News Release

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FHA SUSPENDS TAYLOR, BEAN & WHITAKER MORTGAGE CORP. AND PROPOSES TO SANCTION TWO TOP OFFICIALS

Ginnie Mae Issues Default Notice and Transfers Portfolio

WASHINGTON - The Federal Housing Administration (FHA) today suspended Taylor, Bean and Whitaker Mortgage Corporation (TBW) of Ocala, Florida, thereby preventing the Company from originating and underwriting new FHA-insured mortgages. The Government National Mortgage Association (Ginnie Mae) is also defaulting and terminating TBW as an issuer in its Mortgage-Backed Securities (MBS) program and is ending TBW's ability to continue to service Ginnie Mae securities. This means that, effective immediately, TBW will not be able to issue Ginnie Mae securities, and Ginnie Mae will take control of TBW's nearly $25 billion Ginnie Mae portfolio.

FHA and Ginnie Mae are imposing these actions because TBW failed to submit a required annual financial report and misrepresented that there were no unresolved issues with its independent auditor even though the auditor ceased its financial examination after discovering certain irregular transactions that raised concerns of fraud. FHA's suspension is also based on TBW's failure to disclose, and its false certifications concealing, that it was the subject of two examinations into its business practices in the past year.

"Today, we suspend one company but there is a very clear message that should be heard throughout the FHA lending world - operate within our standards or we won't do business with you," said HUD Secretary Shaun Donovan.

FHA Commissioner David Stevens said, "TBW failed to provide FHA with financial records that help us to protect the integrity of our insurance fund and our ability to continue a 75-year track record of promoting, preserving and protecting the American Dream. We were also troubled that the Company not only failed to disclose it was a target of a multi-state examination and a separate action by the Commonwealth of Kentucky, but then falsely certified that it had not been sanctioned by any state. FHA won't tolerate irresponsible lending practices."

Rules and Regulations

Federal Register
Vol. 70, No. 65
Wednesday, April 6, 2005

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: Final amendments.

SUMMARY: The Office of Federal Housing Enterprise Oversight (OFHEO) is issuing amendments to its corporate governance regulation establishing corporate governance standards applicable to the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation in order to further promote the safety and soundness of their operations.

DATES: Effective June 6, 2005.

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:

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 (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 soundly in compliance with applicable laws, rules, and regulations.

In furtherance of its supervisory responsibilities, in 2002, OFHEO published a final corporate governance regulation, taking into consideration comments filed in response to an earlier proposed regulation.[1] The corporate governance regulation sets forth 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*[2] *(Report of Special Examination),* and based on the experience of OFHEO supervising the activities of the Enterprises, as well as developments in law, OFHEO is amending 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.''[3] The *Report of Special Examination,* among other things, made specific recommendations with respect to practices in corporate governance that Freddie Mac should follow and that OFHEO should require.[4] 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 practices that were recommended in the *Report of Special Examination,* as well as other remedial steps.[5]

Through ongoing oversight and supervision of both Enterprises and its special examinations, OFHEO has gained insights as to the need for enhancements or adjustments in the existing corporate governance standards for both Enterprises. Thus, OFHEO proposed to add prudential requirements to its corporate governance regulation that would have general applicability consistent with the practices recommended or required by the *Report of Special Examination* or the Consent Order.

OFHEO also 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 which makes them unlike many other large financial institutions in some significant respects. Since their creation, the Enterprises have grown to become two of the largest and highly leveraged financial companies in the world in terms of assets, and together they control a majority share of the secondary market for conforming mortgages. Yet they are relatively small in terms of their total numbers of employees, and have a unique board

[1] 12 CFR Part 1710, 67 FR 38361 (June 4, 2002).

[2] 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.*

[3] *Id.,* at 4 (footnote omitted).

[4] *Id.,* at 163–171.

[5] 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.*

structure, public mission and regulatory framework. In addition, due to their Government sponsorship, the Enterprises are not as susceptible to some forms of market and management discipline. These distinctive characteristics also played a large part in the determination that Fannie Mae and Freddie Mac should adhere to certain policies that may not be applicable to other companies.

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

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.[9] Upon registration, Freddie Mac will be subject to the same requirements. To help meet its statutory responsibilities, 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 Enterprise corporate governance in response to a violation of its corporate governance regulation, including behavior that violates laws or requirements set forth therein.

Comments Received

The proposed amendments were published on April 12, 2004 (69 FR 19126). OFHEO received comments from 19 commenters as follows: (1) An individual shareholder of an Enterprise; (2) an individual; (3) Ernst & Young, an accounting firm; (4) America's Community Bankers, a trade association representing community banks; (5) National Association of Corporate Directors, an educational, publishing, and research organization on board leadership and a membership association for boards, directors, director candidates, and board advisers; (6) PriceWaterhouseCoopers, an accounting firm; (7) Business Roundtable, an association of chief executive officers of corporations; (8) Chamber of Commerce, a business federation; (9) American Institute of Certified Public Accountants, a professional association of certified public accountants; (10) KPMG, an accounting firm; (11) Deloitte & Touche, an accounting firm; (12) Freddie Mac; (13) Consumer Mortgage Coalition, a trade association of national mortgage lenders, servicers, and service providers; (14) an individual, Dean's Professor of Financial Regulatory Policy, University of Massachusetts-Amherst; (15) Nominating and Corporate Governance Committee of Fannie Mae; (16) FM Policy Focus, a coalition of six financial services and housing related trade associations; (17) Independent Community Bankers of America, a trade association of community banks; (18) Mortgage Insurance Companies of America, a trade association representing the private mortgage insurance industry; and, (19) Fannie Mae.

Response to Comments

Board of Directors (§ 1710.11)

OFHEO proposed a section that would add requirements and consolidate existing requirements relating to the board of directors of an Enterprise. OFHEO carefully considered the comments provided.

Separate Chairperson/Chief Executive Officer (§ 1710.11(a)(1))

One provision would require an Enterprise to prohibit the chairperson of the board from also serving as chief executive officer of the Enterprise. Often drawing on the experience and circumstances of non-government sponsored companies, many commenters urged that OFHEO leave this matter to the determination of the board of directors or suggested that a separate chairperson and chief executive officer is not in the best interests of the shareholders. The commenters who urged such a result did not focus on the impact of the unique characteristics of the Enterprises, such as their size, public mission, insulation from full market discipline and distinct board structure—characteristics that counsel against the concentration of power in a single chairperson/chief executive officer. Likewise, commenters did not make a substantial case for disregarding the lessons learned in the special examination of Freddie Mac about the risks of consolidating the chairperson and chief executive officer positions.

OFHEO believes that separating the functions of chairperson and chief executive officer is prudent for safe and sound operations of the Enterprises because it strengthens 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 each Enterprise's management team.[10] 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, but also in light of the recent experience at Freddie Mac and the experience of OFHEO supervising both Enterprises. In the case of Freddie Mac, an earlier separation of the two roles could have caused the board to provide stronger independent guidance to management and identify problems sooner. OFHEO believes that a separation of the chairperson and the

[6] 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 earlier 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.

[7] Pub. L. 107–204 (Jul. 30, 2002).

[8] See *http://www.fanniemae.com/ir/sec/index.jtml?s=SEC+filings* for Fannie Mae and *http://www.freddiemac.com/news/archives/investors/2003/restatement_112103.html* for Freddie Mac.

[9] The existing corporate governance regulation provides that the corporate governance practices and procedures of an Enterprise must comply with its respective chartering act and *other Federal law, rules, and regulations,* and that the practices and procedures must be consistent with the safe and sound operations of the Enterprise. 12 CFR 1710.10(a), 67 FR 38361, 38370 (Jun. 4, 2002).

[10] *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).

chief executive officer functions would enhance the effectiveness of changes being proposed in requirements for the boards of directors to meet their obligations and would promote the public interest in the safety and soundness of the Enterprises. Comments that this would limit the flexibility of the board to structure the company or limit corporate flexibility in general do not overcome the concern that OFHEO expressed for the benefits resulting from greater independence of the board and stronger oversight of these government sponsored enterprises.

OFHEO notes with approval that each Enterprise has now formally agreed to separate the positions of chairperson of the board and chief executive officer. Accordingly, the provision is not included in the final regulation at this time.

Term and Age Limits (§ 1710.11(a)(2))

A requirement that would limit the service of a board member to no more than 10 years or past the age of 72, whichever comes first, was proposed by OFHEO. One commenter approved of the limits, some commenters disapproved of the limits as undermining board leadership, and other commenters recommended transition periods or the ability to seek a waiver. Another commenter requested clarification that the age and term limits be applied as of the date of the meeting of the shareholders.

OFHEO found that a limit on years of service and age for the board members promotes an appropriate level of functioning of the board, strengthens the diversity and expertise of the board, and enhances its ability to respond to the unique, but constantly evolving business environment in which each Enterprise operates.[11] Overall, OFHEO determined that the potential loss of familiarity with the company and the possibility of having an experienced board member leave due to a fixed term based on age or years of service were outweighed by the experience of OFHEO supervising both Enterprises and the possibility of an entrenched board's failing to oversee adequately the company.

In response to comments, OFHEO is making changes to the provision to clarify that a board member who meets the age and term limits as of the date of his or her election or appointment may serve his or her full term. In addition, express language has been added to provide for a waiver by the Director, for good cause consistent with the supervisory responsibilities of OFHEO.

Independence of Board Members (§ 1710.11(a)(3))

OFHEO proposed that a majority of the seated board members of an Enterprise be independent under the rules of the NYSE.[12] 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.

One commenter recommended that OFHEO should supplement the NYSE standards with additional standards. OFHEO determined that the NYSE rule appropriately covers what constitutes independence. As expressly provided by proposed § 1710.30, discussed below, OFHEO has 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.

Another commenter recommended that the independence standard apply to all board members. Section 1710.11(a)(3), as proposed, does not differentiate between elected and presidentially-appointed board members. It was also requested that the provision reflect that the NYSE rules apply as changed from time to time by the NYSE. A technical revision has been made to the provision expressly to address this point. Finally, one commenter recommended that the term ''seated'' be defined. The term is intended to encompass those elected or appointed board members who serve on the board; OFHEO, however, does not believe it useful at this time to define further the term in the regulation.

Frequency of Meetings (§ 1710.11(b)(1))

The proposal 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. One commenter supported the frequency requirement while another commenter suggested that this requirement amounts to micromanagement of the Enterprises. Other commenters suggested that requiring eight meetings a year, with at least one each calendar quarter was more appropriate. Another commenter suggested that the number of meetings be set in the aggregate, but the board be permitted to schedule meetings in such quarters as the board would determine. OFHEO determined that the number of meetings is reasonable and that spreading them over the course of the fiscal year is prudent.

Given the special nature of the Enterprises and the oversight required, OFHEO disagrees that the frequency requirement amounts to micromanagement or that requiring eight meetings a year is inappropriate. Meetings must be frequent enough to ensure that the board of directors can exercise adequate oversight of management. OFHEO determined in its review of Freddie Mac that the meetings of the board of directors were too infrequent to address the issues presented by the company, given its status, size, and complexity. OFHEO determined that to provide flexibility and to avoid practical issues such as requests for waivers and related procedural matters, the proposal would be adopted with the deletion of the requirement that two meetings occur per quarter. OFHEO has determined that the board of directors should meet no less than eight times a year and no less than once a calendar quarter.

Non-Management Board Meetings, Quorum of Board of Directors, Proxies (§ 1710.11(b)(2) and (3))

OFHEO received supporting comments on the provisions of § 1710.11(b)(2) and (3) and has issued them without change. The provisions require that the non-management directors of an Enterprise meet at regularly scheduled executive sessions without management participation in order to promote open discussion.[13] They also consolidate without substantive change the existing requirements of the current OFHEO 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.

Information (§ 1710.11(b)(4))

As proposed, § 1710.11(b)(4) would require that management of an Enterprise provide board members with information that is adequate and appropriate considering what a

[11] *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.

[12] Final NYSE rule Section 303A.

[13] For reference, see final NYSE rule Section 303A.03.

reasonable board member would find important to the fulfillment of his or her fiduciary duties and obligations to the Enterprise.[14] One commenter supported this requirement, while another recommended that it be limited to that information consistent with the requirements of the selected corporate governance law of the Enterprise. It would not be useful to limit information required by the selected corporate governance law because, unlike board members of state-chartered corporations, board members of the Enterprises have specific obligations set forth in the corporate governance regulation that may require additional information to fulfill such obligations. Therefore, OFHEO has determined not to limit the provision as requested and is adopting the provision as proposed.

Annual Review (§ 1710.11(b)(5))

The proposal would require, at least annually, that the Enterprise board of directors review requirements of laws, rules, regulations, and guidelines that are applicable to its activities and duties, with appropriate professional assistance.[15] One commenter recommended that the annual review be expanded to include an annual review of the effectiveness of the corporate governance system. OFHEO has determined not to adopt that recommendation in the context of review of the Enterprise board of director activities and duties. The provision is being adopted as proposed.

Committees of Board of Directors (§ 1710.12)

OFHEO proposed 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.[16]

The current corporate governance regulation requires that an Enterprise establish audit and compensation committees of the board of directors. OFHEO proposed to add a requirement that an Enterprise establish a nominating/corporate governance committee consistent with appropriate application of the final NYSE rules[17] and that the committees of the board of directors comply with NYSE rules.[18] The NYSE rules address, among other things, the independence of audit committee members; the responsibility of the audit committee 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.

As proposed, the amended section also would require that Enterprise 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 appropriate to the Enterprises'' situations and their oversight, as provided under § 1710.30.

OFHEO received one comment on this section that recommended that the provision should be made co-extensive with the corresponding NYSE rules issued pursuant to the SOA, which are incorporated by reference, as those rules may be interpreted or changed from time to time by the responsible bodies. OFHEO has determined that the section, as proposed, has incorporated by reference the appropriate NYSE and SOA section and that, as appropriate, OFHEO would look to the NYSE interpretation of the NYSE rules in determining whether an Enterprise was in compliance with this section. OFHEO has determined that it is unnecessary to state this in the section and § 1710.12 is adopted as proposed.

Compensation of Board Members, Executive Officers, and Employees (§ 1710.13)

OFHEO proposed 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 long-term goals that are addressed in the proposed language of the section.

Two commenters objected to the word ''appropriate'' in that it is not contained in 12 U.S.C. 4518, the statutory provision that requires the Director to prohibit an Enterprise from providing compensation to any executive officer that is not reasonable and comparable with compensation for employment in other similar businesses. The proposed provision is not intended to implement Section 4518, which is implemented by the OFHEO executive compensation regulation at 12 CFR part 1770. Section 1710.13 addresses not only certain covered executive officers, but as well board members and employees, and has as its primary focus the Enterprises—safety and soundness. Although compensation may be reasonable from some perspectives, as in not generally excessive or extreme, it may not be appropriate or suitable under specific circumstances. Thus, OFHEO has determined not to delete the word ''appropriate.''

While the circumstances involved and the foundation for addressing compensation in the corporate governance regulation may differ from those found in the area of executive compensation, the standards used by OFHEO for determining unreasonable, excessive, or inappropriate compensation are the same. In looking to reasonable compensation, OFHEO must consider the totality of circumstances for an Enterprise. This includes inquiry into compensation for comparable positions at other firms, to the degree they exist, along with less formulaic items such as the unique nature of the Enterprises, the responsibilities and duties of the individual involved, and the environment and circumstances that exist when the compensation is provided to the individual. Thus a numerical comparison alone might be inadequate for OFHEO to discharge its obligations in considering compensation. Factors such as an Enterprise's conduct, business challenges, compliance with the mission of the Enterprise, compliance with law and regulation, creation of profit or loss, leadership, suitability of incentive structures, and other relevant matters would be important to making a compensation determination under either the corporate governance rules or the executive compensation rules. In both instances, safety and soundness underlies the goals of Congress expressed in the enabling statute of OFHEO and Congress has clearly indicated that compensation may represent a safety and soundness

[14] *See Report of Special Examination, supra* note 2 at 166.

[15] *See* Consent Order, *supra* note 5 at Art. II, Para. 10.

[16] *See Report of Special Examination, supra* note 2 at 166, (discussing frequency of meetings).

[17] Final NYSE rule Section 303A.04.

[18] *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 ExchangeAct of 1934.

problem should it provide perverse incentives.

Section 1710.13(a), as proposed, is further intended to underscore the impropriety of compensation incentives that excessively focus the attention of management and employees on an Enterprise's 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.[19] Financial incentives at the Enterprises should foster a management culture in which primary consideration is given to risk management, operational stability and legal and regulatory compliance.[20] As noted above, OFHEO has determined, in light of its experience with Freddie Mac, its ongoing supervision of both Enterprises, and given their Federal charters, board structure, public mission, regulatory framework and status, size and role in capital markets, that Fannie Mae and Freddie Mac should be required to adhere to certain policies that may not be applicable to other companies. The compensation requirement in no way detracts from the obligations of Enterprise board members and management to meet their responsibilities to shareholders, but reflects the special attention that needs to be paid as well to other important public mission considerations in directing the course and conduct of an Enterprise.

One commenter recommended that executive incentives should expressly include no rewards for undue reliance on the Enterprise subsidy or any activity that would enlarge it. OFHEO has determined not to adopt that recommendation.

Section 1710.13(b) proposed to 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 of the SOA 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 other appropriate supervisory action against an Enterprise or any of its board members or executive officers pursuant to its enforcement authorities. Enforcement authorities of OFHEO include restitution that may be applied to situations involving conduct subject to reimbursement.

One commenter asked that the reimbursement requirement be clarified to apply to restatement of financial reporting under the securities laws. OFHEO has clarified the language to state so expressly and to note that this section does not limit other OFHEO remedial powers that may be brought to bear for failures to make adequate disclosures. Another commenter suggested that the reimbursement provision is not necessary in view of the broad remedial and civil money penalty powers of OFHEO. If it is retained, the commenter requested that the requirement should apply to Freddie Mac after it has returned to the timely filing of financial statements and completed the voluntary registration of its securities. OFHEO has determined to retain the reimbursement provision as proposed with certain clarifying and technical changes.[21]

Code of Conduct and Ethics (§ 1710.14)

OFHEO proposed 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 provides 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 and appropriateness of the code of conduct and ethics of an Enterprise. In addition, OFHEO proposed 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 practices appropriate for the Enterprise.

A few commenters recommended that OFHEO should require the code of conduct and ethics to include the public mission of the Enterprises, charter compliance, and adherence to new program prior approval standards and affordable housing goals. OFHEO has determined compliance with law, regulation, and rules are appropriately addressed in other sections of the regulation.

Another commenter urged that OFHEO address situations where an Enterprise may use its unique characteristics to exact terms and conditions from service providers. That commenter also urged that the code should bar retaliation against entities for political purposes. OFHEO has determined not to adopt these recommendations. OFHEO notes that such conduct could be determined to violate existing safety and soundness rules and need not be subject to a special rule that could have unintended consequences that may result from unnecessary definition.

One commenter recommended a reference to the NYSE rules requiring a code of conduct and NASDAQ rules relating to review and approval of related party transactions; another commenter recommended express reference to regulations issued by the Commission implementing section 406 of the SOA. After considering these comments, OFHEO determined to clarify the section by adding language requiring the code of conduct and ethics to include standards that comply with applicable law, rules, and regulations, in addition to the express reference to section 406 of the SOA. OFHEO is adding language that expressly incorporates section 406 along with any amendments that may be made from time to time.

Another recommendation was that OFHEO should require more frequent reviews and that OFHEO require the codes to be revised whenever a new market practice or a substantive change in law or rule defines new standards. These recommendations are addressed by the provision, as modified, in that the code of conduct and ethics must include standards that comply with applicable law, rules, and regulations. In addition, OFHEO has clarified the language concerning review of the code to state expressly that after review of the code for consistency with practices appropriate for the Enterprise, the code

[19] *See Report of Special Examination, supra* note 2 at 164.

[20] Consent Order, *supra* note 5 at Art. II, Para. 14.

[21] Freddie Mac will be subject to the requirements of this section once it has filed documents that are covered by the reimbursement provisions of section 304 of the SOA. The final language of § 1710.13 uses the term ''reimbursement'' rather than ''disgorgement'' to be consistent with the language of section 304.

should be appropriately revised. In addition, it was recommended by one commenter that OFHEO change the language concerning review of the code of conduct and ethics from that of ensuring that the code is ''consistent'' with best practices to ''reviewing in light of'' best practices. Recognizing a range of appropriate practices may exist for a given matter, OFHEO has modified the language to clarify that the review of the code is to be for consistency with practices appropriate for the Enterprise.

Conduct and Responsibilities of Board of Directors (§ 1710.15)

Section 1710.15 of the current corporate governance regulation establishes appropriate standards for the conduct and responsibilities of the board of directors of an Enterprise. Given the special situation of the Enterprises, OFHEO proposed to amend § 1710.15 by adding a requirement with respect to the conduct and responsibilities of the board of directors. The proposal would require that the Enterprise 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, so as to promote safety and soundness.

One commenter recommended that OFHEO expressly provide that risk policy mean not only consideration of written policies and procedures but also that the Enterprises comply with such policies and that the board of directors has an affirmative duty to ensure that risk policies are enforced. OFHEO has determined not to adopt this recommendation because the focus of § 1710.15 is on policies and procedures designed to assure compliance. Risk management compliance is appropriately addressed in § 1710.19, discussed below.

Proposed § 1710.15 adds a provision 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. One commenter recommended that this provision be deleted because it is purportedly a narrower substantive obligation than the other oversight requirements and is otherwise addressed elsewhere in the regulation. OFHEO disagrees that it is inappropriate to list the board's oversight responsibility of limits on extensions of credit. Although § 1710.16 prohibits certain extensions of credit, responsibility for oversight is not addressed in that section. OFHEO has determined to adopt the provision as proposed.

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

OFHEO proposed to add § 1710.16, which would limit extensions of credit to Enterprise board members and executive officers as provided generally by section 402 of the SOA. As adopted here, 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. OFHEO believes that it is appropriate to conform the OFHEO regulation to that of other financial institution regulators in addressing extensions of credit by companies they supervise, as the proposed section does.

Two commenters requested that OFHEO delete the reference to any subsidiary of an Enterprise because such reference implies that OFHEO intends that the Enterprises establish subsidiaries. OFHEO sees no such implication in the proposed language. OFHEO has determined not to adopt this recommendation; the intent of the language is to apply to the Enterprises the provisions of section 402 of the SOA.

Another commenter requested an express reference to interpretations of section 402 of the SOA by the Commission. OFHEO will look to the interpretations of the Commission but has determined that a modification of the proposed language is unnecessary; language has been added, however, to clarify that the reference to section 402 of the SOA includes amendments as made from time to time. With this technical modification, OFHEO has issued § 1710.16 as proposed.

Certification of Disclosures by Chief Executive Officer and Chief Financial Officer (§ 1710.17)

OFHEO proposed to add § 1710.17, which would require Enterprise compliance with section 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 the OFHEO supervisory regime to those of other financial regulators, as OFHEO has determined is appropriate. 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.

One commenter expressly supported the proposal. Another commenter requested that OFHEO clarify that the proposed provision would not require Freddie Mac to submit certifications under section 302 of the SOA until Freddie Mac completes the voluntary registration process. OFHEO has determined to retain the provision as proposed.[22] OFHEO has published § 1710.17 as proposed, with a technical correction and the addition of language to clarify that the reference to SOA section 302 includes amendments to that section as made from time to time.

Change of External Audit Partner and External Auditing Firm (§ 1710.18)

OFHEO proposed 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 responsibility for reviewing the external audit, has performed audit services for the Enterprise in each of the five previous fiscal years. This prohibition relates to 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.

One commenter recommended that OFHEO incorporate section 203 of the SOA, as interpreted by the Commission, in the provision. OFHEO has determined not to adopt that recommendation at this time. OFHEO looks to its existing safety and soundness requirements and its supervisory program to assure that the Enterprises mitigate risk by the use of service vendors that meet standards for reliability and recourse.

