director stating its intent to deregister and its understanding that it will remain subject to the requirements of sections 301, 302, 304, 402, and 406 of the SOA, subject to such requirements as provided by § 1710.30 of this part.

13. Add new subpart D to read as follows:

**Subpart D—Modification of Certain Provisions**

**§ 1710.30 Modification of certain provisions.**

In connection with standards of Federal or state law (including the Revised Model Corporation Act) or NYSE rules that are made applicable to an Enterprise by §§ 1710.10, 1710.11, 1710.12, 1710.17, and 1710.19 of this part, the Director, in his or her sole discretion, may modify such standards upon written notice to the Enterprise.

Dated: April 7, 2004.

**Armando Falcon, Jr.,**

*Director, Office of Federal Housing Enterprise Oversight.*

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**DEPARTMENT OF TRANSPORTATION**

**Federal Aviation Administration**

**14 CFR Part 39**

[Docket No. 2004–CE–02–AD]

RIN 2120–AA64

**Airworthiness Directives; deHavilland Inc. Models DHC–2 Mk. I and DHC–2 Mk. II Airplanes and Bombardier Inc. Model (Otter) DHC–3 Airplanes**

**AGENCY:** Federal Aviation Administration (FAA), DOT.

**ACTION:** Notice of proposed rulemaking (NPRM).

**SUMMARY:** The FAA proposes to adopt a new airworthiness directive (AD) for all deHavilland Inc. Models DHC–2 Mk. I and DHC–2 Mk. II airplanes and for all Bombardier Inc. Model (Otter) DHC–3 airplanes powered by radial engines. This proposed AD would require you to visually inspect the firewall ignition plugs and receptacles for proper lockwire security and replace or modify as appropriate. This proposed AD is the result of mandatory continuing airworthiness information (MCAI) issued by the airworthiness authority for Canada. We are issuing this proposed AD to prevent loss of ignition systems during flight caused by improper lockwire security, which could result in engine failure. This failure could lead to a forced landing of the airplane.

**DATES:** We must receive any comments on this proposed AD by May 7, 2004.

**ADDRESSES:** Use one of the following to submit comments on this proposed AD:

- *By mail:* FAA, Central Region, Office of the Regional Counsel, Attention: Rules Docket No. 2004–CE–02–AD, 901 Locust, Room 506, Kansas City, Missouri 64106.
- *By fax:* (816) 329–3771.
- *By e-mail:* 9-ACE-7-Docket@faa.gov. Comments sent electronically must contain “Docket No. 2004–CE–02–AD” in the subject line. If you send comments electronically as attached electronic files, the files must be formatted in Microsoft Word 97 for Windows or ASCII.

You may get the service information identified in this proposed AD from Bombardier Aerospace Regional