Another commenter recommended that the provision require rotation of other audit partners involved in audits of an Enterprise after seven years. OFHEO has determined not to adopt this recommendation, but notes that in

[22] The provision would apply to documents filed by Freddie Mac that meet the certification requirements under section 302 of the SOA.

the matter of non-lead audit partners, OFHEO expects that the Enterprises engage auditing firms that comply with appropriate practices.

OFHEO also proposed a requirement that, at least every ten years, an Enterprise must change its external auditing firm. Many commenters objected to the proposed requirement to change the external auditing firm every ten years on the basis that such a change would be counterproductive because of loss of expertise and associated increased risk of error and fraud, lack of support for such a regulation in current literature or Federal statute, and impracticality in light of the existence of only four large accounting firms available for the work attendant to a government sponsored enterprise. The commenters opined that the safeguards of the SOA, in terms of audit partner rotations and the oversight and audit role of the Public Company Accounting Oversight Board, are adequate.

OFHEO disagrees with these commenters with respect to the Enterprises. In light of its special examination of Freddie Mac and its ongoing supervision of both Enterprises, OFHEO has determined to require Fannie Mae and Freddie Mac to adhere to certain standards to assure safe and sound operations, even though they may represent different standards than those generally applied to non-government sponsored companies or other large regulated companies. Created by Congress to facilitate liquidity and stability in mortgage markets and to advance affordable housing, the Enterprises receive special benefits from government sponsorship making them unlike other large companies in significant respects. The business of the Enterprises is limited by statute; their hedge accounts require intensive and complicated accounting; they have a unique mission; they must undertake specialized tasks by law; and, they are regulated apart from other companies due to their unique structure, that is, a single regulator for only two entities. Further, the Enterprises have grown to become two of the largest and highly leveraged financial companies in the world in terms of assets, controlling together a majority share of the secondary market for conforming mortgages. In addition, due to the government sponsorship, the Enterprises are not as susceptible to certain forms of market discipline. All of these differences and unique features demand full and accurate accounting, accounting that is essential for safe and sound operations and disclosures that assure access to capital markets. These distinctive characteristics would support the determination that Fannie Mae and Freddie Mac should adhere to certain policies that may not be applicable to other companies, including large regulated companies.

The existence of long term accounting relationships has been demonstrated, in the review of the Enterprises by OFHEO, to pose specific risks. The difficulty of changing auditing firms would not outweigh the finding of threatened harm that may be occasioned by certain long term audit relationships. Freddie Mac maintained the same accounting relationship for over 32 years and its accounting problems were only uncovered after it changed auditors in 2002. In 2005, Fannie Mae has announced that it will replace its auditor with which it has had a relationship for over 36 years.

A central argument of commenters was that the required change undermines the pressure on an audit firm, that is, if a firm has a contract and produces less than satisfactory work, then a termination of that contract brings the firm into the public eye. Also, the requirement to change firms, it is argued, removes the incentive to move against a firm as the requirement would change the firm at a set point. This, the argument goes, would remove positive pressures on the engaging company and the auditing firm. OFHEO disagrees with respect to the Enterprises. Further, in the case of the Enterprises, Congress saw fit to create a regulator to oversee the operations of the firms, including accounting standards and external audit relationships. OFHEO has the ability to act in the case of a poorly performing Enterprise auditor at any time, not just at the time of a planned change.

Further, it should be noted that OFHEO does not consider the existence at present of four major auditing firms to be an insurmountable impediment. With the proper safeguards, OFHEO would consider appropriate both Enterprises using the same auditing firm concurrently, thereby contributing to the options open to an Enterprise.

However, because both Enterprises have now changed audit firms, the provision is not included in this final regulation.

Compliance and Risk Management Programs (§ 1710.19(a) and (b))

Proposed § 1710.19 would require an Enterprise to establish and maintain a compliance program and a risk management program. OFHEO believes that the establishment and maintenance of compliance and risk management programs are essential for the continued safe and sound operations of the Enterprises.[23] The establishment of such programs, with a view to best practices appropriate for the Enterprises, will assist the boards of directors in managing their responsibilities to oversee the adequacy of policies and procedures for compliance and risk management.

Commenters generally supported the proposal. One commenter suggested that OFHEO consider whether there should be a direct reporting relationship to the board; others recommended more flexibility with respect to the structure and reporting scheme of the compliance and risk management programs. OFHEO has determined to retain the requirement that the chief compliance officer and chief risk officer report directly to the chief executive officer of the Enterprise, but has clarified that the regular reporting of such officers may be made to the board of directors or to an appropriate committee thereof. OFHEO has made other clarifying and technical changes to make the section easier to read.

Compliance With Other Laws (§ 1710.19(c))

OFHEO also proposed that if an Enterprise deregisters or does not register its common stock with the Commission, the Enterprise must comply with sections 301, 302, 304, 402, and 406 of the SOA, subject to such additional requirements as provided by § 1710.30.[24] 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.

One commenter requested that OFHEO clarify that this provision would not apply to a situation in which an Enterprise deregisters its securities and that § 1710.30 should not be referenced in § 1710.19. OFHEO disagrees and has determined to adopt § 1710.19(c) as proposed, with minor clarifying and technical changes.

Modification of Certain Provisions (§ 1710.30)

OFHEO proposed 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 and employing other

[23] *See Report of Special Examination,* Recommended Actions, Nos. 9 and 10, *supra* note 2 at 167–168, and Consent Order, *supra* note 5.

[24] This provision would apply to Freddie Mac as will provisions of sections 1710.13(b) and 1710.17 for reports that are filed subject to section 302 and 304 of SOA.

sources for corporate governance standards, may modify its requirements to meet its statutory responsibilities for oversight of the Enterprises. References to standards of Federal or state law (including the Revised Model Corporation Act), or NYSE rules in §§ 1710.10, 1710.11, 1710.12, 1710.17, and 1710.19 do not limit the ability of OFHEO to modify OFHEO standards as necessary to meet its statutory responsibilities.[25] The proposal would require that notice be provided to the Enterprises of any modifications.

Some commenters noted that OFHEO would be required to publish any modifications for notice and comment under the Administrative Procedure Act. OFHEO is clarifying the provision by adding language that would make clear that OFHEO would make modifications to its requirements pursuant to 5 U.S.C. 553. Section 553 requires notice and comment of a substantive regulation with certain exceptions, including where the regulation would grant or recognize an exemption or relieve a restriction, or for good cause found by the agency.

Issuance of Final Amendments to Regulation

OFHEO has determined to issue the final amendments to its corporate governance regulation at 12 CFR 1710. The final regulation incorporates provisions adopted as proposed as well as modifications that enhance clarity or craft a more workable regulation, many of the modifications result from comments that provided useful legal and operational insights. The final regulation continues to build the OFHEO supervisory infrastructure and to meet the ongoing efforts of OFHEO to operate in a transparent manner. The final regulation should provide greater certainty for the Enterprises regarding regulatory expectations. Appropriate corporate governance and appropriate corporate governance supervision help ensure the continued safe and sound operation of the Enterprises as directed by Congress.

Regulatory Impact

Executive Order 12866, Regulatory Planning and Review

The 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. Nevertheless, the final amendments were 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 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 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 amendments thereto 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 amendments to the corporate governance regulation under the Regulatory Flexibility Act. The General Counsel of OFHEO certifies that the corporate governance regulation and the amendments thereto 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.

■ Accordingly, for the reasons stated in the preamble, OFHEO amends 12 CFR part 1710 to subchapter C of chapter XVII 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 as §§ 1710.12 and 1710.13]

■ 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) *Limits on service of board members*—(i) *General requirement.* No board member of an Enterprise may serve on the board of directors for more than 10 years or past the age of 72, whichever comes first; provided, however, a board member may serve his or her full term if he or she has served less than 10 years or is 72 years on the date of his or her election or appointment to the board.

(ii) *Waiver.* Upon written request of an Enterprise, the Director may waive, in his or her sole discretion and for good cause, the limits on the service of a board member under paragraph (a)(1)(i) of this section.

(2) *Independence of board members.* A majority of seated members of the

[25] 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.

board of directors of an Enterprise shall be independent board members, as defined under rules set forth by the NYSE, as amended from time to time.

(b) *Meetings, quorum and proxies, information, and annual review*—(1) *Frequency of meetings.* The board of directors of an Enterprise shall meet at least eight times a year and no less than once a calendar 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, rules, regulations, 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, Pub. L. 107–204 (Jul. 30, 2002) (SOA), as amended from time to time, with respect to the audit committee, and under rules issued by the NYSE, as amended from time to time—

(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 risk management, 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) *Reimbursement.* 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 the securities laws, the chief executive officer and chief financial officer of the Enterprise shall reimburse the Enterprise as provided under section 304 of the SOA, as amended from time to time. This provision does not otherwise limit the authority of OFHEO to employ remedies available to it under its enforcement authorities.

■ 7. Amend § 1710.14 by revising the section heading, revising newly designated paragraph (a) and adding new paragraph (b) 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, as amended from time to time, and other applicable laws, rules, and regulations.

(b) *Review.* Not less than once every three years, an Enterprise shall review the adequacy of its code of conduct and ethics for consistency with practices appropriate to the Enterprise and make any appropriate revisions to such code.

■ 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, as amended from time to time.

■ 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 review 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, as amended from time to time.

■ 11. Add new § 1710.18 to read as follows:

§ 1710.18 Change of audit partner.

An Enterprise may not accept audit services from an external auditing firm if the lead or coordinating audit partner who has primary responsibility for the external audit of the Enterprise, or the external audit partner who has responsibility for reviewing the external audit has performed audit services for the Enterprise in each of the five previous fiscal years.

■ 12. Add new § 1710.19 to read as follows:

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

(a) *Compliance program.* (1) An Enterprise shall establish and maintain a compliance program that is reasonably designed to assure that the Enterprise complies with applicable laws, rules, regulations, and internal controls.

(2) The compliance program shall be headed by a compliance officer, however styled, who reports directly to the chief executive officer of the Enterprise. The compliance officer shall report regularly to the board of directors or an appropriate committee of the board of directors on compliance with and the adequacy of current compliance policies and procedures of the Enterprise, and shall recommend any adjustments to such policies and procedures that he or she considers necessary and appropriate.

(b) *Risk management program.* (1) An Enterprise shall establish and maintain a risk management program that is reasonably designed to manage the risks of the operations of the Enterprise.

(2) The risk management program shall be headed by a risk management officer, however styled, who reports directly to the chief executive officer of the Enterprise. The risk management officer shall report regularly to the board of directors or an appropriate committee of the board of directors on compliance with and the adequacy of current risk management policies and procedures of the Enterprise, and shall recommend any adjustments to such policies and procedures that he or she considers necessary and appropriate.

(c) *Compliance with other laws.* (1) If an Enterprise deregisters or has not registered its common stock with the U.S. Securities and Exchange Commission (Commission) under the Securities Exchange Act of 1934, the Enterprise shall comply or continue to comply with sections 301, 302, 304, 402, and 406 of the SOA, as amended from time to time, 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, as amended from time to time, 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 the standards contained in this part in accordance with 5 U.S.C. 553 and upon written notice to the Enterprise.

Dated: March 31, 2005.

Stephen A. Blumenthal,

Acting Director, Office of Federal Housing Enterprise Oversight.

[FR Doc. 05–6781 Filed 4–5–05; 8:45 am]

BILLING CODE 4220–01–P

DEPARTMENT OF TRANSPORTATION

Federal Aviation Administration

14 CFR Part 39

[Docket No. FAA–2004–18561; Directorate Identifier 2004–NM–13–AD; Amendment 39–14042; AD 2005–07–18]

RIN 2120–AA64

Airworthiness Directives; McDonnell Douglas Model DC–9–15F Airplanes Modified In Accordance With Supplemental Type Certificate (STC) SA1993SO; and Model DC–9–10, DC–9–20, DC–9–30, DC–9–40, and DC–9–50 Series Airplanes in All-Cargo Configuration, Equipped With a Main-Deck Cargo Door

AGENCY: Federal Aviation Administration (FAA), Department of Transportation (DOT).

ACTION: Final rule.

SUMMARY: The FAA is adopting a new airworthiness directive (AD) for the airplanes listed above. For certain airplanes, this AD requires inspecting to determine the airplane's cargo configuration, and reporting findings to the FAA. For airplanes modified in accordance with a certain STC or with a cargo configuration that deviates from the as-delivered configuration, this AD requires revising certain manuals and manual supplements to specify certain cargo limitations. This AD also requires relocating all cargo restraints on the main cargo deck. This AD is prompted by reports that deficiencies related to the cargo loading system may exist on all McDonnell Douglas Model DC–9–15F airplanes modified in accordance with STC SA1993SO. We are issuing this AD to ensure that cargo in the main cabin is adequately restrained and to prevent failure of components of the cargo loading system, failure of the floor structure, or shifting of cargo. Any of these conditions could cause cargo to exceed load distribution limits or cause damage to the fuselage or control cables, which could result in reduced controllability of the airplane.

DATES: This AD becomes effective May 11, 2005.

Docket: The AD docket contains the proposed AD, comments, and any final disposition. You can examine the AD docket on the Internet at *http://dms.dot.gov*, or in person at the Docket Management Facility office between 9 a.m. and 5 p.m., Monday through Friday, except Federal holidays. The Docket Management Facility office (telephone (800) 647–5227) is located on the plaza level of the Nassif Building at

Rules and Regulations

Federal Register
Vol. 70, No. 65
Wednesday, April 6, 2005

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: Final amendments.

SUMMARY: The Office of Federal Housing Enterprise Oversight (OFHEO) is issuing amendments to its corporate governance regulation establishing corporate governance standards applicable to the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation in order to further promote the safety and soundness of their operations.

DATES: Effective June 6, 2005.

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:

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 (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 soundly in compliance with applicable laws, rules, and regulations.

In furtherance of its supervisory responsibilities, in 2002, OFHEO published a final corporate governance regulation, taking into consideration comments filed in response to an earlier proposed regulation.[1] The corporate governance regulation sets forth 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*[2] *(Report of Special Examination),* and based on the experience of OFHEO supervising the activities of the Enterprises, as well as developments in law, OFHEO is amending 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.''[3] The *Report of Special Examination,* among other things, made specific recommendations with respect to practices in corporate governance that Freddie Mac should follow and that OFHEO should require.[4] 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 practices that were recommended in the *Report of Special Examination,* as well as other remedial steps.[5]

Through ongoing oversight and supervision of both Enterprises and its special examinations, OFHEO has gained insights as to the need for enhancements or adjustments in the existing corporate governance standards for both Enterprises. Thus, OFHEO proposed to add prudential requirements to its corporate governance regulation that would have general applicability consistent with the practices recommended or required by the *Report of Special Examination* or the Consent Order.

OFHEO also 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 which makes them unlike many other large financial institutions in some significant respects. Since their creation, the Enterprises have grown to become two of the largest and highly leveraged financial companies in the world in terms of assets, and together they control a majority share of the secondary market for conforming mortgages. Yet they are relatively small in terms of their total numbers of employees, and have a unique board

[1] 12 CFR Part 1710, 67 FR 38361 (June 4, 2002).

[2] 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.*

[3] *Id.,* at 4 (footnote omitted).

[4] *Id.,* at 163–171.

[5] 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.*

structure, public mission and regulatory framework. In addition, due to their Government sponsorship, the Enterprises are not as susceptible to some forms of market and management discipline. These distinctive characteristics also played a large part in the determination that Fannie Mae and Freddie Mac should adhere to certain policies that may not be applicable to other companies.

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

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.[9] Upon registration, Freddie Mac will be subject to the same requirements. To help meet its statutory responsibilities, 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 Enterprise corporate governance in response to a violation of its corporate governance regulation, including behavior that violates laws or requirements set forth therein.

Comments Received

The proposed amendments were published on April 12, 2004 (69 FR 19126). OFHEO received comments from 19 commenters as follows: (1) An individual shareholder of an Enterprise; (2) an individual; (3) Ernst & Young, an accounting firm; (4) America's Community Bankers, a trade association representing community banks; (5) National Association of Corporate Directors, an educational, publishing, and research organization on board leadership and a membership association for boards, directors, director candidates, and board advisers; (6) PriceWaterhouseCoopers, an accounting firm; (7) Business Roundtable, an association of chief executive officers of corporations; (8) Chamber of Commerce, a business federation; (9) American Institute of Certified Public Accountants, a professional association of certified public accountants; (10) KPMG, an accounting firm; (11) Deloitte & Touche, an accounting firm; (12) Freddie Mac; (13) Consumer Mortgage Coalition, a trade association of national mortgage lenders, servicers, and service providers; (14) an individual, Dean's Professor of Financial Regulatory Policy, University of Massachusetts-Amherst; (15) Nominating and Corporate Governance Committee of Fannie Mae; (16) FM Policy Focus, a coalition of six financial services and housing related trade associations; (17) Independent Community Bankers of America, a trade association of community banks; (18) Mortgage Insurance Companies of America, a trade association representing the private mortgage insurance industry; and, (19) Fannie Mae.

Response to Comments

Board of Directors (§ 1710.11)

OFHEO proposed a section that would add requirements and consolidate existing requirements relating to the board of directors of an Enterprise. OFHEO carefully considered the comments provided.

Separate Chairperson/Chief Executive Officer (§ 1710.11(a)(1))

One provision would require an Enterprise to prohibit the chairperson of the board from also serving as chief executive officer of the Enterprise. Often drawing on the experience and circumstances of non-government sponsored companies, many commenters urged that OFHEO leave this matter to the determination of the board of directors or suggested that a separate chairperson and chief executive officer is not in the best interests of the shareholders. The commenters who urged such a result did not focus on the impact of the unique characteristics of the Enterprises, such as their size, public mission, insulation from full market discipline and distinct board structure—characteristics that counsel against the concentration of power in a single chairperson/chief executive officer. Likewise, commenters did not make a substantial case for disregarding the lessons learned in the special examination of Freddie Mac about the risks of consolidating the chairperson and chief executive officer positions.

OFHEO believes that separating the functions of chairperson and chief executive officer is prudent for safe and sound operations of the Enterprises because it strengthens 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 each Enterprise's management team.[10] 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, but also in light of the recent experience at Freddie Mac and the experience of OFHEO supervising both Enterprises. In the case of Freddie Mac, an earlier separation of the two roles could have caused the board to provide stronger independent guidance to management and identify problems sooner. OFHEO believes that a separation of the chairperson and the

[6] 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 earlier 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.

[7] Pub. L. 107–204 (Jul. 30, 2002).

[8] See *http://www.fanniemae.com/ir/sec/index.jtml?s=SEC+filings* for Fannie Mae and *http://www.freddiemac.com/news/archives/investors/2003/restatement_112103.html* for Freddie Mac.

[9] The existing corporate governance regulation provides that the corporate governance practices and procedures of an Enterprise must comply with its respective chartering act and *other Federal law, rules, and regulations,* and that the practices and procedures must be consistent with the safe and sound operations of the Enterprise. 12 CFR 1710.10(a), 67 FR 38361, 38370 (Jun. 4, 2002).

[10] *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).

chief executive officer functions would enhance the effectiveness of changes being proposed in requirements for the boards of directors to meet their obligations and would promote the public interest in the safety and soundness of the Enterprises. Comments that this would limit the flexibility of the board to structure the company or limit corporate flexibility in general do not overcome the concern that OFHEO expressed for the benefits resulting from greater independence of the board and stronger oversight of these government sponsored enterprises.

OFHEO notes with approval that each Enterprise has now formally agreed to separate the positions of chairperson of the board and chief executive officer. Accordingly, the provision is not included in the final regulation at this time.

Term and Age Limits (§ 1710.11(a)(2))

A requirement that would limit the service of a board member to no more than 10 years or past the age of 72, whichever comes first, was proposed by OFHEO. One commenter approved of the limits, some commenters disapproved of the limits as undermining board leadership, and other commenters recommended transition periods or the ability to seek a waiver. Another commenter requested clarification that the age and term limits be applied as of the date of the meeting of the shareholders.

OFHEO found that a limit on years of service and age for the board members promotes an appropriate level of functioning of the board, strengthens the diversity and expertise of the board, and enhances its ability to respond to the unique, but constantly evolving business environment in which each Enterprise operates.[11] Overall, OFHEO determined that the potential loss of familiarity with the company and the possibility of having an experienced board member leave due to a fixed term based on age or years of service were outweighed by the experience of OFHEO supervising both Enterprises and the possibility of an entrenched board's failing to oversee adequately the company.

In response to comments, OFHEO is making changes to the provision to clarify that a board member who meets the age and term limits as of the date of his or her election or appointment may serve his or her full term. In addition, express language has been added to provide for a waiver by the Director, for good cause consistent with the supervisory responsibilities of OFHEO.

Independence of Board Members (§ 1710.11(a)(3))

OFHEO proposed that a majority of the seated board members of an Enterprise be independent under the rules of the NYSE.[12] 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.

One commenter recommended that OFHEO should supplement the NYSE standards with additional standards. OFHEO determined that the NYSE rule appropriately covers what constitutes independence. As expressly provided by proposed § 1710.30, discussed below, OFHEO has 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.

Another commenter recommended that the independence standard apply to all board members. Section 1710.11(a)(3), as proposed, does not differentiate between elected and presidentially-appointed board members. It was also requested that the provision reflect that the NYSE rules apply as changed from time to time by the NYSE. A technical revision has been made to the provision expressly to address this point. Finally, one commenter recommended that the term ''seated'' be defined. The term is intended to encompass those elected or appointed board members who serve on the board; OFHEO, however, does not believe it useful at this time to define further the term in the regulation.

Frequency of Meetings (§ 1710.11(b)(1))

The proposal 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. One commenter supported the frequency requirement while another commenter suggested that this requirement amounts to micromanagement of the Enterprises. Other commenters suggested that requiring eight meetings a year, with at least one each calendar quarter was more appropriate. Another commenter suggested that the number of meetings be set in the aggregate, but the board be permitted to schedule meetings in such quarters as the board would determine. OFHEO determined that the number of meetings is reasonable and that spreading them over the course of the fiscal year is prudent.

Given the special nature of the Enterprises and the oversight required, OFHEO disagrees that the frequency requirement amounts to micromanagement or that requiring eight meetings a year is inappropriate. Meetings must be frequent enough to ensure that the board of directors can exercise adequate oversight of management. OFHEO determined in its review of Freddie Mac that the meetings of the board of directors were too infrequent to address the issues presented by the company, given its status, size, and complexity. OFHEO determined that to provide flexibility and to avoid practical issues such as requests for waivers and related procedural matters, the proposal would be adopted with the deletion of the requirement that two meetings occur per quarter. OFHEO has determined that the board of directors should meet no less than eight times a year and no less than once a calendar quarter.

Non-Management Board Meetings, Quorum of Board of Directors, Proxies (§ 1710.11(b)(2) and (3))

OFHEO received supporting comments on the provisions of § 1710.11(b)(2) and (3) and has issued them without change. The provisions require that the non-management directors of an Enterprise meet at regularly scheduled executive sessions without management participation in order to promote open discussion.[13] They also consolidate without substantive change the existing requirements of the current OFHEO 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.

Information (§ 1710.11(b)(4))

As proposed, § 1710.11(b)(4) would require that management of an Enterprise provide board members with information that is adequate and appropriate considering what a

[11] *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.

[12] Final NYSE rule Section 303A.

[13] For reference, see final NYSE rule Section 303A.03.

reasonable board member would find important to the fulfillment of his or her fiduciary duties and obligations to the Enterprise.[14] One commenter supported this requirement, while another recommended that it be limited to that information consistent with the requirements of the selected corporate governance law of the Enterprise. It would not be useful to limit information required by the selected corporate governance law because, unlike board members of state-chartered corporations, board members of the Enterprises have specific obligations set forth in the corporate governance regulation that may require additional information to fulfill such obligations. Therefore, OFHEO has determined not to limit the provision as requested and is adopting the provision as proposed.

Annual Review (§ 1710.11(b)(5))

The proposal would require, at least annually, that the Enterprise board of directors review requirements of laws, rules, regulations, and guidelines that are applicable to its activities and duties, with appropriate professional assistance.[15] One commenter recommended that the annual review be expanded to include an annual review of the effectiveness of the corporate governance system. OFHEO has determined not to adopt that recommendation in the context of review of the Enterprise board of director activities and duties. The provision is being adopted as proposed.

Committees of Board of Directors (§ 1710.12)

OFHEO proposed 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.[16]

The current corporate governance regulation requires that an Enterprise establish audit and compensation committees of the board of directors. OFHEO proposed to add a requirement that an Enterprise establish a nominating/corporate governance committee consistent with appropriate application of the final NYSE rules[17] and that the committees of the board of directors comply with NYSE rules.[18] The NYSE rules address, among other things, the independence of audit committee members; the responsibility of the audit committee 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.

As proposed, the amended section also would require that Enterprise 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 appropriate to the Enterprises'' situations and their oversight, as provided under § 1710.30.

OFHEO received one comment on this section that recommended that the provision should be made co-extensive with the corresponding NYSE rules issued pursuant to the SOA, which are incorporated by reference, as those rules may be interpreted or changed from time to time by the responsible bodies. OFHEO has determined that the section, as proposed, has incorporated by reference the appropriate NYSE and SOA section and that, as appropriate, OFHEO would look to the NYSE interpretation of the NYSE rules in determining whether an Enterprise was in compliance with this section. OFHEO has determined that it is unnecessary to state this in the section and § 1710.12 is adopted as proposed.

Compensation of Board Members, Executive Officers, and Employees (§ 1710.13)

OFHEO proposed 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 long-term goals that are addressed in the proposed language of the section.

Two commenters objected to the word ''appropriate'' in that it is not contained in 12 U.S.C. 4518, the statutory provision that requires the Director to prohibit an Enterprise from providing compensation to any executive officer that is not reasonable and comparable with compensation for employment in other similar businesses. The proposed provision is not intended to implement Section 4518, which is implemented by the OFHEO executive compensation regulation at 12 CFR part 1770. Section 1710.13 addresses not only certain covered executive officers, but as well board members and employees, and has as its primary focus the Enterprises—safety and soundness. Although compensation may be reasonable from some perspectives, as in not generally excessive or extreme, it may not be appropriate or suitable under specific circumstances. Thus, OFHEO has determined not to delete the word ''appropriate.''

While the circumstances involved and the foundation for addressing compensation in the corporate governance regulation may differ from those found in the area of executive compensation, the standards used by OFHEO for determining unreasonable, excessive, or inappropriate compensation are the same. In looking to reasonable compensation, OFHEO must consider the totality of circumstances for an Enterprise. This includes inquiry into compensation for comparable positions at other firms, to the degree they exist, along with less formulaic items such as the unique nature of the Enterprises, the responsibilities and duties of the individual involved, and the environment and circumstances that exist when the compensation is provided to the individual. Thus a numerical comparison alone might be inadequate for OFHEO to discharge its obligations in considering compensation. Factors such as an Enterprise's conduct, business challenges, compliance with the mission of the Enterprise, compliance with law and regulation, creation of profit or loss, leadership, suitability of incentive structures, and other relevant matters would be important to making a compensation determination under either the corporate governance rules or the executive compensation rules. In both instances, safety and soundness underlies the goals of Congress expressed in the enabling statute of OFHEO and Congress has clearly indicated that compensation may represent a safety and soundness

[14] *See Report of Special Examination, supra* note 2 at 166.

[15] *See* Consent Order, *supra* note 5 at Art. II, Para. 10.

[16] *See Report of Special Examination, supra* note 2 at 166, (discussing frequency of meetings).

[17] Final NYSE rule Section 303A.04.

[18] *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 ExchangeAct of 1934.

problem should it provide perverse incentives.

Section 1710.13(a), as proposed, is further intended to underscore the impropriety of compensation incentives that excessively focus the attention of management and employees on an Enterprise's 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.[19] Financial incentives at the Enterprises should foster a management culture in which primary consideration is given to risk management, operational stability and legal and regulatory compliance.[20] As noted above, OFHEO has determined, in light of its experience with Freddie Mac, its ongoing supervision of both Enterprises, and given their Federal charters, board structure, public mission, regulatory framework and status, size and role in capital markets, that Fannie Mae and Freddie Mac should be required to adhere to certain policies that may not be applicable to other companies. The compensation requirement in no way detracts from the obligations of Enterprise board members and management to meet their responsibilities to shareholders, but reflects the special attention that needs to be paid as well to other important public mission considerations in directing the course and conduct of an Enterprise.

One commenter recommended that executive incentives should expressly include no rewards for undue reliance on the Enterprise subsidy or any activity that would enlarge it. OFHEO has determined not to adopt that recommendation.

Section 1710.13(b) proposed to 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 of the SOA 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 other appropriate supervisory action against an Enterprise or any of its board members or executive officers pursuant to its enforcement authorities. Enforcement authorities of OFHEO include restitution that may be applied to situations involving conduct subject to reimbursement.

One commenter asked that the reimbursement requirement be clarified to apply to restatement of financial reporting under the securities laws. OFHEO has clarified the language to state so expressly and to note that this section does not limit other OFHEO remedial powers that may be brought to bear for failures to make adequate disclosures. Another commenter suggested that the reimbursement provision is not necessary in view of the broad remedial and civil money penalty powers of OFHEO. If it is retained, the commenter requested that the requirement should apply to Freddie Mac after it has returned to the timely filing of financial statements and completed the voluntary registration of its securities. OFHEO has determined to retain the reimbursement provision as proposed with certain clarifying and technical changes.[21]

Code of Conduct and Ethics (§ 1710.14)

OFHEO proposed 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 provides 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 and appropriateness of the code of conduct and ethics of an Enterprise. In addition, OFHEO proposed 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 practices appropriate for the Enterprise.

A few commenters recommended that OFHEO should require the code of conduct and ethics to include the public mission of the Enterprises, charter compliance, and adherence to new program prior approval standards and affordable housing goals. OFHEO has determined compliance with law, regulation, and rules are appropriately addressed in other sections of the regulation.

Another commenter urged that OFHEO address situations where an Enterprise may use its unique characteristics to exact terms and conditions from service providers. That commenter also urged that the code should bar retaliation against entities for political purposes. OFHEO has determined not to adopt these recommendations. OFHEO notes that such conduct could be determined to violate existing safety and soundness rules and need not be subject to a special rule that could have unintended consequences that may result from unnecessary definition.

One commenter recommended a reference to the NYSE rules requiring a code of conduct and NASDAQ rules relating to review and approval of related party transactions; another commenter recommended express reference to regulations issued by the Commission implementing section 406 of the SOA. After considering these comments, OFHEO determined to clarify the section by adding language requiring the code of conduct and ethics to include standards that comply with applicable law, rules, and regulations, in addition to the express reference to section 406 of the SOA. OFHEO is adding language that expressly incorporates section 406 along with any amendments that may be made from time to time.

Another recommendation was that OFHEO should require more frequent reviews and that OFHEO require the codes to be revised whenever a new market practice or a substantive change in law or rule defines new standards. These recommendations are addressed by the provision, as modified, in that the code of conduct and ethics must include standards that comply with applicable law, rules, and regulations. In addition, OFHEO has clarified the language concerning review of the code to state expressly that after review of the code for consistency with practices appropriate for the Enterprise, the code

[19] *See Report of Special Examination, supra* note 2 at 164.

[20] Consent Order, *supra* note 5 at Art. II, Para. 14.

[21] Freddie Mac will be subject to the requirements of this section once it has filed documents that are covered by the reimbursement provisions of section 304 of the SOA. The final language of § 1710.13 uses the term ''reimbursement'' rather than ''disgorgement'' to be consistent with the language of section 304.

should be appropriately revised. In addition, it was recommended by one commenter that OFHEO change the language concerning review of the code of conduct and ethics from that of ensuring that the code is ''consistent'' with best practices to ''reviewing in light of'' best practices. Recognizing a range of appropriate practices may exist for a given matter, OFHEO has modified the language to clarify that the review of the code is to be for consistency with practices appropriate for the Enterprise.

Conduct and Responsibilities of Board of Directors (§ 1710.15)

Section 1710.15 of the current corporate governance regulation establishes appropriate standards for the conduct and responsibilities of the board of directors of an Enterprise. Given the special situation of the Enterprises, OFHEO proposed to amend § 1710.15 by adding a requirement with respect to the conduct and responsibilities of the board of directors. The proposal would require that the Enterprise 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, so as to promote safety and soundness.

One commenter recommended that OFHEO expressly provide that risk policy mean not only consideration of written policies and procedures but also that the Enterprises comply with such policies and that the board of directors has an affirmative duty to ensure that risk policies are enforced. OFHEO has determined not to adopt this recommendation because the focus of § 1710.15 is on policies and procedures designed to assure compliance. Risk management compliance is appropriately addressed in § 1710.19, discussed below.

Proposed § 1710.15 adds a provision 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. One commenter recommended that this provision be deleted because it is purportedly a narrower substantive obligation than the other oversight requirements and is otherwise addressed elsewhere in the regulation. OFHEO disagrees that it is inappropriate to list the board's oversight responsibility of limits on extensions of credit. Although § 1710.16 prohibits certain extensions of credit, responsibility for oversight is not addressed in that section. OFHEO has determined to adopt the provision as proposed.

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

OFHEO proposed to add § 1710.16, which would limit extensions of credit to Enterprise board members and executive officers as provided generally by section 402 of the SOA. As adopted here, 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. OFHEO believes that it is appropriate to conform the OFHEO regulation to that of other financial institution regulators in addressing extensions of credit by companies they supervise, as the proposed section does.

Two commenters requested that OFHEO delete the reference to any subsidiary of an Enterprise because such reference implies that OFHEO intends that the Enterprises establish subsidiaries. OFHEO sees no such implication in the proposed language. OFHEO has determined not to adopt this recommendation; the intent of the language is to apply to the Enterprises the provisions of section 402 of the SOA.

Another commenter requested an express reference to interpretations of section 402 of the SOA by the Commission. OFHEO will look to the interpretations of the Commission but has determined that a modification of the proposed language is unnecessary; language has been added, however, to clarify that the reference to section 402 of the SOA includes amendments as made from time to time. With this technical modification, OFHEO has issued § 1710.16 as proposed.

Certification of Disclosures by Chief Executive Officer and Chief Financial Officer (§ 1710.17)

OFHEO proposed to add § 1710.17, which would require Enterprise compliance with section 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 the OFHEO supervisory regime to those of other financial regulators, as OFHEO has determined is appropriate. 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.

One commenter expressly supported the proposal. Another commenter requested that OFHEO clarify that the proposed provision would not require Freddie Mac to submit certifications under section 302 of the SOA until Freddie Mac completes the voluntary registration process. OFHEO has determined to retain the provision as proposed.[22] OFHEO has published § 1710.17 as proposed, with a technical correction and the addition of language to clarify that the reference to SOA section 302 includes amendments to that section as made from time to time.

Change of External Audit Partner and External Auditing Firm (§ 1710.18)

OFHEO proposed 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 responsibility for reviewing the external audit, has performed audit services for the Enterprise in each of the five previous fiscal years. This prohibition relates to 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.

One commenter recommended that OFHEO incorporate section 203 of the SOA, as interpreted by the Commission, in the provision. OFHEO has determined not to adopt that recommendation at this time. OFHEO looks to its existing safety and soundness requirements and its supervisory program to assure that the Enterprises mitigate risk by the use of service vendors that meet standards for reliability and recourse.

Another commenter recommended that the provision require rotation of other audit partners involved in audits of an Enterprise after seven years. OFHEO has determined not to adopt this recommendation, but notes that in

[22] The provision would apply to documents filed by Freddie Mac that meet the certification requirements under section 302 of the SOA.

the matter of non-lead audit partners, OFHEO expects that the Enterprises engage auditing firms that comply with appropriate practices.

OFHEO also proposed a requirement that, at least every ten years, an Enterprise must change its external auditing firm. Many commenters objected to the proposed requirement to change the external auditing firm every ten years on the basis that such a change would be counterproductive because of loss of expertise and associated increased risk of error and fraud, lack of support for such a regulation in current literature or Federal statute, and impracticality in light of the existence of only four large accounting firms available for the work attendant to a government sponsored enterprise. The commenters opined that the safeguards of the SOA, in terms of audit partner rotations and the oversight and audit role of the Public Company Accounting Oversight Board, are adequate.

OFHEO disagrees with these commenters with respect to the Enterprises. In light of its special examination of Freddie Mac and its ongoing supervision of both Enterprises, OFHEO has determined to require Fannie Mae and Freddie Mac to adhere to certain standards to assure safe and sound operations, even though they may represent different standards than those generally applied to non-government sponsored companies or other large regulated companies. Created by Congress to facilitate liquidity and stability in mortgage markets and to advance affordable housing, the Enterprises receive special benefits from government sponsorship making them unlike other large companies in significant respects. The business of the Enterprises is limited by statute; their hedge accounts require intensive and complicated accounting; they have a unique mission; they must undertake specialized tasks by law; and, they are regulated apart from other companies due to their unique structure, that is, a single regulator for only two entities. Further, the Enterprises have grown to become two of the largest and highly leveraged financial companies in the world in terms of assets, controlling together a majority share of the secondary market for conforming mortgages. In addition, due to the government sponsorship, the Enterprises are not as susceptible to certain forms of market discipline. All of these differences and unique features demand full and accurate accounting, accounting that is essential for safe and sound operations and disclosures that assure access to capital markets. These distinctive characteristics would support the determination that Fannie Mae and Freddie Mac should adhere to certain policies that may not be applicable to other companies, including large regulated companies.

The existence of long term accounting relationships has been demonstrated, in the review of the Enterprises by OFHEO, to pose specific risks. The difficulty of changing auditing firms would not outweigh the finding of threatened harm that may be occasioned by certain long term audit relationships. Freddie Mac maintained the same accounting relationship for over 32 years and its accounting problems were only uncovered after it changed auditors in 2002. In 2005, Fannie Mae has announced that it will replace its auditor with which it has had a relationship for over 36 years.

A central argument of commenters was that the required change undermines the pressure on an audit firm, that is, if a firm has a contract and produces less than satisfactory work, then a termination of that contract brings the firm into the public eye. Also, the requirement to change firms, it is argued, removes the incentive to move against a firm as the requirement would change the firm at a set point. This, the argument goes, would remove positive pressures on the engaging company and the auditing firm. OFHEO disagrees with respect to the Enterprises. Further, in the case of the Enterprises, Congress saw fit to create a regulator to oversee the operations of the firms, including accounting standards and external audit relationships. OFHEO has the ability to act in the case of a poorly performing Enterprise auditor at any time, not just at the time of a planned change.

Further, it should be noted that OFHEO does not consider the existence at present of four major auditing firms to be an insurmountable impediment. With the proper safeguards, OFHEO would consider appropriate both Enterprises using the same auditing firm concurrently, thereby contributing to the options open to an Enterprise.

However, because both Enterprises have now changed audit firms, the provision is not included in this final regulation.

Compliance and Risk Management Programs (§ 1710.19(a) and (b))

Proposed § 1710.19 would require an Enterprise to establish and maintain a compliance program and a risk management program. OFHEO believes that the establishment and maintenance of compliance and risk management programs are essential for the continued safe and sound operations of the Enterprises.[23] The establishment of such programs, with a view to best practices appropriate for the Enterprises, will assist the boards of directors in managing their responsibilities to oversee the adequacy of policies and procedures for compliance and risk management.

Commenters generally supported the proposal. One commenter suggested that OFHEO consider whether there should be a direct reporting relationship to the board; others recommended more flexibility with respect to the structure and reporting scheme of the compliance and risk management programs. OFHEO has determined to retain the requirement that the chief compliance officer and chief risk officer report directly to the chief executive officer of the Enterprise, but has clarified that the regular reporting of such officers may be made to the board of directors or to an appropriate committee thereof. OFHEO has made other clarifying and technical changes to make the section easier to read.

Compliance With Other Laws (§ 1710.19(c))

OFHEO also proposed that if an Enterprise deregisters or does not register its common stock with the Commission, the Enterprise must comply with sections 301, 302, 304, 402, and 406 of the SOA, subject to such additional requirements as provided by § 1710.30.[24] 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.

One commenter requested that OFHEO clarify that this provision would not apply to a situation in which an Enterprise deregisters its securities and that § 1710.30 should not be referenced in § 1710.19. OFHEO disagrees and has determined to adopt § 1710.19(c) as proposed, with minor clarifying and technical changes.

Modification of Certain Provisions (§ 1710.30)

OFHEO proposed 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 and employing other

[23] *See Report of Special Examination,* Recommended Actions, Nos. 9 and 10, *supra* note 2 at 167–168, and Consent Order, *supra* note 5.

[24] This provision would apply to Freddie Mac as will provisions of sections 1710.13(b) and 1710.17 for reports that are filed subject to section 302 and 304 of SOA.

sources for corporate governance standards, may modify its requirements to meet its statutory responsibilities for oversight of the Enterprises. References to standards of Federal or state law (including the Revised Model Corporation Act), or NYSE rules in §§ 1710.10, 1710.11, 1710.12, 1710.17, and 1710.19 do not limit the ability of OFHEO to modify OFHEO standards as necessary to meet its statutory responsibilities.[25] The proposal would require that notice be provided to the Enterprises of any modifications.

Some commenters noted that OFHEO would be required to publish any modifications for notice and comment under the Administrative Procedure Act. OFHEO is clarifying the provision by adding language that would make clear that OFHEO would make modifications to its requirements pursuant to 5 U.S.C. 553. Section 553 requires notice and comment of a substantive regulation with certain exceptions, including where the regulation would grant or recognize an exemption or relieve a restriction, or for good cause found by the agency.

Issuance of Final Amendments to Regulation

OFHEO has determined to issue the final amendments to its corporate governance regulation at 12 CFR 1710. The final regulation incorporates provisions adopted as proposed as well as modifications that enhance clarity or craft a more workable regulation, many of the modifications result from comments that provided useful legal and operational insights. The final regulation continues to build the OFHEO supervisory infrastructure and to meet the ongoing efforts of OFHEO to operate in a transparent manner. The final regulation should provide greater certainty for the Enterprises regarding regulatory expectations. Appropriate corporate governance and appropriate corporate governance supervision help ensure the continued safe and sound operation of the Enterprises as directed by Congress.

Regulatory Impact

Executive Order 12866, Regulatory Planning and Review

The 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. Nevertheless, the final amendments were 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 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 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 amendments thereto 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 amendments to the corporate governance regulation under the Regulatory Flexibility Act. The General Counsel of OFHEO certifies that the corporate governance regulation and the amendments thereto 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.

■ Accordingly, for the reasons stated in the preamble, OFHEO amends 12 CFR part 1710 to subchapter C of chapter XVII 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 as §§ 1710.12 and 1710.13]

■ 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) *Limits on service of board members*—(i) *General requirement.* No board member of an Enterprise may serve on the board of directors for more than 10 years or past the age of 72, whichever comes first; provided, however, a board member may serve his or her full term if he or she has served less than 10 years or is 72 years on the date of his or her election or appointment to the board.

(ii) *Waiver.* Upon written request of an Enterprise, the Director may waive, in his or her sole discretion and for good cause, the limits on the service of a board member under paragraph (a)(1)(i) of this section.

(2) *Independence of board members.* A majority of seated members of the

[25] 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.

board of directors of an Enterprise shall be independent board members, as defined under rules set forth by the NYSE, as amended from time to time.

(b) *Meetings, quorum and proxies, information, and annual review*—(1) *Frequency of meetings.* The board of directors of an Enterprise shall meet at least eight times a year and no less than once a calendar 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, rules, regulations, 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, Pub. L. 107–204 (Jul. 30, 2002) (SOA), as amended from time to time, with respect to the audit committee, and under rules issued by the NYSE, as amended from time to time—

(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 risk management, 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) *Reimbursement.* 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 the securities laws, the chief executive officer and chief financial officer of the Enterprise shall reimburse the Enterprise as provided under section 304 of the SOA, as amended from time to time. This provision does not otherwise limit the authority of OFHEO to employ remedies available to it under its enforcement authorities.

■ 7. Amend § 1710.14 by revising the section heading, revising newly designated paragraph (a) and adding new paragraph (b) 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, as amended from time to time, and other applicable laws, rules, and regulations.

(b) *Review.* Not less than once every three years, an Enterprise shall review the adequacy of its code of conduct and ethics for consistency with practices appropriate to the Enterprise and make any appropriate revisions to such code.

■ 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, as amended from time to time.

■ 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 review 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, as amended from time to time.

■ 11. Add new § 1710.18 to read as follows:

§ 1710.18 Change of audit partner.

An Enterprise may not accept audit services from an external auditing firm if the lead or coordinating audit partner who has primary responsibility for the external audit of the Enterprise, or the external audit partner who has responsibility for reviewing the external audit has performed audit services for the Enterprise in each of the five previous fiscal years.

■ 12. Add new § 1710.19 to read as follows:

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

(a) *Compliance program.* (1) An Enterprise shall establish and maintain a compliance program that is reasonably designed to assure that the Enterprise complies with applicable laws, rules, regulations, and internal controls.

(2) The compliance program shall be headed by a compliance officer, however styled, who reports directly to the chief executive officer of the Enterprise. The compliance officer shall report regularly to the board of directors or an appropriate committee of the board of directors on compliance with and the adequacy of current compliance policies and procedures of the Enterprise, and shall recommend any adjustments to such policies and procedures that he or she considers necessary and appropriate.

(b) *Risk management program.* (1) An Enterprise shall establish and maintain a risk management program that is reasonably designed to manage the risks of the operations of the Enterprise.

(2) The risk management program shall be headed by a risk management officer, however styled, who reports directly to the chief executive officer of the Enterprise. The risk management officer shall report regularly to the board of directors or an appropriate committee of the board of directors on compliance with and the adequacy of current risk management policies and procedures of the Enterprise, and shall recommend any adjustments to such policies and procedures that he or she considers necessary and appropriate.

(c) *Compliance with other laws.* (1) If an Enterprise deregisters or has not registered its common stock with the U.S. Securities and Exchange Commission (Commission) under the Securities Exchange Act of 1934, the Enterprise shall comply or continue to comply with sections 301, 302, 304, 402, and 406 of the SOA, as amended from time to time, 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, as amended from time to time, 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 the standards contained in this part in accordance with 5 U.S.C. 553 and upon written notice to the Enterprise.

Dated: March 31, 2005.

Stephen A. Blumenthal,

Acting Director, Office of Federal Housing Enterprise Oversight.

[FR Doc. 05–6781 Filed 4–5–05; 8:45 am]

BILLING CODE 4220–01–P

DEPARTMENT OF TRANSPORTATION

Federal Aviation Administration

14 CFR Part 39

[Docket No. FAA–2004–18561; Directorate Identifier 2004–NM–13–AD; Amendment 39–14042; AD 2005–07–18]

RIN 2120–AA64

Airworthiness Directives; McDonnell Douglas Model DC–9–15F Airplanes Modified In Accordance With Supplemental Type Certificate (STC) SA1993SO; and Model DC–9–10, DC–9–20, DC–9–30, DC–9–40, and DC–9–50 Series Airplanes in All-Cargo Configuration, Equipped With a Main-Deck Cargo Door

AGENCY: Federal Aviation Administration (FAA), Department of Transportation (DOT).

ACTION: Final rule.

SUMMARY: The FAA is adopting a new airworthiness directive (AD) for the airplanes listed above. For certain airplanes, this AD requires inspecting to determine the airplane's cargo configuration, and reporting findings to the FAA. For airplanes modified in accordance with a certain STC or with a cargo configuration that deviates from the as-delivered configuration, this AD requires revising certain manuals and manual supplements to specify certain cargo limitations. This AD also requires relocating all cargo restraints on the main cargo deck. This AD is prompted by reports that deficiencies related to the cargo loading system may exist on all McDonnell Douglas Model DC–9–15F airplanes modified in accordance with STC SA1993SO. We are issuing this AD to ensure that cargo in the main cabin is adequately restrained and to prevent failure of components of the cargo loading system, failure of the floor structure, or shifting of cargo. Any of these conditions could cause cargo to exceed load distribution limits or cause damage to the fuselage or control cables, which could result in reduced controllability of the airplane.

DATES: This AD becomes effective May 11, 2005.

Docket: The AD docket contains the proposed AD, comments, and any final disposition. You can examine the AD docket on the Internet at *http://dms.dot.gov*, or in person at the Docket Management Facility office between 9 a.m. and 5 p.m., Monday through Friday, except Federal holidays. The Docket Management Facility office (telephone (800) 647–5227) is located on the plaza level of the Nassif Building at

Rules and Regulations

Federal Register
Vol. 70, No. 65
Wednesday, April 6, 2005

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: Final amendments.

SUMMARY: The Office of Federal Housing Enterprise Oversight (OFHEO) is issuing amendments to its corporate governance regulation establishing corporate governance standards applicable to the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation in order to further promote the safety and soundness of their operations.

DATES: Effective June 6, 2005.

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:

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 (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 soundly in compliance with applicable laws, rules, and regulations.

In furtherance of its supervisory responsibilities, in 2002, OFHEO published a final corporate governance regulation, taking into consideration comments filed in response to an earlier proposed regulation.[1] The corporate governance regulation sets forth 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*[2] *(Report of Special Examination),* and based on the experience of OFHEO supervising the activities of the Enterprises, as well as developments in law, OFHEO is amending 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.''[3] The *Report of Special Examination,* among other things, made specific recommendations with respect to practices in corporate governance that Freddie Mac should follow and that OFHEO should require.[4] 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 practices that were recommended in the *Report of Special Examination,* as well as other remedial steps.[5]

Through ongoing oversight and supervision of both Enterprises and its special examinations, OFHEO has gained insights as to the need for enhancements or adjustments in the existing corporate governance standards for both Enterprises. Thus, OFHEO proposed to add prudential requirements to its corporate governance regulation that would have general applicability consistent with the practices recommended or required by the *Report of Special Examination* or the Consent Order.

OFHEO also 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 which makes them unlike many other large financial institutions in some significant respects. Since their creation, the Enterprises have grown to become two of the largest and highly leveraged financial companies in the world in terms of assets, and together they control a majority share of the secondary market for conforming mortgages. Yet they are relatively small in terms of their total numbers of employees, and have a unique board

[1] 12 CFR Part 1710, 67 FR 38361 (June 4, 2002).

[2] 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.*

[3] *Id.,* at 4 (footnote omitted).

[4] *Id.,* at 163–171.

[5] 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.*

structure, public mission and regulatory framework. In addition, due to their Government sponsorship, the Enterprises are not as susceptible to some forms of market and management discipline. These distinctive characteristics also played a large part in the determination that Fannie Mae and Freddie Mac should adhere to certain policies that may not be applicable to other companies.

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

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.[9] Upon registration, Freddie Mac will be subject to the same requirements. To help meet its statutory responsibilities, 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 Enterprise corporate governance in response to a violation of its corporate governance regulation, including behavior that violates laws or requirements set forth therein.

Comments Received

The proposed amendments were published on April 12, 2004 (69 FR 19126). OFHEO received comments from 19 commenters as follows: (1) An individual shareholder of an Enterprise; (2) an individual; (3) Ernst & Young, an accounting firm; (4) America's Community Bankers, a trade association representing community banks; (5) National Association of Corporate Directors, an educational, publishing, and research organization on board leadership and a membership association for boards, directors, director candidates, and board advisers; (6) PriceWaterhouseCoopers, an accounting firm; (7) Business Roundtable, an association of chief executive officers of corporations; (8) Chamber of Commerce, a business federation; (9) American Institute of Certified Public Accountants, a professional association of certified public accountants; (10) KPMG, an accounting firm; (11) Deloitte & Touche, an accounting firm; (12) Freddie Mac; (13) Consumer Mortgage Coalition, a trade association of national mortgage lenders, servicers, and service providers; (14) an individual, Dean's Professor of Financial Regulatory Policy, University of Massachusetts-Amherst; (15) Nominating and Corporate Governance Committee of Fannie Mae; (16) FM Policy Focus, a coalition of six financial services and housing related trade associations; (17) Independent Community Bankers of America, a trade association of community banks; (18) Mortgage Insurance Companies of America, a trade association representing the private mortgage insurance industry; and, (19) Fannie Mae.

Response to Comments

Board of Directors (§ 1710.11)

OFHEO proposed a section that would add requirements and consolidate existing requirements relating to the board of directors of an Enterprise. OFHEO carefully considered the comments provided.

Separate Chairperson/Chief Executive Officer (§ 1710.11(a)(1))

One provision would require an Enterprise to prohibit the chairperson of the board from also serving as chief executive officer of the Enterprise. Often drawing on the experience and circumstances of non-government sponsored companies, many commenters urged that OFHEO leave this matter to the determination of the board of directors or suggested that a separate chairperson and chief executive officer is not in the best interests of the shareholders. The commenters who urged such a result did not focus on the impact of the unique characteristics of the Enterprises, such as their size, public mission, insulation from full market discipline and distinct board structure—characteristics that counsel against the concentration of power in a single chairperson/chief executive officer. Likewise, commenters did not make a substantial case for disregarding the lessons learned in the special examination of Freddie Mac about the risks of consolidating the chairperson and chief executive officer positions.

OFHEO believes that separating the functions of chairperson and chief executive officer is prudent for safe and sound operations of the Enterprises because it strengthens 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 each Enterprise's management team.[10] 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, but also in light of the recent experience at Freddie Mac and the experience of OFHEO supervising both Enterprises. In the case of Freddie Mac, an earlier separation of the two roles could have caused the board to provide stronger independent guidance to management and identify problems sooner. OFHEO believes that a separation of the chairperson and the

[6] 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 earlier 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.

[7] Pub. L. 107–204 (Jul. 30, 2002).

[8] See *http://www.fanniemae.com/ir/sec/index.jtml?s=SEC+filings* for Fannie Mae and *http://www.freddiemac.com/news/archives/investors/2003/restatement_112103.html* for Freddie Mac.

[9] The existing corporate governance regulation provides that the corporate governance practices and procedures of an Enterprise must comply with its respective chartering act and *other Federal law, rules, and regulations,* and that the practices and procedures must be consistent with the safe and sound operations of the Enterprise. 12 CFR 1710.10(a), 67 FR 38361, 38370 (Jun. 4, 2002).

[10] *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).

chief executive officer functions would enhance the effectiveness of changes being proposed in requirements for the boards of directors to meet their obligations and would promote the public interest in the safety and soundness of the Enterprises. Comments that this would limit the flexibility of the board to structure the company or limit corporate flexibility in general do not overcome the concern that OFHEO expressed for the benefits resulting from greater independence of the board and stronger oversight of these government sponsored enterprises.

OFHEO notes with approval that each Enterprise has now formally agreed to separate the positions of chairperson of the board and chief executive officer. Accordingly, the provision is not included in the final regulation at this time.

Term and Age Limits (§ 1710.11(a)(2))

A requirement that would limit the service of a board member to no more than 10 years or past the age of 72, whichever comes first, was proposed by OFHEO. One commenter approved of the limits, some commenters disapproved of the limits as undermining board leadership, and other commenters recommended transition periods or the ability to seek a waiver. Another commenter requested clarification that the age and term limits be applied as of the date of the meeting of the shareholders.

OFHEO found that a limit on years of service and age for the board members promotes an appropriate level of functioning of the board, strengthens the diversity and expertise of the board, and enhances its ability to respond to the unique, but constantly evolving business environment in which each Enterprise operates.[11] Overall, OFHEO determined that the potential loss of familiarity with the company and the possibility of having an experienced board member leave due to a fixed term based on age or years of service were outweighed by the experience of OFHEO supervising both Enterprises and the possibility of an entrenched board's failing to oversee adequately the company.

In response to comments, OFHEO is making changes to the provision to clarify that a board member who meets the age and term limits as of the date of his or her election or appointment may serve his or her full term. In addition, express language has been added to provide for a waiver by the Director, for good cause consistent with the supervisory responsibilities of OFHEO.

Independence of Board Members (§ 1710.11(a)(3))

OFHEO proposed that a majority of the seated board members of an Enterprise be independent under the rules of the NYSE.[12] 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.

One commenter recommended that OFHEO should supplement the NYSE standards with additional standards. OFHEO determined that the NYSE rule appropriately covers what constitutes independence. As expressly provided by proposed § 1710.30, discussed below, OFHEO has 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.

Another commenter recommended that the independence standard apply to all board members. Section 1710.11(a)(3), as proposed, does not differentiate between elected and presidentially-appointed board members. It was also requested that the provision reflect that the NYSE rules apply as changed from time to time by the NYSE. A technical revision has been made to the provision expressly to address this point. Finally, one commenter recommended that the term ''seated'' be defined. The term is intended to encompass those elected or appointed board members who serve on the board; OFHEO, however, does not believe it useful at this time to define further the term in the regulation.

Frequency of Meetings (§ 1710.11(b)(1))

The proposal 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. One commenter supported the frequency requirement while another commenter suggested that this requirement amounts to micromanagement of the Enterprises. Other commenters suggested that requiring eight meetings a year, with at least one each calendar quarter was more appropriate. Another commenter suggested that the number of meetings be set in the aggregate, but the board be permitted to schedule meetings in such quarters as the board would determine. OFHEO determined that the number of meetings is reasonable and that spreading them over the course of the fiscal year is prudent.

Given the special nature of the Enterprises and the oversight required, OFHEO disagrees that the frequency requirement amounts to micromanagement or that requiring eight meetings a year is inappropriate. Meetings must be frequent enough to ensure that the board of directors can exercise adequate oversight of management. OFHEO determined in its review of Freddie Mac that the meetings of the board of directors were too infrequent to address the issues presented by the company, given its status, size, and complexity. OFHEO determined that to provide flexibility and to avoid practical issues such as requests for waivers and related procedural matters, the proposal would be adopted with the deletion of the requirement that two meetings occur per quarter. OFHEO has determined that the board of directors should meet no less than eight times a year and no less than once a calendar quarter.

Non-Management Board Meetings, Quorum of Board of Directors, Proxies (§ 1710.11(b)(2) and (3))

OFHEO received supporting comments on the provisions of § 1710.11(b)(2) and (3) and has issued them without change. The provisions require that the non-management directors of an Enterprise meet at regularly scheduled executive sessions without management participation in order to promote open discussion.[13] They also consolidate without substantive change the existing requirements of the current OFHEO 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.

Information (§ 1710.11(b)(4))

As proposed, § 1710.11(b)(4) would require that management of an Enterprise provide board members with information that is adequate and appropriate considering what a

[11] *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.

[12] Final NYSE rule Section 303A.

[13] For reference, see final NYSE rule Section 303A.03.

reasonable board member would find important to the fulfillment of his or her fiduciary duties and obligations to the Enterprise.[14] One commenter supported this requirement, while another recommended that it be limited to that information consistent with the requirements of the selected corporate governance law of the Enterprise. It would not be useful to limit information required by the selected corporate governance law because, unlike board members of state-chartered corporations, board members of the Enterprises have specific obligations set forth in the corporate governance regulation that may require additional information to fulfill such obligations. Therefore, OFHEO has determined not to limit the provision as requested and is adopting the provision as proposed.

Annual Review (§ 1710.11(b)(5))

The proposal would require, at least annually, that the Enterprise board of directors review requirements of laws, rules, regulations, and guidelines that are applicable to its activities and duties, with appropriate professional assistance.[15] One commenter recommended that the annual review be expanded to include an annual review of the effectiveness of the corporate governance system. OFHEO has determined not to adopt that recommendation in the context of review of the Enterprise board of director activities and duties. The provision is being adopted as proposed.

Committees of Board of Directors (§ 1710.12)

OFHEO proposed 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.[16]

The current corporate governance regulation requires that an Enterprise establish audit and compensation committees of the board of directors. OFHEO proposed to add a requirement that an Enterprise establish a nominating/corporate governance committee consistent with appropriate application of the final NYSE rules[17] and that the committees of the board of directors comply with NYSE rules.[18] The NYSE rules address, among other things, the independence of audit committee members; the responsibility of the audit committee 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.

As proposed, the amended section also would require that Enterprise 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 appropriate to the Enterprises'' situations and their oversight, as provided under § 1710.30.

OFHEO received one comment on this section that recommended that the provision should be made co-extensive with the corresponding NYSE rules issued pursuant to the SOA, which are incorporated by reference, as those rules may be interpreted or changed from time to time by the responsible bodies. OFHEO has determined that the section, as proposed, has incorporated by reference the appropriate NYSE and SOA section and that, as appropriate, OFHEO would look to the NYSE interpretation of the NYSE rules in determining whether an Enterprise was in compliance with this section. OFHEO has determined that it is unnecessary to state this in the section and § 1710.12 is adopted as proposed.

Compensation of Board Members, Executive Officers, and Employees (§ 1710.13)

OFHEO proposed 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 long-term goals that are addressed in the proposed language of the section.

Two commenters objected to the word ''appropriate'' in that it is not contained in 12 U.S.C. 4518, the statutory provision that requires the Director to prohibit an Enterprise from providing compensation to any executive officer that is not reasonable and comparable with compensation for employment in other similar businesses. The proposed provision is not intended to implement Section 4518, which is implemented by the OFHEO executive compensation regulation at 12 CFR part 1770. Section 1710.13 addresses not only certain covered executive officers, but as well board members and employees, and has as its primary focus the Enterprises—safety and soundness. Although compensation may be reasonable from some perspectives, as in not generally excessive or extreme, it may not be appropriate or suitable under specific circumstances. Thus, OFHEO has determined not to delete the word ''appropriate.''

While the circumstances involved and the foundation for addressing compensation in the corporate governance regulation may differ from those found in the area of executive compensation, the standards used by OFHEO for determining unreasonable, excessive, or inappropriate compensation are the same. In looking to reasonable compensation, OFHEO must consider the totality of circumstances for an Enterprise. This includes inquiry into compensation for comparable positions at other firms, to the degree they exist, along with less formulaic items such as the unique nature of the Enterprises, the responsibilities and duties of the individual involved, and the environment and circumstances that exist when the compensation is provided to the individual. Thus a numerical comparison alone might be inadequate for OFHEO to discharge its obligations in considering compensation. Factors such as an Enterprise's conduct, business challenges, compliance with the mission of the Enterprise, compliance with law and regulation, creation of profit or loss, leadership, suitability of incentive structures, and other relevant matters would be important to making a compensation determination under either the corporate governance rules or the executive compensation rules. In both instances, safety and soundness underlies the goals of Congress expressed in the enabling statute of OFHEO and Congress has clearly indicated that compensation may represent a safety and soundness

[14] *See Report of Special Examination, supra* note 2 at 166.

[15] *See* Consent Order, *supra* note 5 at Art. II, Para. 10.

[16] *See Report of Special Examination, supra* note 2 at 166, (discussing frequency of meetings).

[17] Final NYSE rule Section 303A.04.

[18] *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 ExchangeAct of 1934.

problem should it provide perverse incentives.

Section 1710.13(a), as proposed, is further intended to underscore the impropriety of compensation incentives that excessively focus the attention of management and employees on an Enterprise's 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.[19] Financial incentives at the Enterprises should foster a management culture in which primary consideration is given to risk management, operational stability and legal and regulatory compliance.[20] As noted above, OFHEO has determined, in light of its experience with Freddie Mac, its ongoing supervision of both Enterprises, and given their Federal charters, board structure, public mission, regulatory framework and status, size and role in capital markets, that Fannie Mae and Freddie Mac should be required to adhere to certain policies that may not be applicable to other companies. The compensation requirement in no way detracts from the obligations of Enterprise board members and management to meet their responsibilities to shareholders, but reflects the special attention that needs to be paid as well to other important public mission considerations in directing the course and conduct of an Enterprise.

One commenter recommended that executive incentives should expressly include no rewards for undue reliance on the Enterprise subsidy or any activity that would enlarge it. OFHEO has determined not to adopt that recommendation.

Section 1710.13(b) proposed to 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 of the SOA 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 other appropriate supervisory action against an Enterprise or any of its board members or executive officers pursuant to its enforcement authorities. Enforcement authorities of OFHEO include restitution that may be applied to situations involving conduct subject to reimbursement.

One commenter asked that the reimbursement requirement be clarified to apply to restatement of financial reporting under the securities laws. OFHEO has clarified the language to state so expressly and to note that this section does not limit other OFHEO remedial powers that may be brought to bear for failures to make adequate disclosures. Another commenter suggested that the reimbursement provision is not necessary in view of the broad remedial and civil money penalty powers of OFHEO. If it is retained, the commenter requested that the requirement should apply to Freddie Mac after it has returned to the timely filing of financial statements and completed the voluntary registration of its securities. OFHEO has determined to retain the reimbursement provision as proposed with certain clarifying and technical changes.[21]

Code of Conduct and Ethics (§ 1710.14)

OFHEO proposed 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 provides 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 and appropriateness of the code of conduct and ethics of an Enterprise. In addition, OFHEO proposed 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 practices appropriate for the Enterprise.

A few commenters recommended that OFHEO should require the code of conduct and ethics to include the public mission of the Enterprises, charter compliance, and adherence to new program prior approval standards and affordable housing goals. OFHEO has determined compliance with law, regulation, and rules are appropriately addressed in other sections of the regulation.

Another commenter urged that OFHEO address situations where an Enterprise may use its unique characteristics to exact terms and conditions from service providers. That commenter also urged that the code should bar retaliation against entities for political purposes. OFHEO has determined not to adopt these recommendations. OFHEO notes that such conduct could be determined to violate existing safety and soundness rules and need not be subject to a special rule that could have unintended consequences that may result from unnecessary definition.

One commenter recommended a reference to the NYSE rules requiring a code of conduct and NASDAQ rules relating to review and approval of related party transactions; another commenter recommended express reference to regulations issued by the Commission implementing section 406 of the SOA. After considering these comments, OFHEO determined to clarify the section by adding language requiring the code of conduct and ethics to include standards that comply with applicable law, rules, and regulations, in addition to the express reference to section 406 of the SOA. OFHEO is adding language that expressly incorporates section 406 along with any amendments that may be made from time to time.

Another recommendation was that OFHEO should require more frequent reviews and that OFHEO require the codes to be revised whenever a new market practice or a substantive change in law or rule defines new standards. These recommendations are addressed by the provision, as modified, in that the code of conduct and ethics must include standards that comply with applicable law, rules, and regulations. In addition, OFHEO has clarified the language concerning review of the code to state expressly that after review of the code for consistency with practices appropriate for the Enterprise, the code

[19] *See Report of Special Examination, supra* note 2 at 164.

[20] Consent Order, *supra* note 5 at Art. II, Para. 14.

[21] Freddie Mac will be subject to the requirements of this section once it has filed documents that are covered by the reimbursement provisions of section 304 of the SOA. The final language of § 1710.13 uses the term ''reimbursement'' rather than ''disgorgement'' to be consistent with the language of section 304.

should be appropriately revised. In addition, it was recommended by one commenter that OFHEO change the language concerning review of the code of conduct and ethics from that of ensuring that the code is ''consistent'' with best practices to ''reviewing in light of'' best practices. Recognizing a range of appropriate practices may exist for a given matter, OFHEO has modified the language to clarify that the review of the code is to be for consistency with practices appropriate for the Enterprise.

Conduct and Responsibilities of Board of Directors (§ 1710.15)

Section 1710.15 of the current corporate governance regulation establishes appropriate standards for the conduct and responsibilities of the board of directors of an Enterprise. Given the special situation of the Enterprises, OFHEO proposed to amend § 1710.15 by adding a requirement with respect to the conduct and responsibilities of the board of directors. The proposal would require that the Enterprise 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, so as to promote safety and soundness.

One commenter recommended that OFHEO expressly provide that risk policy mean not only consideration of written policies and procedures but also that the Enterprises comply with such policies and that the board of directors has an affirmative duty to ensure that risk policies are enforced. OFHEO has determined not to adopt this recommendation because the focus of § 1710.15 is on policies and procedures designed to assure compliance. Risk management compliance is appropriately addressed in § 1710.19, discussed below.

Proposed § 1710.15 adds a provision 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. One commenter recommended that this provision be deleted because it is purportedly a narrower substantive obligation than the other oversight requirements and is otherwise addressed elsewhere in the regulation. OFHEO disagrees that it is inappropriate to list the board's oversight responsibility of limits on extensions of credit. Although § 1710.16 prohibits certain extensions of credit, responsibility for oversight is not addressed in that section. OFHEO has determined to adopt the provision as proposed.

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

OFHEO proposed to add § 1710.16, which would limit extensions of credit to Enterprise board members and executive officers as provided generally by section 402 of the SOA. As adopted here, 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. OFHEO believes that it is appropriate to conform the OFHEO regulation to that of other financial institution regulators in addressing extensions of credit by companies they supervise, as the proposed section does.

Two commenters requested that OFHEO delete the reference to any subsidiary of an Enterprise because such reference implies that OFHEO intends that the Enterprises establish subsidiaries. OFHEO sees no such implication in the proposed language. OFHEO has determined not to adopt this recommendation; the intent of the language is to apply to the Enterprises the provisions of section 402 of the SOA.

Another commenter requested an express reference to interpretations of section 402 of the SOA by the Commission. OFHEO will look to the interpretations of the Commission but has determined that a modification of the proposed language is unnecessary; language has been added, however, to clarify that the reference to section 402 of the SOA includes amendments as made from time to time. With this technical modification, OFHEO has issued § 1710.16 as proposed.

Certification of Disclosures by Chief Executive Officer and Chief Financial Officer (§ 1710.17)

OFHEO proposed to add § 1710.17, which would require Enterprise compliance with section 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 the OFHEO supervisory regime to those of other financial regulators, as OFHEO has determined is appropriate. 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.

One commenter expressly supported the proposal. Another commenter requested that OFHEO clarify that the proposed provision would not require Freddie Mac to submit certifications under section 302 of the SOA until Freddie Mac completes the voluntary registration process. OFHEO has determined to retain the provision as proposed.[22] OFHEO has published § 1710.17 as proposed, with a technical correction and the addition of language to clarify that the reference to SOA section 302 includes amendments to that section as made from time to time.

Change of External Audit Partner and External Auditing Firm (§ 1710.18)

OFHEO proposed 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 responsibility for reviewing the external audit, has performed audit services for the Enterprise in each of the five previous fiscal years. This prohibition relates to 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.

One commenter recommended that OFHEO incorporate section 203 of the SOA, as interpreted by the Commission, in the provision. OFHEO has determined not to adopt that recommendation at this time. OFHEO looks to its existing safety and soundness requirements and its supervisory program to assure that the Enterprises mitigate risk by the use of service vendors that meet standards for reliability and recourse.

Another commenter recommended that the provision require rotation of other audit partners involved in audits of an Enterprise after seven years. OFHEO has determined not to adopt this recommendation, but notes that in

[22] The provision would apply to documents filed by Freddie Mac that meet the certification requirements under section 302 of the SOA.

the matter of non-lead audit partners, OFHEO expects that the Enterprises engage auditing firms that comply with appropriate practices.

OFHEO also proposed a requirement that, at least every ten years, an Enterprise must change its external auditing firm. Many commenters objected to the proposed requirement to change the external auditing firm every ten years on the basis that such a change would be counterproductive because of loss of expertise and associated increased risk of error and fraud, lack of support for such a regulation in current literature or Federal statute, and impracticality in light of the existence of only four large accounting firms available for the work attendant to a government sponsored enterprise. The commenters opined that the safeguards of the SOA, in terms of audit partner rotations and the oversight and audit role of the Public Company Accounting Oversight Board, are adequate.

OFHEO disagrees with these commenters with respect to the Enterprises. In light of its special examination of Freddie Mac and its ongoing supervision of both Enterprises, OFHEO has determined to require Fannie Mae and Freddie Mac to adhere to certain standards to assure safe and sound operations, even though they may represent different standards than those generally applied to non-government sponsored companies or other large regulated companies. Created by Congress to facilitate liquidity and stability in mortgage markets and to advance affordable housing, the Enterprises receive special benefits from government sponsorship making them unlike other large companies in significant respects. The business of the Enterprises is limited by statute; their hedge accounts require intensive and complicated accounting; they have a unique mission; they must undertake specialized tasks by law; and, they are regulated apart from other companies due to their unique structure, that is, a single regulator for only two entities. Further, the Enterprises have grown to become two of the largest and highly leveraged financial companies in the world in terms of assets, controlling together a majority share of the secondary market for conforming mortgages. In addition, due to the government sponsorship, the Enterprises are not as susceptible to certain forms of market discipline. All of these differences and unique features demand full and accurate accounting, accounting that is essential for safe and sound operations and disclosures that assure access to capital markets. These distinctive characteristics would support the determination that Fannie Mae and Freddie Mac should adhere to certain policies that may not be applicable to other companies, including large regulated companies.

The existence of long term accounting relationships has been demonstrated, in the review of the Enterprises by OFHEO, to pose specific risks. The difficulty of changing auditing firms would not outweigh the finding of threatened harm that may be occasioned by certain long term audit relationships. Freddie Mac maintained the same accounting relationship for over 32 years and its accounting problems were only uncovered after it changed auditors in 2002. In 2005, Fannie Mae has announced that it will replace its auditor with which it has had a relationship for over 36 years.

A central argument of commenters was that the required change undermines the pressure on an audit firm, that is, if a firm has a contract and produces less than satisfactory work, then a termination of that contract brings the firm into the public eye. Also, the requirement to change firms, it is argued, removes the incentive to move against a firm as the requirement would change the firm at a set point. This, the argument goes, would remove positive pressures on the engaging company and the auditing firm. OFHEO disagrees with respect to the Enterprises. Further, in the case of the Enterprises, Congress saw fit to create a regulator to oversee the operations of the firms, including accounting standards and external audit relationships. OFHEO has the ability to act in the case of a poorly performing Enterprise auditor at any time, not just at the time of a planned change.

Further, it should be noted that OFHEO does not consider the existence at present of four major auditing firms to be an insurmountable impediment. With the proper safeguards, OFHEO would consider appropriate both Enterprises using the same auditing firm concurrently, thereby contributing to the options open to an Enterprise.

However, because both Enterprises have now changed audit firms, the provision is not included in this final regulation.

Compliance and Risk Management Programs (§ 1710.19(a) and (b))

Proposed § 1710.19 would require an Enterprise to establish and maintain a compliance program and a risk management program. OFHEO believes that the establishment and maintenance of compliance and risk management programs are essential for the continued safe and sound operations of the Enterprises.[23] The establishment of such programs, with a view to best practices appropriate for the Enterprises, will assist the boards of directors in managing their responsibilities to oversee the adequacy of policies and procedures for compliance and risk management.

Commenters generally supported the proposal. One commenter suggested that OFHEO consider whether there should be a direct reporting relationship to the board; others recommended more flexibility with respect to the structure and reporting scheme of the compliance and risk management programs. OFHEO has determined to retain the requirement that the chief compliance officer and chief risk officer report directly to the chief executive officer of the Enterprise, but has clarified that the regular reporting of such officers may be made to the board of directors or to an appropriate committee thereof. OFHEO has made other clarifying and technical changes to make the section easier to read.

Compliance With Other Laws (§ 1710.19(c))

OFHEO also proposed that if an Enterprise deregisters or does not register its common stock with the Commission, the Enterprise must comply with sections 301, 302, 304, 402, and 406 of the SOA, subject to such additional requirements as provided by § 1710.30.[24] 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.

One commenter requested that OFHEO clarify that this provision would not apply to a situation in which an Enterprise deregisters its securities and that § 1710.30 should not be referenced in § 1710.19. OFHEO disagrees and has determined to adopt § 1710.19(c) as proposed, with minor clarifying and technical changes.

Modification of Certain Provisions (§ 1710.30)

OFHEO proposed 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 and employing other

[23] *See Report of Special Examination,* Recommended Actions, Nos. 9 and 10, *supra* note 2 at 167–168, and Consent Order, *supra* note 5.

[24] This provision would apply to Freddie Mac as will provisions of sections 1710.13(b) and 1710.17 for reports that are filed subject to section 302 and 304 of SOA.

sources for corporate governance standards, may modify its requirements to meet its statutory responsibilities for oversight of the Enterprises. References to standards of Federal or state law (including the Revised Model Corporation Act), or NYSE rules in §§ 1710.10, 1710.11, 1710.12, 1710.17, and 1710.19 do not limit the ability of OFHEO to modify OFHEO standards as necessary to meet its statutory responsibilities.[25] The proposal would require that notice be provided to the Enterprises of any modifications.

Some commenters noted that OFHEO would be required to publish any modifications for notice and comment under the Administrative Procedure Act. OFHEO is clarifying the provision by adding language that would make clear that OFHEO would make modifications to its requirements pursuant to 5 U.S.C. 553. Section 553 requires notice and comment of a substantive regulation with certain exceptions, including where the regulation would grant or recognize an exemption or relieve a restriction, or for good cause found by the agency.

Issuance of Final Amendments to Regulation

OFHEO has determined to issue the final amendments to its corporate governance regulation at 12 CFR 1710. The final regulation incorporates provisions adopted as proposed as well as modifications that enhance clarity or craft a more workable regulation, many of the modifications result from comments that provided useful legal and operational insights. The final regulation continues to build the OFHEO supervisory infrastructure and to meet the ongoing efforts of OFHEO to operate in a transparent manner. The final regulation should provide greater certainty for the Enterprises regarding regulatory expectations. Appropriate corporate governance and appropriate corporate governance supervision help ensure the continued safe and sound operation of the Enterprises as directed by Congress.

Regulatory Impact

Executive Order 12866, Regulatory Planning and Review

The 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. Nevertheless, the final amendments were 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 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 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 amendments thereto 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 amendments to the corporate governance regulation under the Regulatory Flexibility Act. The General Counsel of OFHEO certifies that the corporate governance regulation and the amendments thereto 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.

■ Accordingly, for the reasons stated in the preamble, OFHEO amends 12 CFR part 1710 to subchapter C of chapter XVII 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 as §§ 1710.12 and 1710.13]

■ 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) *Limits on service of board members*—(i) *General requirement.* No board member of an Enterprise may serve on the board of directors for more than 10 years or past the age of 72, whichever comes first; provided, however, a board member may serve his or her full term if he or she has served less than 10 years or is 72 years on the date of his or her election or appointment to the board.

(ii) *Waiver.* Upon written request of an Enterprise, the Director may waive, in his or her sole discretion and for good cause, the limits on the service of a board member under paragraph (a)(1)(i) of this section.

(2) *Independence of board members.* A majority of seated members of the

[25] 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.

board of directors of an Enterprise shall be independent board members, as defined under rules set forth by the NYSE, as amended from time to time.

(b) *Meetings, quorum and proxies, information, and annual review*—(1) *Frequency of meetings.* The board of directors of an Enterprise shall meet at least eight times a year and no less than once a calendar 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, rules, regulations, 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, Pub. L. 107–204 (Jul. 30, 2002) (SOA), as amended from time to time, with respect to the audit committee, and under rules issued by the NYSE, as amended from time to time—

(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 risk management, 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) *Reimbursement.* 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 the securities laws, the chief executive officer and chief financial officer of the Enterprise shall reimburse the Enterprise as provided under section 304 of the SOA, as amended from time to time. This provision does not otherwise limit the authority of OFHEO to employ remedies available to it under its enforcement authorities.

■ 7. Amend § 1710.14 by revising the section heading, revising newly designated paragraph (a) and adding new paragraph (b) 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, as amended from time to time, and other applicable laws, rules, and regulations.

(b) *Review.* Not less than once every three years, an Enterprise shall review the adequacy of its code of conduct and ethics for consistency with practices appropriate to the Enterprise and make any appropriate revisions to such code.

■ 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, as amended from time to time.

■ 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 review 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, as amended from time to time.

■ 11. Add new § 1710.18 to read as follows:

§ 1710.18 Change of audit partner.

An Enterprise may not accept audit services from an external auditing firm if the lead or coordinating audit partner who has primary responsibility for the external audit of the Enterprise, or the external audit partner who has responsibility for reviewing the external audit has performed audit services for the Enterprise in each of the five previous fiscal years.

■ 12. Add new § 1710.19 to read as follows:

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

(a) *Compliance program.* (1) An Enterprise shall establish and maintain a compliance program that is reasonably designed to assure that the Enterprise complies with applicable laws, rules, regulations, and internal controls.

(2) The compliance program shall be headed by a compliance officer, however styled, who reports directly to the chief executive officer of the Enterprise. The compliance officer shall report regularly to the board of directors or an appropriate committee of the board of directors on compliance with and the adequacy of current compliance policies and procedures of the Enterprise, and shall recommend any adjustments to such policies and procedures that he or she considers necessary and appropriate.

(b) *Risk management program.* (1) An Enterprise shall establish and maintain a risk management program that is reasonably designed to manage the risks of the operations of the Enterprise.

(2) The risk management program shall be headed by a risk management officer, however styled, who reports directly to the chief executive officer of the Enterprise. The risk management officer shall report regularly to the board of directors or an appropriate committee of the board of directors on compliance with and the adequacy of current risk management policies and procedures of the Enterprise, and shall recommend any adjustments to such policies and procedures that he or she considers necessary and appropriate.

(c) *Compliance with other laws.* (1) If an Enterprise deregisters or has not registered its common stock with the U.S. Securities and Exchange Commission (Commission) under the Securities Exchange Act of 1934, the Enterprise shall comply or continue to comply with sections 301, 302, 304, 402, and 406 of the SOA, as amended from time to time, 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, as amended from time to time, 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 the standards contained in this part in accordance with 5 U.S.C. 553 and upon written notice to the Enterprise.

Dated: March 31, 2005.

Stephen A. Blumenthal,

Acting Director, Office of Federal Housing Enterprise Oversight.

[FR Doc. 05–6781 Filed 4–5–05; 8:45 am]

BILLING CODE 4220–01–P

DEPARTMENT OF TRANSPORTATION

Federal Aviation Administration

14 CFR Part 39

[Docket No. FAA–2004–18561; Directorate Identifier 2004–NM–13–AD; Amendment 39–14042; AD 2005–07–18]

RIN 2120–AA64

Airworthiness Directives; McDonnell Douglas Model DC–9–15F Airplanes Modified In Accordance With Supplemental Type Certificate (STC) SA1993SO; and Model DC–9–10, DC–9–20, DC–9–30, DC–9–40, and DC–9–50 Series Airplanes in All-Cargo Configuration, Equipped With a Main-Deck Cargo Door

AGENCY: Federal Aviation Administration (FAA), Department of Transportation (DOT).

ACTION: Final rule.

SUMMARY: The FAA is adopting a new airworthiness directive (AD) for the airplanes listed above. For certain airplanes, this AD requires inspecting to determine the airplane's cargo configuration, and reporting findings to the FAA. For airplanes modified in accordance with a certain STC or with a cargo configuration that deviates from the as-delivered configuration, this AD requires revising certain manuals and manual supplements to specify certain cargo limitations. This AD also requires relocating all cargo restraints on the main cargo deck. This AD is prompted by reports that deficiencies related to the cargo loading system may exist on all McDonnell Douglas Model DC–9–15F airplanes modified in accordance with STC SA1993SO. We are issuing this AD to ensure that cargo in the main cabin is adequately restrained and to prevent failure of components of the cargo loading system, failure of the floor structure, or shifting of cargo. Any of these conditions could cause cargo to exceed load distribution limits or cause damage to the fuselage or control cables, which could result in reduced controllability of the airplane.

DATES: This AD becomes effective May 11, 2005.

Docket: The AD docket contains the proposed AD, comments, and any final disposition. You can examine the AD docket on the Internet at *http://dms.dot.gov*, or in person at the Docket Management Facility office between 9 a.m. and 5 p.m., Monday through Friday, except Federal holidays. The Docket Management Facility office (telephone (800) 647–5227) is located on the plaza level of the Nassif Building at

Office of Federal Housing Enterprise Oversight
(OFHEO)

NEWS RELEASE

Contact: Corinne Russell (202) 414-6921
Stefanie Mullin (202) 414-6376

For Immediate Release
December 10, 2003

OFHEO Imposes Corrective Actions and $125 Million Penalty

Report Details Accounting and Management Misconduct

WASHINGTON, D.C. — Armando Falcon, Jr., Director of the Office of Federal Housing Enterprise Oversight (OFHEO), has announced that Freddie Mac has agreed to implement corrective measures and pay a civil money penalty of $125-million dollars as part of a Consent Order with OFHEO. The actions come as OFHEO released a report detailing a pattern of inappropriate conduct and improper management of earnings that led to the company's recent restatement.

"A government sponsored enterprise like Freddie Mac lives on a public trust that should never be violated," said OFHEO Director Falcon. "OFHEO will take strong action against an enterprise and responsible individuals if that trust is ever broken."

Among the findings in the OFHEO report:

- Freddie Mac disregarded accounting rules, internal controls, disclosure standards, and ultimately, the public trust in the pursuit of steady earnings growth.
- The incentive compensation plans of senior executives contributed to the improper accounting and management practices of the enterprise.
- Weaknesses existed in every aspect of Freddie Mac's accounting process.
- The Board of Directors was complacent and failed to exercise

adequate oversight.

- Former management exhibited a disdain for appropriate disclosure standards.

The report also recommends specific actions for the agency to implement, including:

- Freddie Mac should be required to separate the functions of the CEO and the Chairman of the Board.
- Freddie Mac should be required to develop financial incentives for employees based on long-term goals, not short-term earnings.
- OFHEO should establish a regulatory system of mandatory disclosures for the enterprises or their securities exemptions should be repealed.
- OFHEO should consider requiring a periodic change of the external auditors at the enterprises, not just a change in engagement partner.
- OFHEO should require Freddie Mac to hold a capital surplus and should consider limiting the growth of the retained portfolio until Freddie Mac produces timely and certified financial statements.
- OFHEO should establish a “materiality” standard to assure the provision of sufficient information to the Board of Directors.

While conducting its investigation, OFHEO took numerous actions regarding present and former executives at the enterprise. These included: the freezing of compensation packages, removal of the CEO and General Counsel, the levying of a civil money penalty on the former Vice Chairman, and beginning the process of terminating the former CEO and CFO for cause.

The $125-million dollar penalty in the Consent Order is the largest civil money penalty by a safety and soundness regulator. Some of the recommendations in the OFHEO report are also part of the Order.

OFHEO's investigation of the role of Freddie Mac's counter-parties continues and we have begun our review of accounting and management practices at Fannie Mae.

###

Consent Order follows.

Link to Report of the Special Examination of Freddie Mac: http://fhfa.gov/webfiles/749/specialreport122003.pdf.

OFHEO's mission is to promote housing and a strong national housing finance system by ensuring the safety and soundness of Fannie Mae and Freddie Mac.

(C) A grader not licensed under State law, but who is employed by a warehouse operator who has a commodity storage agreement with the Commodity Credit Corporation and is in compliance with State law regarding warehouses; and

(v) With regard to substances or conditions injurious to human or animal health, the samples are analyzed by a laboratory approved by us.

* * * * *

5. Amend § 457.140 as follows:

a. Revise the introductory text to read as set forth below;

b. Amend section 12(e)(2)(iii) of the crop insurance provisions by removing "and" at the end thereof; and

c. Revise section 12(e)(2)(iv) and add section 12(e)(2)(v) of the crop insurance provisions, to read as follows:

§ 457.140 Dry pea crop insurance provisions.

The dry pea crop insurance provisions for the 2003 and succeeding crop years are as follows:

United States Department of Agriculture

Federal Crop Insurance Corporation

* * * * *

12. Settlement of Claim.

* * * * *

(e) * * *

(2) * * *

(iv) With regard to deficiencies in quality (except test weight, which may be determined by our loss adjuster), the samples are analyzed by:

(A) A grader licensed under the United States Agricultural Marketing Act or the United States Warehouse Act;

(B) A grader licensed under State law and employed by a warehouse operator who has a storage agreement with the Commodity Credit Corporation; or

(C) A grader not licensed under State law, but who is employed by a warehouse operator who has a commodity storage agreement with the Commodity Credit Corporation and is in compliance with State law regarding warehouses; and

(v) With regard to substances or conditions injurious to human or animal health, the samples are analyzed by a laboratory approved by us.

* * * * *

6. Amend § 457.141 as follows:

a. Revise the introductory text to read as set forth below;

b. Amend section 12(d)(3)(iii) of the crop insurance provisions by removing "and" at the end thereof; and

c. Revise section 12(d)(3)(iv) and add section 12(d)(3)(v) of the crop insurance provisions, to read as follows:

§ 457.141 Rice crop insurance provisions.

The rice crop insurance provisions for the 2003 and succeeding crop years are as follows:

United States Department of Agriculture

Federal Crop Insurance Corporation

* * * * *

12. Settlement of Claim.

* * * * *

(d) * * *

(3) * * *

(iv) With regard to deficiencies in quality (except test weight, which may be determined by our loss adjuster), the samples are analyzed by:

(A) A grader licensed under the United States Agricultural Marketing Act or the United States Warehouse Act;

(B) A grader licensed under State law and employed by a warehouse operator who has a storage agreement with the Commodity Credit Corporation; or

(C) A grader not licensed under State law, but who is employed by a warehouse operator who has a commodity storage agreement with the Commodity Credit Corporation and is in compliance with State law regarding warehouses; and

(v) With regard to substances or conditions injurious to human or animal health, the samples are analyzed by a laboratory approved by us.

* * * * *

7. Amend § 457.150 as follows:

a. Revise the introductory text to read as set forth below;

b. Amend section 13(e)(3)(iii) of the crop insurance provisions by removing "and" at the end thereof; and

c. Revise section 13(e)(3)(iv) and add section 13(e)(3)(v) of the crop insurance provisions, to read as follows:

§ 457.150 Dry bean crop insurance provisions.

The dry bean crop insurance provisions for the 2003 and succeeding crop years are as follows:

United States Department of Agriculture

Federal Crop Insurance Corporation

* * * * *

13. Settlement of Claim.

* * * * *

(e) * * *

(3) * * *

(iv) With regard to deficiencies in quality (except test weight, which may be determined by our loss adjuster), the samples are analyzed by:

(A) A grader licensed under the United States Agricultural Marketing Act or the United States Warehouse Act;

(B) A grader licensed under State law and employed by a warehouse operator who has a storage agreement with the Commodity Credit Corporation; or

(C) A grader not licensed under State law, but who is employed by a warehouse operator who has a commodity storage agreement with the Commodity Credit Corporation and is in compliance with State law regarding warehouses; and

(v) With regard to substances or conditions injurious to human or animal health, the samples are analyzed by a laboratory approved by us.

* * * * *

Signed in Washington, DC on August 27, 2002.

Byron E. Anderson,

Acting Manager, Federal Crop Insurance Corporation.

[FR Doc. 02–22258 Filed 8–28–02; 8:58 am]

BILLING CODE 3410–08–P

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Office of Federal Housing Enterprise Oversight

12 CFR Part 1720

RIN 2550–AA22

Safety and Soundness Regulation

AGENCY: Office of Federal Housing Enterprise Oversight, DHUD.

ACTION: Final rule.

SUMMARY: The Office of Federal Housing Enterprise Oversight (OFHEO) is issuing a final rule to support increased transparency and public awareness of minimum supervisory standards adopted by OFHEO and applied in overseeing the safety and soundness of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) (collectively, the Enterprises). The final rule's format reflects that used by other federal regulators. The rule delineates supervisory standards in a manner consistent with recent rulings by the United States Supreme Court affecting agency pronouncements. OFHEO will adopt and publish supervisory policy guidance as appendices to the rule as it deems appropriate to illuminate areas of particular interest or potential concern.

EFFECTIVE DATES: September 30, 2002.

FOR FURTHER INFORMATION CONTACT: David W. Roderer, Deputy General Counsel, or Marvin Shaw, Senior Counsel, at (202) 414–3775 (not a toll-free number), Office of General Counsel,

Office of Federal Housing Enterprise Oversight, 1700 G Street NW., Fourth Floor, Washington, DC 20552. The telephone number for the Telecommunications for the Deaf is: (800) 877–8339 (TTD *only*).

SUPPLEMENTARY INFORMATION: The Federal Housing Enterprises Financial Safety and Soundness Act of 1992, Title XIII of Pub. L. No. 102–550 (the Act), empowers OFHEO to take any such action as the Director determines to be appropriate to ensure that the federally sponsored housing enterprises, the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) (collectively, the Enterprises), are adequately capitalized and operating safely by, among other things, adopting supervisory policies and standards by regulation or other guidance or process.

On December 19, 2000, OFHEO issued Policy Guidance PG–00–001 setting forth minimum supervisory standards in eight broad areas of particular regulatory interest and potential concern and issued Policy Guidance PG–00–002, that addressed standards for non-mortgage liquidity.[1] One year later, a third policy guidance was adopted that specifically sets out the minimum safety and soundness standards for information systems and security.[2] That policy guidance, entitled "Safety and Soundness Standards for Information," focused narrowly on safety and soundness concerns with the adequacy of the Enterprises' respective policies and procedures affecting the security of their information systems and integrity of such information, including borrower information maintained by the Enterprises.

The minimum standards set forth in OFHEO's policy guidances are designed to identify key safety and soundness concerns regarding operation and management of an Enterprise, and to ensure that the conduct and practices of the Enterprises reasonably avoid the emergence of problems that might entail serious risks. The minimum standards also reflect the need for internal policies and procedures in particular areas that, if not appropriately addressed by an Enterprise, may warrant supervisory action by OFHEO in order to reduce risks of loss and corresponding capital impairment. The minimum standards set out in such guidances are intended to affect these purposes without dictating how the Enterprises must be operated and managed.

On June 21, 2002, OFHEO published a notice in the **Federal Register** proposing a rule that would provide the regulatory framework for the adoption and publication of such policy guidance.[3] The format of the proposed regulation, as a formal agency pronouncement delineating the parameters of the supervisory standards applicable to the Enterprise, mirrors that used by the Office of Comptroller of the Currency (OCC) in promulgating safety and soundness standards for national banks[4] pursuant to Section 39 of the Federal Deposit Insurance Act.[5] The OCC used a similar format when it adopted specific supervisory standards applicable to bank information systems.[6]

OFHEO received comments from Freddie Mac, Fannie Mae and the Mortgage Bankers Association of America (MBAA). The commenters generally supported the proposal. Freddie Mac agreed with the purpose of the rule of improving transparency and public awareness of supervisory standards applicable to the Enterprises. In particular, Freddie Mac acknowledged the issuance of guidance is the most effective way to integrate safety and soundness objectives into an ever-changing business environment. Similarly, Fannie Mae supported the purpose of the rule: to enhance transparency and public awareness of these minimum supervisory standards. MBAA noted that the proposal and the specific authorities set forth by OFHEO appear to be reasonable and within the bounds of prudent regulatory practice.

OFHEO analyzed the comments and suggestions for improvement of the proposed rule. Freddie Mac recommended section § 1720.2 be modified with respect to the Director's authority to include the phrase "to the extent such actions are authorized by the Act." OFHEO agrees with Freddie Mac that the Director may only exercise such authority as is specifically granted, or by implication is necessary to carry out specific grants of authority, in legislation enacted by Congress. Accordingly, OFHEO believes that it is unnecessary to amend the regulatory text in section § 1720.2 to state this principle.

Fannie Mae questioned the need for what they believe are "duplicative reassertions of authority" since OFHEO has asserted its authority in the guidances and in 12 CFR Part 1777. Fannie Mae also requested confirmation of its belief that the rulemaking does not convert OFHEO's policy guidances into rules subject to the Administrative Procedure Act (APA). Finally, Fannie Mae requested that OFHEO solicit input from the Enterprises whenever it develops any supervisory policy guidance.

OFHEO notes that its assertion of statutory authority in this rulemaking as well as in the guidances and Part 1777 reflect common practice among federal agencies in specifying their authority whenever they publish agency rules or other pronouncements. This practice cites the authority of the agency to those coming into contact with an agency pronouncement for the first time. OFHEO agrees that the safety and soundness rule set forth in final form here does not "convert" existing or future guidance into rules subject to the APA. Indeed, this would be contrary to OFHEO's intent and reduce its use of this important and flexible supervisory device.

As explained in the NPR, the final regulation and appended guidances are intended to facilitate the public awareness and enforceability of such standards as official agency pronouncements in a manner consistent with recent United States Supreme Court's rulings.[7]

Nothing in the OFHEO Policy Guidances limits the authority of OFHEO to otherwise address unsafe or unsound conditions or practices, or violations of applicable laws, regulations or supervisory orders, as detailed in section § 1720.1(b).

Regulatory Impact

Executive Order 12866, Regulatory Planning and Review

The regulation is not classified as a significant rule under Executive Order 12866 because it will 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

[1] OFHEO Policy Guidance PG–00–001, Minimum Safety and Soundness Requirements (Dec. 19, 2000) and Policy Guidance PG–00–002, Non-mortgage Liquidity Investments (December 19, 2000) (available on OFHEO's web site at *http://www.ofheo.gov*).

[2] OFHEO Policy Guidance PG–01–001, Safety and Soundness Standards for Information (Dec. 19, 2001) (available on OFHEO's web site at *http://www.ofheo.gov*).

[3] 67 FR 42200 (June 21, 2002).

[4] For the OCC, these regulations appear at 12 CFR Part 30, Appendix A: "Interagency Guidelines Establishing Standards for Safety and Soundness"; *see also*, for the Board of Governors of the Federal Reserve System at 12 CFR Part 263; and for the Federal Deposit Insurance Corporation at 12 CFR 308, subpart R; and for the Office of Thrift Supervision at 12 CFR Part 570.

[5] 12 U.S.C. 1381p–1.

[6] *See*, Appendix B of 12 CFR Part 30.

[7] *See United States* v. *Mead Corp.*, 533 U.S. 218 (2001), and *Christensen* v. *Harris County*, 529 U.S. 576 (2000).

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 regulation need not be submitted to the Office of Management and Budget for formal review.

Unfunded Mandates Reform Act of 1995

This rule does not include a Federal mandate that could result in the expenditure by State, local, and tribal governments, in the aggregate, or by the private sector, of $100,000,000 or more (adjusted annually for inflation) in any one year. As a result, the rule does not warrant the preparation of an assessment statement in accordance with the Unfunded Mandates Reform Act of 1995.

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 regulation under the Regulatory Flexibility Act. The General Counsel of OFHEO certifies that the regulation is not likely to have a significant economic impact on a substantial number of small business entities because the regulation only affects the Enterprises, which are not small entities for purposes of the Regulatory Flexibility Act.

Paperwork Reduction Act of 1995

This regulatory action contains no information collection requirement that would require the approval of the Office of Management and Budget pursuant to the Paperwork Reduction Act, 44 U.S.C. 3501–3520.

List of Subjects in 12 CFR Part 1720

Administrative practice and procedure, Mortgages.

Accordingly, for the reasons set out in the preamble, the Office of Federal Housing Enterprise Oversight is adding part 1720 to subchapter C of 12 CFR chapter XVII to read as follows:

PART 1720—SAFETY AND SOUNDNESS

Sec.

Authority: 12 U.S.C. 4513(a), 4513(b)(1), 4513(b)(5), 4517(a), 4521(a)(2) through (3), 4631, 4632, and 4636.

§ 1720.1 Authority.

(a) *Authority.* This part is issued by the Office of Federal Housing Enterprise Oversight (OFHEO) pursuant to sections 1313(a), 1313(b)(1), and 1313(b)(5) of the Federal Housing Enterprise Financial Safety and Soundness Act (Act) (12 U.S.C. 4513(a), 4513(b)(1), and 4513(b)(5)). These provisions of the Act authorize OFHEO to take any action deemed appropriate by the Director of OFHEO to ensure that the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation (the Enterprises) are operated in a safe and sound manner, including by adopting supervisory policies and standards by regulation, guidance, or other process.

(b) *Preservation of existing authority.* No action by OFHEO undertaken with reference to a policy guidance or this regulation will in any way limit the authority of the Director otherwise to address unsafe or unsound conditions or practices, or other violations of law, rule or regulation. Action with reference to a policy guidance or this regulation may be taken separate from, in conjunction with, or in addition to any other supervisory response, enforcement action, or agency-imposed requirements deemed appropriate by OFHEO. Nothing in this regulation or any guidance issued by OFHEO limits the authority of the Director pursuant to section 1313 of the Act (12 U.S.C. 4513) or any other provision of law, rule or regulation applicable to the Enterprises.

§ 1720.2 Safety and soundness standards.

Policy guidances as may be adopted from time to time by OFHEO, addressing safety and soundness standards, shall apply to the Enterprises. If OFHEO determines that an Enterprise does not meet a requirement set out in such policy guidance, it may require corrective or remedial actions by the Enterprise, and take such enforcement action as the Director deems to be appropriate.

Appendix A to Part 1720—Policy Guidance; Minimum Safety and Soundness Requirements

A—Background and Introduction

I. Background. The Federal Housing Enterprises Safety and Soundness Act of 1992, Title XIII of Pub. L. No. 102–550 (the Act) empowers OFHEO to take any such action as the Director determines to be appropriate to ensure that the federally sponsored housing enterprises, Fannie Mae and Freddie Mac, are, among other things, adequately capitalized and operating safely, including by adopting supervisory policies and standards by regulation or other guidance or process.

i. OFHEO herein sets forth the minimum supervisory requirements used by the agency in reviewing the ensuring, the adequacy of policies and procedures of the Enterprises in the areas of: (1) Asset underwriting and credit quality; (2) balance sheet growth; (3) market risks; (4) information technology; (5) internal controls; (6) audits; (7) information reporting and documentation; and (8) board and management responsibilities and functions. If the agency finds that an Enterprise fails to meet any requirement or standard set forth in this pronouncement, the Director may, among other things, require the Enterprise to submit to the agency and implement an adequate plan to achieve timely compliance with the requirement or standard. If the Enterprise fails to submit such an adequate plan within the time specified by the agency or fails in any material respect to implement the plan, the agency may take additional supervisory action. The Director may at any time prescribe such supervisory actions as deemed appropriate to correct conditions resulting from an unsafe or unsound practice or condition or deficiency in complying with regulatory requirements or standards including, but not limited to, issuance of a notice of charges or order, imposition of civil money penalties, or other remedial actions or sanctions as determined by the Director.

ii. The minimum supervisory requirements and standards identify key safety and

soundness concerns regarding operation and management of an Enterprise, and ensure that action is taken to avoid the emergence of problems that might entail serious risks to an Enterprise. The minimum supervisory requirements of the Policy Guidance also reflect the need for internal policies and procedures in particular areas that, if not appropriately addressed by the Enterprises, may warrant action by OFHEO in order to reduce risks of loss and possible capital impairment. The proposed minimum requirements set forth herein are intended to effect these purposes without dictating how the Enterprises must be operated and managed; moreover, the Policy Guidance does not set out detailed operational and managerial procedures that an Enterprise must have in place. The Policy Guidance is intended to identify the ends that proper operational and management policies and procedures are to achieve, while leaving the means to be devised by each Enterprise as it designs and implements its own policies and procedures. Where OFHEO does specify particular requirements, each Enterprise's management is left with substantial flexibility to fashion and implement them.

iii. The Policy Guidance is not intended to effect a change in OFHEO's policies; the announced minimum requirements reflect the basic underlying criteria OFHEO uses to assess the operations and managerial quality of an Enterprise. OFHEO will determine compliance with the requirements and related standards through examinations of the Enterprises, as well as off-site surveillance means and other interchanges with each Enterprise.

iv. OFHEO routinely undertakes to evaluate an Enterprise's overall policies, in order to determine whether such policies are safe and sound in principle and in practice. OFHEO also evaluates whether procedures are in place to ensure that an Enterprise's overall policies as adopted by the Enterprise's board of directors and management are, in fact, applied in the normal course of business. As reflected in the Policy Guidance, the Enterprises are, at a minimum, expected to adopt appropriate policies and internal guidelines, and to put in place procedures to ensure they are followed as a matter of routine.

v. Nothing in the Policy Guidance in any way limits the authority of OFHEO to otherwise address unsafe or unsound conditions or practices, or violations of applicable law, regulation or supervisory order. Action referencing the Policy Guidance may be taken separate from, in conjunction with or in addition to any other enforcement action available to OFHEO. Compliance with the Policy Guidance in general would not preclude a finding by the agency that an Enterprise is otherwise engaged in a specific unsafe or unsound practice or is in an unsafe or unsound condition, or requiring corrective or remedial action with regard to such practice or condition. That is, supervisory action is not precluded against an Enterprise that has not been cited for a deficiency under the Policy Guidance. Conversely, an Enterprise's failure to comply with one of the supervisory requirements set forth in the Policy Guidance may not warrant a formal supervisory response from OFHEO, if the agency determines the matter may be otherwise addressed in a satisfactory manner. For example, OFHEO may require timely submission of a plan to achieve compliance with the particular requirement or standard without taking any other enforcement action.

II. Introduction. i. *Authority, purpose, and scope.*

a. Authority. This Policy Guidance is issued by the Office of Federal Housing Enterprise Oversight (OFHEO) pursuant to sections 1313(a), 1313(b)(1), 1313(b)(5) and 1371 of the Federal Housing Enterprise Safety and Soundness Act (Act) (12 U.S.C. 4513(a), 4513(b)(1), 4513(b)(5) and 4631). These provisions of the Act authorize OFHEO to take any action deemed appropriate by the Director of OFHEO to ensure that the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation (the Enterprises) are operated in a safe and sound manner, including by adopting supervisory policies and standards by regulation, guidance, or other process.

b. Purpose and scope. This Policy Guidance sets out certain minimum safety and soundness requirements for the business and operations of the Enterprises, and reiterates agency policies requiring the Enterprises to establish and implement policies and procedures that are sufficient to effectuate compliance with supervisory standards. If OFHEO determines that an Enterprise does not meet the requirements set forth herein, the Director may require the Enterprise to submit and carry out a plan to achieve compliance, or may take other corrective and remedial actions. The requirements enumerated herein are supervisory minimums. In order to satisfy an Enterprise's overarching obligation under the Act to conduct is operations in a safe and sound manner, it may be necessary and appropriate for an Enterprise to take additional measures in these or other areas, as directed by OFHEO through regulation, guidance, order or otherwise as part of the supervisory process.

ii. *Preservation of existing authority.* Neither this Policy Guidance nor any action by OFHEO to enforce compliance of an Enterprise therewith in any way limits the authority of the Director otherwise to address unsafe or unsound conditions or practices, or other violations of law or other regulation. Action under this Policy Guidance may be taken separate from, in conjunction with, or in addition to any other enforcement action deemed appropriate by OFHEO. Nothing in this Policy Guidance or related guidances limits the authority of the Director pursuant to section 1313 of the Act (12 U.S.C. 4513) or any other provision of law, rule or regulation applicable to the Enterprises.

iii. *Definitions.* For purposes of this Policy Guidance, except as modified therein or unless the context otherwise requires, the terms used have the same meaning as set forth in section 1303 of the Act (12 U.S.C. 4502).

B—Operational and Managerial Requirements

I. Asset underwriting and credit quality. An Enterprise should establish and implement policies and procedures to adequately assess credit risks before they are assumed, and monitor such risks subsequently to ensure that they conform to the Enterprise's credit risk standards on an individual and an aggregate basis. The Enterprise should:

i. For loans purchased and loans collateralizing securities guaranteed by the Enterprise, adopt and implement prudent underwriting standards and procedures commensurate with the type of loan or loans and the markets in which the loan or loans were made that include consideration of the borrower's and any guarantor's financial condition and ability to repay as well as the type and value of any collateral or credit enhancement;

ii. To the extent the Enterprise's assets are serviced or administered by other entities or are covered by mortgage insurance or other credit enhancements or arrangements, the Enterprise's policies and procedures should recognize the consequences and implications of such contractual arrangements for the Enterprise's credit risk;

iii. Establish and implement policies and procedures to address declining credit quality and to require appropriate corrective action; to establish sufficient reserves; and to deal with defaulted assets so as to minimize losses;

iv. Establish and implement policies and procedures to select and price credit risk to ensure that the Enterprise is appropriately compensated commensurate with the credit risk it assumes and its statutory obligations;

v. Establish and implement policies and procedures that address the prudential selection, management and handling of counterparty credit exposure that arises from engaging in hedging activities and the use derivative instruments; and

vi. Establish and implement policies and procedures to identify, monitor and evaluate its credit exposures on an aggregate basis so as to assess the implications and consequences of matters such as concentration exposure (including geographic as well as product concentrations), to identify and evaluate credit risk trends effectively, and to maintain and revise appropriately its systems and procedures for underwriting, servicing, and monitoring of such exposures and changes to those exposures.

II. Balance sheet growth and management. An Enterprise's balance sheet growth should be prudent and consider:

i. The source, volatility, and use of funds that support balance sheet growth;

ii. Any changes in credit risk or interest rate risk resulting from balance sheet growth;

iii. The effect of balance sheet growth on the Enterprise's capital adequacy; and

iv. The appropriate policies and procedures needed to manage changes in risk that may occur as a result of balance sheet growth.

III. Market risk. An Enterprise should establish and implement policies and procedures that allow for the effective identification, measurement, monitoring, and

management of market risk. The Enterprise should:

i. Establish and implement policies and procedures sufficient to quantify and monitor the interest rate risk of the Enterprise effectively and to model the effect of differing interest rate scenarios on the Enterprise's financial condition and operations;

ii. Develop risk management strategies that respond appropriately to changes in interest rates;

iii. Establish and implement policies and procedures sufficient to quantify and monitor the Enterprise's liquidity effectively, and to identify and anticipate various market environments and their effects on the Enterprises' liquidity; and

iv. Establish and maintain an effective contingency plan for liquidity under varying scenarios.

IV. Information technology. An Enterprise should establish and implement policies and procedures to ensure that its computing resources, proprietary and nonpublic information and data are:

i. Protected from access by unauthorized users, and otherwise protected by appropriate security measures;

ii. Reliable, accurate and available at all times as needed for its business operations, including an ability to effect timely recovery and resume operations after a reasonably foreseeable adverse event; and

iii. Designed to ensure adequate support of business operations.

V. Internal controls. An Enterprise should maintain and implement internal controls appropriate to the nature, scope and risk of its business activities that, at a minimum, provide for:

i. An organizational structure and assignment of responsibility for management, employees, consultants and contractors, that provide for accountability and controls, including adherence to policies and procedures;

ii. A control framework commensurate with the Enterprise's risks;

iii. Policies and procedures adequate to safeguard and to manage assets; and

iv. Compliance with applicable laws, regulations and policies.

VI. Audits. An Enterprise should establish and implement internal and external audit programs appropriate to the nature and scope of its business activities that, at minimum, provide for:

i. Adequate monitoring of internal controls through an audit function appropriate to the Enterprise's size, structure and scope of operations;

ii. Independence of the audit function;

iii. Qualified professionals and management for the conduct and review of audit functions;

iv. Adequate testing and review of audited areas together with adequate documentation of findings and of any recommendations and corrective actions; and

v. Verification and review of measures and actions undertaken to address identified materjal weaknesses.

VII. Information reporting and documentation. An Enterprise should establish and implement policies and procedures for generating and retaining reports and documents that:

i. Enable the Enterprise's board of directors (including appropriate committees) to make informed decisions and to exercise its oversight function, by providing all such relevant information of an appropriate level of detail as necessary;

ii. Enable the Enterprise's managers to make informed business decisions and to assess risks for all aspects of the Enterprise's business on an ongoing basis, by providing sufficient relevant information of an appropriate level of detail as necessary;

iii. Ensure decision-makers have appropriate and necessary information about particular transactions and business operations;

iv. Enable the Enterprise to administer and supervise all assets, liabilities, commitments and other financial obligations appropriately;

v. Enable the Enterprise to enforce legal claims against borrowers, counterparties and other obligors; and

vi. Ensure timely and complete submissions of reports of financial condition and operations, as well as annual and other periodic reports and special reports to OFHEO whenever requested or required by OFHEO.

VIII. Board and management responsibilities and function. An Enterprise's board of directors shall ensure that the board (including appropriate committees) works with executive management to establish the Enterprise's strategies and goals in an informed manner, and that the Enterprise's executive managers and other managers, as appropriate, implement such strategies, by ensuring at a minimum that:

i. The board (including appropriate committees) oversees the development of the Enterprise's strategies in key areas and exercises oversight necessary to ensure that management sets policies and controls to implement such strategies effectively;

ii. The board (including appropriate committees) hires qualified executive management, and exercises oversight to hold management accountable for meeting the Enterprise's goals and objectives;

iii. The board (including appropriate committees) is provided with accurate information about the operations and financial condition of the Enterprise in a timely fashion, and sufficient to enable the board to effect its oversight duties and responsibilities;

iv. Management of the Enterprise sets policies and controls to ensure the Enterprise's strategies are implemented effectively, and that the Enterprise's organization structure and assignment of responsibilities provide clear accountability and controls; and

v. Management of the Enterprise establishes and maintains an effective risk management framework, including review of such framework to monitor its effectiveness and taking appropriate action to correct any weaknesses.

IX. Format of policies and procedures. i. Generally, the policies of an Enterprise contemplated by this Policy Guidance should be in writing and in such form and detail as appropriate in light of their intended purpose, nature, and potential consequences for the operations and financial condition of the Enterprise, and approved by the board of directors (including appropriate committees) or such responsible officer or officers as designated by the board.

ii. The policies and procedures of an Enterprise contemplated by this Policy Guidance should be provided to OFHEO at such time and in such format as OFHEO directs.

C—Compliance Plans

I. Notice; submission and review of compliance plans. i. *Determination.* The Director of OFHEO may, based upon a report of examination, or other supervisory information however acquired, determine that an Enterprise has failed or is likely to fail to satisfy the minimum supervisory requirements or standards set forth in part B of this appendix.

ii. *Request for compliance plan.* If the Director determines pursuant to paragraph C.I.i of thiis appendix that an Enterprise has failed or is likely to fail to satisfy a supervisory requirement or standard, OFHEO may require the submission of a written compliance plan.

iii. *Schedule for filing compliance plan.* An Enterprise may be required to file a written compliance plan with OFHEO within thirty days of receiving a written request for a compliance plan pursuant to paragraph C.I.ii of this appendix.

iv. *Contents of plan.* A required compliance plan should include, subject to additional direction by OFHEO, a detailed description of the steps the Enterprise will take to correct a deficiency and any condition resulting therefrom and the time within which such steps will be undertaken and fully implemented.

v. *Review of compliance plans.* If the compliance plan submitted under this section is deemed to be inadequate or incomplete, OFHEO may provide written notice of such inadequacy or deficiencies thereof to the Enterprise OFHEO or seek additional information from the Enterprise regarding the plan.

vi. *Amendment of compliance plan.* An Enterprise that has filed a required compliance plan to which no objection has been raised by OFHEO may, after prior written notice to and approval by the Director, amend the plan to reflect changes in circumstance, policies and procedures.

II. Failure to submit acceptable plan or to comply with plan. If an Enterprise does not submit an adequate and complete plan as required by the agency within the time specified by OFHEO or does not implement such an adequate and complete plan, the Director may require the Enterprise to correct any deficiency and may require additional corrective or remedial actions by the Enterprise as deemed to be appropriate pursuant to the Act, including sections 1371 (12 U.S.C. 4631), 1372 (12 U.S.C. 4632), and 1376 (12 U.S.C. 4636).

Appendix B to Part 1720—Policy Guidance; Non-Mortgage Liquidity Investments

A—Purpose
B—Activities Covered
C—Standards for Non-mortgage Liquidity Investment Activities

A—Purpose

1. Fannie Mae and Freddie Mac (the Enterprises) were chartered by Congress as government-sponsored enterprises with public missions. They perform an important role in the United States mortgage market by gathering funds and purchasing mortgages from mortgage originators and guaranteeing mortgage-backed securities. In chartering the Enterprises, Congress charged the Enterprises with: (1) providing stability to mortgage markets; (2) responding to the changing capital markets; (3) assisting the secondary markets including the support of these markets for affordable housing; and (4) promoting access to credit throughout the country by increasing liquidity and improving distribution of investment capital for residential mortgage finance. These functions require the Enterprises, as principals in the secondary mortgage market, to serve as bedrock in providing liquidity to the U.S. housing finance system.

2. For the Enterprises effectively to perform their public purposes, they must be financially sound and liquid. As the Enterprises' financial safety and soundness regulator, OFHEO conducts its regulatory programs to ensure these companies adhere to safety and soundness standards. In addition, OFHEO interprets this to include heightening the positive effect of market discipline on the Enterprises by encouraging quality disclosures, appropriate accounting standards, and state-of-the-art risk management further strengthens their safety and soundness. More specifically, OFHEO conducts comprehensive safety and soundness examinations and requires the Enterprises to adhere to regulatory capital requirements. In conducting its regulatory programs, OFHEO applies a series of safety and soundness standards to assess the Enterprises' liquidity management, including their investments in non-mortgage liquidity assets. It is appropriate to issue initial guidance that addresses the safety and soundness standards OFHEO uses to evaluate Enterprise investment activities in non-mortgage liquidity assets.

3. Further, it should be noted that the Secretary of HUD, who has general regulatory power over the Enterprises and who is required to make such rules and regulations as necessary to ensure that the purposes of the GSE's respective Charter Acts are accomplished, has issued an Advanced Notice of Proposed Rulemaking on possible substantive and/or procedural rules governing the GSEs' non-mortgage investment activities. Accordingly, the GSEs may be subject to regulations in this area through future HUD actions, in addition to this initial guidance.

B—Activities Covered

1. The Enterprises must maintain sufficient liquidity to meet both known and unexpected payment demands on borrowings and mortgage securities, for operations and to purchase mortgage assets. Liquidity management is the process by which the Enterprises manage the use and availability of various funding sources to meet current and future needs. Liquidity must be closely managed on a daily basis.

2. The Enterprises manage liquidity through three primary channels: securitizations, issuance of debt and conversion of liquid assets into cash. It is through careful management within and among the three channels, that the Enterprises can effectively meet demands and remain safe and sound under all market conditions. This Guidance specifically addresses "non-mortgage liquidity investments" which are conducted within the liquidity channel whereby the Enterprises are able to convert their own assets into cash.

3. There are various types of investments that may be appropriate for non-mortgage liquidity holdings. Appropriate non-mortgage liquidity investments are characterized by both creditworthiness and low price volatility. Even though an investment may be creditworthy, if the holding is subject to undue price volatility (e.g. common stock), the investment is inappropriate for inclusion in the non-mortgage liquidity portfolio since the investment may not be readily converted into cash without substantial loss.

4. For the purposes of this Guidance, the types of assets listed below are generally considered to be appropriate non-mortgage liquidity investments. This list is subject to revision over time as new asset types are introduced and/or market activities change. The presence of an asset on the list does not mean that OFHEO will necessarily consider any and all Enterprise investments in these assets to be safe and sound, especially if they fail to meet appropriate credit quality, maturity and diversification objectives:

a. Debt issued by the United States Treasury,

b. Debt issued by U.S. Government Agencies,

c. General obligation debt issued by states and municipal authorities,

d. Revenue obligations issued by states and municipal authorities,

e. Corporate debt instruments,

f. Money market instruments,

g. Non-mortgage asset-backed securities, and

h. Reverse repurchase agreements.

5. This Guidance does not address investments in mortgage-backed securities, mortgage revenue bonds, or other investments secured by housing (including commercial mortgage-backed securities with a significant housing component) since these assets are not principally held for liquidity purposes. Also, upon implementation of FAS 133, this Guidance is not intended to address the use of derivative instruments. For activities not covered in this Guidance on non-mortgage liquidity investments, there should be no inferences drawn about OFHEO's views.

C—Standards for Non-Mortgage Liquidity Investment Activities

To ensure there are sufficient funds available to the mortgage market, the Enterprise must actively manage liquidity across all three channels. OFHEO assesses the safety and soundness of non-mortgage liquidity investment activities against five criteria. The five criteria and details about each of the criteria are:

- Prudent investment policies and procedures that guide the Enterprise's process;
- Quality management information that ensures timely performance measures and governance data;
- Safe & sound investment holdings and investment culture;
- Quality controls and personnel administering and governing the process; and
- Independent testing of the process to assure compliance.

1. Prudent Investment Policies and Procedures That Guide the Enterprise's Process

a. The Enterprise must have a comprehensive written investment policy that clearly expresses the goals for the non-mortgage liquidity investment activities. The Board of Directors and management must evaluate the effectiveness of non-mortgage liquidity investments in meeting the goals set out in the policy; and management must evaluate activities against the procedures and limitations in the policy. At a minimum, the policy should cover:

i. The purpose of the non-mortgage liquidity investment holdings;

ii. The institutional goal(s) for the non-mortgage liquidity investment holdings;

iii. The authorized instruments and activities;

iv. The internal control standards;

v. The limits structure;

vi. The performance standards and measures; and

vii. The reporting requirements.

b. The policy should clearly document the purpose for non-mortgage liquidity investment holdings. Management should install a series of procedures and controls that produce behaviors and performance that are consistent with the defined purpose for the non-mortgage liquidity investment activities.

c. The policy should establish the primary goals for the non-mortgage liquidity investment activities. For an Enterprise, some primary goals should be to augment liquidity and to generate a rate of return that is reasonable in light of the purpose of such investments. The emphasis placed on individual goals may vary based upon institutional differences. However, non-mortgage liquidity investments made with a goal of maximizing earnings or maximizing arbitrage opportunities would be inconsistent with this Guidance for the maintenance of an Enterprise's liquidity portfolio.

d. The policy should clearly define the authorized investment vehicles and establish guidelines for the introduction of new types of investment vehicles.

e. The Enterprise's procedures should include a framework of controls that provide an appropriate separation of duties and responsibilities. There should be responsibility assigned for an independent review of non-mortgage liquidity investments by a designated unit, such as audit or an independent risk oversight group.

f. The Enterprise should adopt a limit structure to promote diversification in the non-mortgage liquidity investment portfolio and emphasizes strategies for risk mitigation. Additionally, there should be limits for the aggregate size of the non-mortgage liquidity investment portfolio.

g. The Enterprise should adopt measures to evaluate performance against the policy and its objectives.

h. The Enterprise should adopt internal reporting requirements that quantify performance, document exceptions, and serve as a basis for communicating information about activities involving non-mortgage liquidity assets.

i. The Enterprise should periodically evaluate the adequacy and content of its public disclosure for non-mortgage investment liquidity activities.

2. Quality Management Information That Ensures Timely Performance Measures and Governance Data

a. The Enterprise must maintain systems that adequately identify, measure and report the nature and level of exposure associated with their non-mortgage liquidity investments. Management must remain appropriately informed about the activity in non-mortgage liquidity investments. Also, the Board of Directors should periodically be provided a summary of non-mortgage liquidity investment activities. At a minimum, management's reports to the Board should:

i. Summarize non-mortgage investment activity since the last report;

ii. Identify and explain any material changes or trends in the non-mortgage liquidity investment portfolio risk and returns; and

iii. Report and explain exceptions to the policy or risk guidelines for liquidity investments.

b. Meaningful changes in portfolio volume and spreads from period to period should be identified and explained to the Board in terms of why they occurred (*e.g.*, changes in portfolio composition, changes in funding costs, *etc.*). In overseeing the day-to-day management of non-mortgage liquidity investment activities, management should consider the discrete risks associated with the non-mortgage liquidity investment portfolio as well as the exposure of this portfolio within the context of risks across the entire Enterprise. This includes assessing the non-mortgage liquidity investment portfolio's sensitivity to changes in interest rates, expressed in terms of net interest income sensitivity and portfolio value sensitivity.

3. Safe and Sound Investment Holdings and Investment Culture

a. The Enterprise should implement and enforce policies and/or procedures for non-mortgage liquidity investments. Management should establish limits and procedures in a manner that is consistent with the Board's sanctioned goals and risk appetite. Certain risk-limits for non-mortgage liquidity investments may be expressed in terms of how they affect the Enterprise's overall risk-profile, such as those pertaining to interest-rate sensitivity. Other risk limits may be more appropriately expressed in terms of individual portfolios and instruments. In addition, limits restricting the size-range and scope of the non-mortgage liquidity investment activities should be established.

b. The limits and procedures should delineate the acceptable investment instruments, acceptable markets, acceptable counterparties, along with unacceptable investment or portfolio activities. The Enterprise should maintain sufficient documentation to demonstrate due diligence in adhering to policies, procedures, limits and guidelines.

c. At a minimum, limits should be established and reviewed annually, for:

i. Credit threshold guidelines: Credit quality is a compelling factor for liquidity investments. Since liquidity investments should be able to be readily converted into cash without substantial exposure to losses, investments should be insulated from price vulnerabilities that are associated with creditworthiness. The most effective means of insulating against price exposure from credit quality concerns is to invest in high-quality instruments and the debt obligations of high-quality issuers. The Enterprise should establish thresholds identifying the minimum credit standards of any security eligible for purchase. Where these standards involve credit ratings, the ratings should come from a nationally recognized rating organization. Procedures should be included that determine the steps to be taken by management if an instrument's credit rating falls below the minimum threshold before maturity.

ii. Maturity guidelines: Because the maturity of an investment significantly affects its exposure to credit risk and price volatility, longer maturity instruments have limited suitability as liquidity investments. The Enterprise should establish the maximum maturity allowable for non-mortgage liquidity investments. It would be appropriate to have different maturity limits for certain types of instruments. For example, management may wish to establish shorter maturity limits for fixed-coupon instruments than for adjustable-rate securities. Management may have different maturity limits for bullet securities and amortizing structures. It would be appropriate to establish a maturity matrix based upon an instrument's credit rating at the time of purchase.

iii. Diversification and concentration guidelines: Credit concentrations can increase credit risk. Accordingly, the Enterprise should establish guidelines that limit investments in the securities of any single issuer. Such limits may be established as a percentage limit (*e.g.*, as a percentage of capital) or as an absolute dollar amount. To enhance portfolio liquidity, there should also be a limit on the percentage of any particular issue held by the Enterprise.

4. Quality Controls and Personnel Administering and Governing the Process

a. The Enterprise should maintain a comprehensive set of controls to enforce the appropriate separation of duties and responsibilities. These controls should translate into clear procedures for routine operations. At a minimum, the internal control program for non-mortgage liquidity investment activities should include procedures for the following: portfolio valuation, personnel, settlement, physical control and documentation, conflict of interest, and accounting.

i. Portfolio valuation procedures. Portfolio valuation procedures should require pricing that is independent of the investment portfolio managers. Pricing securities provides an indication of the market depth and liquidity for individual instruments, and is an important process for providing data to the risk management function, particularly within a framework of estimating market value sensitivity. Pricing is particularly important for securities that are classified as "available-for-sale" for accounting purposes.

ii. Personnel guidelines. Personnel guidelines should require competent and experienced staff be responsible for conducting transactions and managing the non-mortgage investment portfolio. There should be clear guidance regarding the roles and responsibilities of individuals involved with the non-mortgage liquidity portfolio.

iii. Settlement practices. Procedures should cover standard settlement practices for the various types of non-mortgage liquidity investments in the Enterprise's portfolio. Inadequate understanding of standard settlement practices, coupled with poor internal controls, could result in unnecessary costs or losses.

iv. Control and documentation. Procedures covering control and documentation should be comprehensive and consistent with the evolving better practices in the marketplace. The procedures should include, for example, standards for: processing and controlling purchased instruments, safeguarding investment documentation and reviewing trade tickets and confirmations.

v. Conflict of interest. Conflict of interest guidelines should govern all Enterprise personnel authorized to purchase or sell non-mortgage liquidity investments. These guidelines should ensure that all directors, officers and employees act in the Enterprise's best interest. Conflict of interest guidelines should address employee relationships with authorized broker/dealers. Guidelines should also address personnel accepting gifts and travel expenses from broker/dealers.

vi. Accounting. Accounting practices should be evaluated to determine the level of compliance with GAAP standards.

5. Independent Testing and Review of the Process to Assure Compliance

a. An independent review of non-mortgage liquidity investment activities should be conducted periodically to ensure:

i. The accuracy and integrity of information provided to the Board, management and other oversight bodies;

ii. The adherence to policy, procedures, limits and guidelines;

iii. The timeliness, accuracy and usefulness of non-mortgage investment reports;

iv. The adequacy of personnel resources and capabilities; and

v. The non-mortgage liquidity investment activities remain appropriate in the context of the marketplace and the external environment.

b. This review may be conducted by a risk oversight unit or internal audit department, or any party that is independent of the routine risk-taking decisions and should be commensurate with the level of review of other primary Enterprise activities. Independent review findings for non-mortgage liquidity investments should be reported to the Board directly or through one of its committees. The Board should consider the independent review when reaffirming policies, and should address any issues raised.

D—Disclosure of Non-Mortgage Liquidity Investment Activities

1. Sound risk management practices include thorough disclosures about the Enterprise's risks and further regulators' efforts to increase financial transparency for regulated financial companies. Quality disclosures about risks and risk management can be an effective deterrent to excessive risk-taking. Three essential elements needed to promote market discipline for non-mortgage liquidity investments are (1) type of issuer and security, (2) maturity, and (3) credit quality or rating. Accordingly, quality disclosure for a portfolio of non-mortgage liquidity investments should include a detailed categorization of the portfolio with respect to each of these elements and cross-categorization, so that (for example) the quantity of any longer-maturity, lower-credit-quality assets is clearly identified. Information about fair values; yields; and narrative discussions of objectives, risk management policies, and controls can also promote transparency of risk and should be included. Such disclosures should be made quarterly, and they should be made using average balances so that average risks can be assessed—not just the risks on a given date.

2. Over the next few quarters, OFHEO will discuss more specifically with the Enterprise how these disclosures will meet the expectations expressed in this guidance. An example of a disclosure format that may be used by the Enterprise is available on the OFHEO Web site at *http://www.ofheo.gov*. However, the Enterprise may disclose the risks in its non-mortgage liquidity investment activities, consistent with the expectations expressed in this guidance, using a format of its choice.

E—Summary

This Guidance sets forth OFHEO's process for evaluating the safety and soundness of liquidity non-mortgage investment activities. OFHEO remains committed to ensuring the Enterprises remain financially sound, have appropriate control environments, and engage only in financially sound business and investment activities. OFHEO's examiners have been instructed to incorporate this evaluation process into their ongoing safety and soundness examinations. Examiners will evaluate and test the Enterprise's non-mortgage liquidity investment processes and activities to ensure they are in compliance with this guidance.

Appendix C to Part 1720—Policy Guidance; Safety and Soundness Standards for Information

A—Introduction

1. Scope.
2. Preservation of Existing Authority.
3. Definitions.

B—Safety and Soundness Standards for Information

1. Information Security Program.
2. Objectives.

C—Development and Implementation of Information Security Program

1. Involve the Board of Directors.
2. Assess Risk.
3. Manage and Control Risk.
4. Oversee Service Provider Arrangements.
5. Adjust the Program.
6. Report to the Board.
7. Implementation.

A—Introduction

The Policy Guidance on Safety and Soundness Standards for Information sets forth standards pursuant to section 1313 of the Federal Housing Enterprise Safety and Soundness Act (12 U.S.C. 4513). The Guidance addresses standards for developing and implementing administrative, technical, and physical safeguards to protect the security, confidentiality, and integrity of information.

1. Scope. The Guidance applies to information maintained by or on behalf of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) (collectively, the Enterprises).

2. Preservation of Existing Authority. Nothing in the Guidance in any way limits the authority of OFHEO to otherwise address unsafe or unsound conditions or practices or violations of applicable law, regulation or supervisory order. Action referencing the Policy Guidance may be taken separate from, in conjunction with or in addition to any other enforcement action available to OFHEO. Compliance with the Policy Guidance in general would not preclude a finding by the agency that an Enterprise is otherwise engaged in a specific unsafe or unsound practice or is in an unsafe or unsound condition, or requiring corrective or remedial action with regard to such practice or condition. That is, supervisory action is not precluded against an Enterprise that has not been cited for a deficiency under the Policy Guidance. Conversely, an Enterprise's failure to comply with one of the supervisory requirements set forth in the Policy Guidance may not warrant a formal supervisory response from OFHEO, if the agency determines the matter may be otherwise addressed in a satisfactory manner. For example, OFHEO may require the submission of a plan to achieve compliance with the particular requirement or standard without taking any other enforcement action.

3. Definitions. For purposes of the Guidance, the following definitions apply:

a. *Information* means any record of an Enterprise, whether in paper, electronic, or other form, that is handled or maintained by or on behalf of an Enterprise;

b. *Information security program* means the administrative, technical, or physical safeguards used by an Enterprise to access, collect, process, store, use, transmit, dispose of, or otherwise handle information;

c. *Information systems* means any methods used to access, collect, store, use, transmit, protect, or dispose of information;

d. *Service provider* means any person or entity, including any third party vendor, that maintains, processes or otherwise is permitted access to information through its provision of services directly or indirectly to an Enterprise.

B—Safety and Soundness Standards For Information

1. Information Security Program. Each Enterprise shall implement a comprehensive written information security program that includes administrative, technical, and physical safeguards appropriate to the nature and scope of its activities. While all parts of the Enterprise are not required to implement a uniform set of policies, all elements of the information security program must be coordinated.

2. Objectives. An Enterprise's information security program shall be designed to:

a. Ensure the security and confidentiality of information;

b. Protect against any anticipated threats or hazards to the security or integrity of such information; and

c. Protect against unauthorized access to or use of such information.

C—Development and Implementation of Information Security Program

1. Involve the Board of Directors. The board of directors or an appropriate committee of the board of each Enterprise shall:

a. Approve the Enterprise's written information security program; and

b. Oversee the development, implementation, and maintenance of the Enterprise's information security program, including assigning specific responsibility for its implementation and reviewing reports from management.

2. Assess Risk. Each Enterprise shall:

a. Identify reasonably foreseeable internal and external threats that could result in unauthorized disclosure, misuse, alteration, or destruction of information or information systems;

b. Assess the likelihood and potential damage of these threats, taking into consideration the sensitivity of nonpublic information; and

c. Assess the sufficiency of policies, procedures, information systems, and other arrangements in place to control risks.

3. Manage and Control Risk. Each Enterprise shall:

a. Design its information security program to manage and control the identified risks, commensurate with the sensitivity of the information as well as the complexity and scope of the Enterprise's activities. Each Enterprise should consider whether the following security measures are appropriate for the Enterprise and, if so, adopt those measures the Enterprise concludes are appropriate:

i. Access controls over information systems, including controls to authenticate and permit access only to authorized individuals and controls to prevent employees from providing information to unauthorized individuals who may seek to obtain this information through fraudulent means;

ii. Access restrictions at physical locations containing information, such as buildings, computer facilities, and records storage facilities to permit access only to authorized individuals;

iii. Encryption of electronic information, including while in transit or in storage on networks or systems to which unauthorized individuals may have access;

iv. Procedures designed to ensure that information system modifications are consistent with the Enterprise's information security program;

v. Dual control procedures, segregation of duties, and employee background checks for employees with responsibilities for or access to information;

vi. Monitoring systems and procedures to detect actual and attempted attacks on or intrusion into information systems;

vii. Response programs that specify actions to be taken when the Enterprise suspects or detects that unauthorized individuals have gained access to information systems, including appropriate reports to regulatory and law enforcement agencies; and

viii. Measures to protect against destruction, loss or damage of information due to potential environmental hazards, such as fire and water damage or technological failures.

b. Train staff to implement the Enterprise's information security program; and

c. Regularly test the key controls, systems and procedures of the information security program. The frequency and nature of such tests should be determined by the Enterprise's risk assessment. Tests should be conducted or reviewed by independent third parties or staff that are independent of those that develop or maintain the security programs.

4. Oversee Service Provider Arrangements. Each Enterprise shall:

a. Exercise appropriate due diligence in selecting its service providers;

b. Require its service providers by contract to implement appropriate measures designed to meet the objectives of the Guidance; and

c. Where indicated by the Enterprise's risk assessment, monitor its service providers to confirm that they have satisfied their obligations as required by section 9(b). As part of this monitoring, an Enterprise should review audits, summaries of test results, or other equivalent evaluations of its service providers.

5. Adjust the Program. Each Enterprise shall monitor, evaluate, and adjust, as appropriate, the information security program in light of any relevant changes in technology, the sensitivity of its information, internal or external threats to information, and the Enterprise's own changing business arrangements, such as acquisitions, alliances and joint ventures, outsourcing arrangements, and changes to information systems.

6. Report to the Board. Each Enterprise shall report to its board or an appropriate committee of the board at least annually. This report should describe the overall status of the information security program and the Enterprise's compliance with the Guidance. The reports should discuss material matters related to its program, addressing issues such as: risk assessment; risk management and control decisions; service provider arrangements; results of testing; security breaches or violations and management's responses; and recommendations for changes in the information security program.

7. Implementation. a. Each Enterprise should implement an information security program pursuant to the Guidance.

b. Until January 1, 2004, a contract that an Enterprise has entered into with a service provider to perform services for it or functions on its behalf satisfies the provisions of section 9, even if the contract does not include a requirement that the servicer maintain the security and confidentiality of information, as long as the Enterprise entered into the contract on or before the effective date.

Dated: August 20, 2002.

Armando Falcon, Jr.,

Director, Office of Federal Housing Enterprise Oversight.

[FR Doc. 02–21780 Filed 8–29–02; 8:45 am]

BILLING CODE 4220–01–U

DEPARTMENT OF TRANSPORTATION

Federal Aviation Administration

14 CFR Part 23

[Docket No. CE187, Special Condition 23–127–SC]

Special Conditions; Chelton Flight Systems, Inc.; Various Airplane Models; Protection of Systems for High Intensity Radiated Fields (HIRF)

AGENCY: Federal Aviation Administration (FAA), DOT.

ACTION: Final special conditions; request for comments.

SUMMARY: These special conditions are issued to Chelton Flight Systems, Inc., 1109 Main Street, Suite 560, Boise, ID 83702, for a Supplemental Type Certificate for the models listed under the heading "Type Certification Basis." This special condition includes various airplane models to streamline the certification process as recommended from completed Safer Sky Programs. The primary objective of streamlining the certification process is to improve the safety of the airplane fleet by fostering the incorporation of both new technologies that can be certificated affordably under 14 CFR part 23.

The airplanes will have novel and unusual design features when compared to the state of technology envisaged in the applicable airworthiness standards. These novel and unusual design features include the installation of electronic flight instrument system (EFIS) display Model EFIS II manufactured by Chelton Flight Systems, Inc., for which the applicable regulations do not contain adequate or appropriate airworthiness standards for the protection of these systems from the effects of high intensity radiated fields (HIRF). These special conditions contain the additional safety standards that the Administrator considers necessary to establish a level of safety equivalent to the airworthiness standards applicable to these airplanes.

DATES: The effective date of these special conditions is August 21, 2002. Comments must be received on or before September 30, 2002.

ADDRESSES: Comments may be mailed in duplicate to: Federal Aviation Administration, Regional Counsel, ACE–7, Attention: Rules Docket Clerk, Docket No. CE187, Room 506, 901 Locust, Kansas City, Missouri 64106. All comments must be marked: Docket No. CE187. Comments may be inspected in the Rules Docket weekdays, except Federal holidays, between 7:30 a.m. and 4 p.m.

FOR FURTHER INFORMATION CONTACT: Ervin Dvorak, Aerospace Engineer, Standards Office (ACE–110), Small Airplane Directorate, Aircraft Certification Service, Federal Aviation Administration, 901 Locust, Room 301, Kansas City, Missouri 64106; telephone (816) 329–4123.

SUPPLEMENTARY INFORMATION: The FAA has determined that notice and opportunity for prior public comment hereon are impracticable because these procedures would significantly delay issuance of the approval design and thus delivery of the affected aircraft. In addition, the substance of these special conditions has been subject to the public comment process in several prior instances with no substantive comments received. The FAA, therefore, finds that good cause exists for making these special conditions effective upon issuance.

Comments Invited

Interested persons are invited to submit such written data, views, or arguments as they may desire. Communications should identify the regulatory docket or notice number and be submitted in duplicate to the address specified above. All communications received on or before the closing date for comments will be considered by the Administrator. The special conditions

FinCEN no later than 30 calendar days from the date the suspicious activity is initially detected, unless there is no identified suspect on the date of detection. If no suspect is identified on the date of detection, a credit union may use an additional 30 calendar days to identify a suspect before filing a SAR. In no case may a credit union take more than 60 days from the date it initially detects a reportable transaction to file a SAR. In situations involving violations requiring immediate attention, such as ongoing money laundering schemes, a credit union must immediately notify, by telephone, an appropriate law enforcement authority and its supervisory authority, in addition to filing a SAR.

(ii) *Content.* A credit union must complete, fully and accurately, SAR form TDF 90–22.47, Suspicious Activity Report (also known as NCUA Form 2362) in accordance with the form's instructions and 31 CFR Part 103.18. A copy of the SAR form may be obtained from the credit union resources section of NCUA's Web site, *http://www.ncua.gov,* or the regulatory section of FinCEN's Web site, *http://www.fincen.gov.* These sites include other useful guidance on SARs, for example, forms and filing instructions, Frequently Asked Questions, and the FFIEC Bank Secrecy Act/Anti-Money Laundering Examination Manual.

(iii) *Compliance.* Failure to file a SAR as required by the form's instructions and 31 CFR Part 103.18 may subject the credit union, its officials, employees, and agents to the assessment of civil money penalties or other administrative actions.

(3) *Retention of Records.* A credit union must maintain a copy of any SAR that it files and the original or business record equivalent of all supporting documentation to the report for a period of five years from the date of the report. Supporting documentation must be identified and maintained by the credit union as such. Supporting documentation is considered a part of the filed report even though it should not be actually filed with the submitted report. A credit union must make all supporting documentation available to appropriate law enforcement authorities and its regulatory supervisory authority upon request.

(4) *Notification to board of directors.* (i) *Generally.* The management of the credit union must promptly notify its board of directors, or a committee designated by the board of directors to receive such notice, of any SAR filed.

(ii) *Suspect is a director or committee member.* If a credit union files a SAR and the suspect is a director or member of a committee designated by the board of directors to receive notice of SAR filings, the credit union may not notify the suspect, pursuant to 31 U.S.C. 5318(g)(2), but must notify the remaining directors, or designated committee members, who are not suspects.

(5) *Confidentiality of reports.* SARs are confidential. Any credit union, including its officials, employees, and agents, subpoenaed or otherwise requested to disclose a SAR or the information in a SAR must decline to produce the SAR or to provide any information that would disclose that a SAR was prepared or filed, citing this part, applicable law, for example, 31 U.S.C. 5318(g), or both, and notify NCUA of the request. A credit union must make the filed report and all supporting documentation available to appropriate law enforcement authorities and its regulatory supervisory authority upon request.

(6) *Safe Harbor.* Any credit union, including its officials, employees, and agents, that makes a report of suspected or known criminal violations and suspicious activities to law enforcement and financial institution supervisory authorities, including supporting documentation, are protected from liability for any disclosure in the report, or for failure to disclose the existence of the report, or both, to the full extent provided by 31 U.S.C. 5318(g)(3). This protection applies if the report is filed pursuant to this part or is filed on a voluntary basis.

[FR Doc. E6–17838 Filed 10–26–06; 8:45 am]

BILLING CODE 7535–01–P

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Office of Federal Housing Enterprise Oversight

12 CFR Part 1732

RIN 2550–AA34

Record Retention

AGENCY: Office of Federal Housing Enterprise Oversight, HUD.

ACTION: Final regulation.

SUMMARY: The Office of Federal Housing Enterprise Oversight (OFHEO) is issuing a final regulation that sets forth record retention requirements with respect to the record management programs of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation consistent with the safety and soundness responsibilities of OFHEO under the Federal Housing Enterprises Financial Safety and Soundness Act of 1992.

DATES: The effective date of this regulation is October 27, 2006.

FOR FURTHER INFORMATION CONTACT: Tina Dion, Associate General Counsel, telephone (202) 414–3838 (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:

I. Background

A. Introduction

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. OFHEO is statutorily mandated to ensure that the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) (collectively, the Enterprises) are capitalized adequately and operate in a safe and sound manner and in compliance with applicable laws, rules, and regulations.

The Act provides that the Director of OFHEO (the Director) is authorized to make such determinations, take such actions, and perform such functions as the Director determines are necessary regarding his supervisory authorities, which include examinations of the Enterprises.[1] Under the Act, the Director is authorized to conduct on-site examinations of the Enterprises each year, and any other examinations that the Director determines are necessary to ensure their safety and soundness.[2]

B. Record Retention and Safe and Sound Operations

OFHEO recognizes that the effectiveness of the examination process is dependent upon the prompt production of complete and accurate records. OFHEO, through the supervisory process, must have access to the records of an Enterprise that are necessary to determine the financial condition of the Enterprise or the details or the purpose of any transaction that

[1] 12 U.S.C. 4513(b)(2).

[2] 12 U.S.C. 4517(a) and (b).

may have a material effect on the financial condition of the Enterprise.[3]

Retention of such records not only facilitates the examination process, but also allows an Enterprise to manage more effectively its business and detect improper behavior that might cause financial damage to the corporation. Additionally, such records serve as documentation for an Enterprise in any controversy over its business activities or transactions.

The importance of sound record retention policies and procedures by regulated institutions also has been recognized by Congress and other federal regulators. Adequate record retention by the institutions has been determined to have a high degree of usefulness in criminal, tax, and regulatory investigations or proceedings, and has been identified as a requisite component of an institution's operation and management on a safety and soundness basis.[4]

In addition to facilitating the oversight and enforcement of federal banking laws, adequate record retention has been recognized by Congress as being essential to the oversight and enforcement of the federal securities laws. For example, as mandated by section 802 of the Sarbanes-Oxley Act,[5] the U.S. Securities and Exchange Commission adopted rules requiring accounting firms to retain for seven years certain records relevant to their audits and reviews of issuers' financial statements. Records to be retained include an accounting firm's workpapers and certain other documents that contain conclusions, opinions, analyses, or financial data related to the audit or review.[6]

Record Retention Regulation

On June 1, 2006, OFHEO published for comment a proposed regulation, at 71 FR 31121, which sets forth proposed safety and soundness requirements with respect to the Enterprises' record retention programs. The 60-day comment period ended on July 31, 2006. All comments received have been made available to the public in the OFHEO Public Reading Room and have been posted on the OFHEO Web site at *http://www.OFHEO.gov*.

II. Comments Received

Comments were received from Freddie Mac and Fannie Mae. Both Enterprises commented in support of the general approach under the proposed regulation. Each Enterprise also provided comments, many of which were technical in nature, on specific provisions of the proposal. All comments were taken into consideration. A discussion of the comments as they related to the proposed sections of the regulation follows.

A. § 1732.1 Purpose and Scope

Proposed § 1732.1 states that the purpose of the regulation is to set forth minimum requirements in connection with the record retention program of each Enterprise, and that the requirements are intended to ensure that complete and accurate records of an Enterprise are readily accessible by OFHEO for examination and other supervisory purposes.

Both Enterprises made technical comments regarding § 1732.1 with respect to the requirement to provide OFHEO with ready access to records. The Enterprises noted the dynamic nature of records management and the evolving nature of information technology. Freddie Mac commented that the methods of accessing hard copies of documents in off-site storage, electronic documents resident on a Local Area Network, and information in legacy databases, active databases, e-mail, and voicemail are quite different. Freddie Mac also noted that the level of management controls and ready access to records is not the same for records created and maintained years ago as that of records created and maintained today. Moreover, Freddie Mac commented that many of the records are subject to specific legal rights of the Enterprise or of individuals that cannot be disregarded. For these reasons, both Enterprises requested clarification that access to their records under the regulation is intended to mean ''reasonable'' access.

OFHEO understands that all records are not equally accessible. For purposes of clarification, OFHEO has added language to § 1732.1, as well as §§ 1732.6(a)(2)(iii) and 1732.7(d), which clarifies that the sections' accessibility requirements are intended to be by reasonable means, consistent with the nature and availability of the records and existing information technology.

B. § 1732.2 Definitions

Active Record

As proposed, the term ''active record'' would be defined under § 1732.2(b) to mean a document that is necessary to conduct the current business of an office or business unit of an Enterprise and, therefore, is readily available for consultation and reference.

The Enterprises made technical comments on this definition, as well as the definitions for the terms ''inactive record'' and ''vital records,'' requesting that the terms be amended by substituting the word ''record'' or ''records'' for ''document'' or documents,'' as appropriate. Each Enterprise stated that such amendments would more fully incorporate what is intended by the proposal, *i.e.*, its definition of ''record,'' and would be consistent with best practices.[7]

OFHEO agrees with the recommended technical changes and has revised the definitions in § 1732.2(b), (h), and (m) accordingly in the final regulation.

Employee

As proposed, the definition of the term ''employee'' would be defined in § 1732.2(e) to mean any officer or employee of an Enterprise, any conservator appointed by OFHEO, or any agent or independent contractor acting on behalf of an Enterprise. Both Enterprises commented that including independent contractors and agents in the definition was significant because such individuals would be subject to several provisions of the proposed regulations, *i.e.*, the training requirements under § 1732.6(b); the record hold notifications under § 1732.7(b); the reporting requirements of potential investigations under § 1732.7(b)(3), and the definition of ''record'' under § 1732.2(j)(3).

Fannie Mae stated that extending the regulation's general reach in this way would create obligations with regard to parties and documents beyond an Enterprise's control, would generate considerable burden and expense for the Enterprise without yielding commensurate gains with respect to improved operations or supervision, and would increase litigation risk by exposing the Enterprise to potential liability for the actions (or non-actions) of third parties or individuals outside the Enterprise's control.

Both Enterprises requested that OFHEO not include agents and independent contractors within the general definition of the term ''employee.'' Rather, they recommended that, to the extent that any section of the regulation is intended to apply to agents

[3] 12 U.S.C. 4632(c).

[4] *See, e.g.*, 12 U.S.C. 1829b, and the *Guidelines and Interagency Standards for Safety and Soundness* at 12 CFR part 30, Appendix A, II, B.

[5] Pub. L. 107–204, 116 Stat. 745 (2002).

[6] 17 CFR part 210. *See* Release Nos. 33–8180; 34–47241; IC–2591; FR–66; File No. S7–46–02.

[7] In their comments on best practices in the field of records management, both Enterprises referred to the guidelines and standards of the following organizations: The Sedona Conference (2005), the American National Standards Institute/Association of Records Managers and Administrators, and the International Organization for Standardization.

or independent contractors, OFHEO amend the section to include specific language making it apply to agents or independent contractors, tailored to what would be appropriate under the circumstances.

In response to the comments, OFHEO has deleted the phrase ''or any agent or independent contractor acting on behalf of an Enterprise'' from § 1732.2(e), and has added specific language for coverage of agents or independent contractors as appropriate in other sections of the final regulation, as noted below.

Inactive Record

As proposed, the term ''inactive record'' would be defined in § 1732.2(h) to mean a document that is seldom used but must be retained by an Enterprise for legislative, fiscal, legal, archival, historical, or vital records purposes.

In its technical comment, Fannie Mae requested that the words ''legislative'' and ''archival'' be deleted from the definition. Fannie Mae stated that the words do not appear to add anything substantive to the other qualifying terms, and that the proposal provides no elaboration as to what these words are intended to capture that is not otherwise covered. Fannie Mae noted that, as an industry practice, records generally are defined for record retention purposes as having operational, vital record, legal or regulatory, fiscal, and historical value.

OFHEO concurs with Fannie Mae's technical comment and has revised the definition of ''inactive record'' accordingly in the final regulation. Also, as noted above, the word ''record'' has been substituted for the word ''document.''

Record

As proposed, the definition of the term ''record'' in § 1732.2(j) would mean: Any document whether generated internally or received from outside sources by an Enterprise or employee in connection with Enterprise business, regardless of the following: (1) Form or format, including hard copy documents (*e.g.,* files, logs, and reports) and electronic documents (*e.g.,* e-mail, databases, spreadsheets, PowerPoint presentations, electronic reporting systems, electronic tapes and back-up tapes, optical discs, CD-ROMS, and DVDs), and voicemail records; (2) where the document is stored or located, including network servers, desktop or laptop computers and handheld computers, other wireless devices with text messaging capabilities, and on-site or off-site at a storage facility; (3) whether the document is maintained or used on Enterprise-owned equipment, or personal or home computer systems of an employee; or (4) whether the document is active or inactive.

Fannie Mae recommended that the proposed regulation use the definition of the term ''record'' provided in Internal Organization for Standards, ISO 15849–1 § 3.15. That standard provides that a record ''is information created, received, and maintained as evidence and information by an organization or person, in the pursuance of legal obligations or in the transaction of business.'' Freddie Mac, also referencing industry standards, requested that the word ''information'' be used in the definition, rather than ''document.'' Freddie Mac requested another technical change that would modify the definition by inserting the term ''maintained'' between the word ''employee'' and the phrase ''in connection with.'' Both Enterprises explained that the recommended revisions better reflect the corporate practices and supervisory concerns.

OFHEO agrees with the technical changes recommended by Freddie Mac and has revised the definition of the term ''record'' in § 1732.2(j) to read ''any information whether generated internally or received from outside sources or employee maintained in connection with Enterprise business * * *'' Conforming changes have also been made to subsections (2), (3), and (4) accordingly.

OFHEO does not agree to make use of the entire ISO definition for the definition of the term ''records,'' as recommended by Fannie Mae, because other elements of the ISO definition are encompassed in § 1732.2 under the definition of the terms ''active record'' and ''vital records.'' In addition, the language of the definition in § 1732.2(j), namely ''whether generated internally or received from outside sources'' is necessary to ensure that records are appropriately retained even if they have not been generated or created by the Enterprise.

Record Retention Schedule

As proposed, the definition of the term ''record retention schedule'' would be defined in § 1732.2(k) to mean ''a form that details the categories of records an Enterprise is required to store and their corresponding record retention periods. The record retention schedule includes reproductions, as well as all media, including microfilm and machine-readable computer records, for each record category.''

Fannie Mae commented that the inclusion of the term ''reproductions'' in the definition would be inconsistent with the standard industry approach, which does not require retention of copies because of the burden and expense of such retention. OFHEO understands that retention of all reproductions or copies of records would be burdensome and expensive. Reproductions would be listed in a record retention schedule only if the original of the official record is not available. Accordingly, OFHEO has revised the second sentence of the proposed definition to read: ''The record retention schedule includes all media, such as microfilm and machine-readable computer records, for each record category. Reproductions are also included for each record category if the original of the official record is not available.''

Fannie Mae also commented that the record retention schedule is envisioned as a ''form.'' Fannie Mae also requested a technical change to the definition, *i.e.,* substitution of the word ''schedule'' for the term ''form,'' to be consistent with the standard industry approach. OFHEO agrees and has changed the term ''form'' to ''schedule'' in the definition of the term ''record retention schedule'' in the final regulation.

Record Period

As proposed, the definition of the term ''Retention period'' would be defined in § 1732.2(l) to mean the length of time that records must be kept before they are destroyed. Records not authorized for destruction would have a retention period of ''permanent.''

Fannie Mae made a technical comment that the definition is ambiguous, and requested that the definition be changed to state that: ''Records not provided with a 'retention period' must be retained, unless scheduled for destruction.''

OFHEO has determined that the definition, as proposed, is clear and, therefore, has not made the technical change.

Vital Records

As proposed, the term ''vital records'' would be defined in § 1732.2(m) to mean documents that are needed to meet operational responsibilities of an Enterprise under emergency or disaster conditions (emergency operating records) or to protect the legal and financial rights of an Enterprise and those affected by Enterprise activities. Emergency operating records would be defined to mean the type of vital records essential to the continued functioning or reconstitution of an Enterprise during and after an emergency. Moreover, a vital record would be further defined to include a record that could be both an emergency operating record and a legal and financial rights record.

Fannie Mae commented that the definition includes documents ''needed * * * to protect the legal and financial rights of * * * those affected by Enterprise activities.'' Fannie Mae stated that the company is very concerned about the possible impact of this language, as it arguably could be read to create new, unpredictable obligations to third parties, and thus potential legal risk. To allay such concerns and to be consistent with industry best practices, Fannie Mae requested that the words ''those affected by Enterprise activities'' be substituted with the phrase ''its employees, creditors, customers and holders of its securities.''

In response to the comment, OFHEO has determined to delete the words ''those affected by Enterprise activities'' from the definition of the term ''vital records'' in the final regulation. Also, as noted above, the word ''records'' has been substituted for the word ''documents.''

C. Section 1732.5 Establishment and Evaluation of Record Retention Program

Section 1732.5(a) of the proposed regulation would require each Enterprise to establish and maintain a written record retention program and provide a copy of such program to the Examiner-in-Charge (EIC) of the Enterprise within 120 days of the regulation's effective date, and annually thereafter, and whenever a significant revision to the program has been made.

Fannie Mae advised in its comments that the company will be prepared to submit a written plan within 120 days of the effective date on the understanding that the EIC will advise if the planned program is acceptable before investments are made in order to avoid costly changes and unnecessary delays. For the build-out process, Fannie Mae further advised that the company anticipates using one or more pilots to test and improve its proposed policy, approach and technology.

Freddie Mac stated that the company expects to include in its initial report to OFHEO a snapshot of its current records retention program, including any additional enhancements that are implemented by the date of that report, together with a description of planned enhancements (both short-term and long-term) to that program. That first report will reflect that Freddie Mac has a records management program in place that encompasses records retention, but that the company is continuing to develop and strengthen its program. Freddie Mac noted that with OFHEO feedback on both its record retention program, and on planned enhancements, the corporation can align the records retention program with the expectations of OFHEO under the final regulation.

OFHEO understands that both Enterprises are in the process of developing and upgrading their records management systems to comport with changing technology and the requirements of the final regulation. To that end, OFHEO encourages an Enterprise to submit relevant materials to and confer with its EIC as needed to ensure that its record retention program is compliant.

D. Section 1732.6 Minimum Requirements of Record Retention Program Requirements

Section 1732.6(a)(2)(iii) of the proposed regulation would require that the record retention program established and maintained by an Enterprise be reasonably designed to assure that the format of retained records and the retention period permit ready access by the Enterprise, and, upon request, by the examination and other staff of OFHEO.

As noted above, in response to technical comments received on § 1732.1, OFHEO has revised subsection (a)(2)(iii) of § 1732.6 in the final regulation to clarify the accessibility requirement to mean access by reasonable means, consistent with the nature and availability of the records and existing information technology.

Additionally, Freddie Mac made a technical comment requesting that OFHEO revise this subsection (and § 1732.7(d), which addresses access to and retrieval of records during a record hold) to include at the end the phrase ''subject to applicable legal rights.''

OFHEO has determined that it is not necessary to add the requested phrase to either subsection because the record retention requirements of the regulation are imposed for purposes of supervisory access by OFHEO to Enterprise records and do not result in a waiver of existing rights.

Section 1732.6(a)(5) of the proposed regulation would require that the record retention program established and maintained by an Enterprise include an accurate, current, and comprehensive record retention schedule that lists records by major categories, subcategories, record type, and retention period, which retention period is appropriate to the specific record and consistent with applicable legal, regulatory, fiscal, and administrative requirements.

Fannie Mae commented that the term ''administrative'' is ambiguous. Fannie Mae stated that, if the term is intended to reference administrative requirements of OFHEO, the term ''regulatory'' already captures these requirements, so the term ''administrative'' should be deleted. If, however, what is intended to be captured are the Enterprises' business needs, the term ''operational'' or ''business'' should be substituted for the term ''administrative.''

OFHEO notes that the term ''administrative'' refers to requirements that are internal to a company, *i.e.*, the Enterprise. Therefore, the term is not duplicative of the term ''regulatory.'' However, for purposes of clarification, OFHEO has determined to revise § 1732.6(a)(5) in the final regulation by substituting the terms ''operational and business'' for the term ''administrative.''

Training

Section 1732.6(b) of the proposed regulation would require that an Enterprise's record retention program provide for training of and notice to all employees on a periodic basis on their record retention responsibilities, including instruction regarding penalties provided by law for the unlawful removal or destruction of records.

The Enterprises commented that this provision should be modified to include specific language tailored to requirements appropriate for independent contractors and agents. In its technical comment, Freddie Mac requested that OFHEO modify the proposal to provide that the training provision applies only to actual employees of an Enterprise, and that the Enterprise also takes reasonable steps to ensure that agents or independent contractors who are involved with creating or maintaining Enterprise records receive notice and/or training regarding record retention responsibilities in a manner appropriate to their engagement. Fannie Mae requested amending the proposed section to include specific language making training for agents or independent contractors consistent with their roles and responsibilities.

As noted above in response to comments on § 1732.2(e), OFHEO has added specific language for coverage of agents or independent contractors to several sections of the final regulation. With respect to § 1732.6, a second sentence has been added to subsection (b) that reads as follows: ''The record retention program also shall provide for training for the agents or independent contractors of an Enterprise, as appropriate, consistent with their respective roles and responsibilities to the Enterprise.''

E. Section 1732.7 Record Hold

Definition

Section 1732.7(a) of the proposed regulation would define the term ''record hold'' to mean a requirement, an order, or a directive from an Enterprise or OFHEO that the Enterprise is to retain records relating to a particular issue in connection with an actual or a potential OFHEO examination, investigation, enforcement proceeding, or litigation.

Both Enterprises expressed concern that criteria for a record hold is stated in terms of a ''potential'' investigation, enforcement proceeding or litigation. Fannie Mae commented that virtually everything that an Enterprise does raises some ''potential'' for litigation, and virtually every question that OFHEO asks raises some ''potential'' for an OFHEO investigation. Fannie Mae stated that the overly broad and ambiguous standard would needlessly create an onerous burden both on the Enterprises and OFHEO. Fannie Mae requested that the word ''likely'' be substituted for the word ''potential.''

Freddie Mac made the technical comment that the term ''potential'' requires or suggests that an Enterprise or employee is obligated and accountable to accurately guess when a matter could possibly give rise to an OFHEO examination, investigation, enforcement proceeding or litigation, resulting in an impossible standard with which to comply in practice. Freddie Mac requested that subsection (a) of § 1732.7 be modified to require that an Enterprise receive notice from OFHEO.

To address these comments, OFHEO has amended subsection (a) of § 1732.7 in the final regulation to clarify that the record retention requirements of a record hold result upon receipt by the Enterprise of notice from OFHEO. As amended, subsection (a) reads as follows: ''For purposes of this part, the term 'record hold' means a requirement, an order, or a directive from an Enterprise or OFHEO that the Enterprise is to retain records relating to a particular issue in connection with an actual or a potential OFHEO examination, investigation, enforcement proceeding, or litigation of which the Enterprise has received notice from OFHEO.'' As a result of the amendment, OFHEO has determined that it is not necessary to substitute the word ''likely'' for the word ''potential.''

Notification by an Enterprise

Section 1732.7(b)(1) of the proposed regulation would require that the record retention program of an Enterprise ''[a]ddress how all employees will receive prompt notification of a record hold; * * *.'' Fannie Mae stated that it understands that this provision requires only that the program provide the mechanism by which all relevant employees will be notified of a record hold, and does not require that all employees in fact be made aware of each and every record hold issued. Otherwise, Fannie Mae stated the result would be a great deal of cost, confusion and unnecessary effort, as the vast majority of Enterprise employees would have nothing germane to a particular hold. Moreover, Fannie Mae stated that industry best practice is not to notify each employee at a company of every records hold, but rather to notify only those employees who are likely to have records covered by the records hold. To that end, Fannie Mae requested that the subsection be modified by deleting the words ''all employees'' and substituting the phrase ''the Enterprise will determine which employees, agents and independent contractors need to and.''

OFHEO understands that not all employees of an Enterprise may fall within the scope of the notification requirements of § 1732.7(b)(1) in light of the nature of their responsibilities and activities. To clarify that understanding, OFHEO has deleted the word ''all'' before the word ''employees'' in the final regulation. Additionally, as noted above, because agents or independent contractors of the Enterprise have been deleted from the definition of the term ''employees,'' specific language has been added to the subsection to cover agents or independent contractors, as appropriate. As amended, § 1732.7(b)(1) reads as follows in the final regulation: ''The record retention program of an Enterprise shall: (1) Address how employees and, as appropriate, how agents or independent contractors consistent with their respective roles and responsibilities to the Enterprise, will receive prompt notification of a record hold;''.

Section 1732.7(b)(3) of the proposed regulation would require that the record retention program of an Enterprise ''[p]rovide that any employee who is aware of a potential investigation, enforcement proceeding, or litigation by OFHEO involving the Enterprise or an employee shall notify immediately the legal department of the Enterprise and shall retain any records that may be relevant in any way to such investigation, enforcement proceeding, or litigation.''

Similar to comments made on other sections, both Enterprises expressed concerns regarding the scope of coverage for the notification requirements of § 1732.7(b)(3) and criteria for determining a ''potential'' investigation, enforcement proceeding, or litigation by OFHEO involving the Enterprise or an employee.

The concerns expressed have been addressed by OFHEO. As noted above in its response to comments received on § 1732.2(e), OFHEO has deleted coverage of agents or independent contractors acting on behalf of an Enterprise from the definition of the term ''employee,'' and their coverage is limited to certain sections of the final regulation as appropriate. OFHEO also amended subsection (a) of § 1732.7 in the final regulation to clarify that the record retention requirements of a record hold result upon receipt by an Enterprise of notice from OFHEO.

To further allay any concerns, OFHEO has amended § 1732.7(b)(3) by replacing the words ''aware of'' with ''has received notice of'' and also by inserting the phrase '' , or otherwise has actual knowledge that an issue is subject to such an enforcement proceeding or litigation,'' before the words ''shall notify.'' Thus, OFHEO would provide written notice to an Enterprise of its intent to conduct an investigation some time in the future, thereby providing notice of a ''potential investigation.'' Also, consistent with other sections discussed above, language has been added to the subsection to require that agents and independent contractors receive notice of a record hold to the extent appropriate in light of the nature of their engagement.

Specifically, § 1732.7(b)(3) of the final regulation provides that the record retention program of an Enterprise shall ''provide that any employee and, as appropriate, any agent or independent contractor consistent with his or her respective role and responsibility to the Enterprise, who has received notice of a potential investigation, enforcement proceeding, or litigation by OFHEO involving the Enterprise or an employee, or otherwise has actual knowledge that an issue is subject to such an investigation, enforcement proceeding or litigation, shall notify immediately the legal department of the Enterprise and shall retain any records that may be relevant in any way to such investigation, enforcement proceeding, or litigation.''

It is noted that OFHEO also has revised subsection (b)(1) of § 1732.7, which requires prompt notification of a record hold, to include, as appropriate, coverage of agents and independent contractors consistent with their roles and responsibilities.

F. Section 1732.10 Supervisory Action

Section 1732.10(a) of the proposed regulation would provide that failure by an Enterprise to comply with this part may subject the Enterprise or the board members, officers, or employees thereof to supervisory action by OFHEO under the Act, including but not limited to cease-and-desist proceedings, temporary cease-and-desist proceedings, and civil money penalties.

Both Enterprises commented on compliance with the proposed section. Fannie Mae noted the necessary complexities of developing a comprehensive record retention scheme and suggested that, consistent with the approach of federal banking regulators, OFHEO establish a specific system for the submission of Enterprise remediation plans (over perhaps a thirty-day period) with regard to any deficiencies regarding compliance with § 1732.10(a). Fannie Mae stated that such a system would provide a routine, efficient framework for the resolution of issues that do not merit formal enforcement action, without foreclosing the ability to take more formal action, as OFHEO deemed appropriate.

Freddie Mac commented that in light of the lack of bright lines as to precisely what is required for full compliance with the regulation, the rapidly changing best practices in the records management field, and the time required to develop and implement enhancements to records management programs, it would be appropriate for OFHEO to first consider using feedback, followed by a request for a remediation plan, prior to considering formal enforcement actions, in instances where OFHEO believes an Enterprise acting in good faith is not in full compliance with the regulation. Thus, Freddie Mac requested that § 1732.10(a) be revised to require appropriate supervisory notification before noncompliance would subject the Enterprise to a supervisory action by OFHEO.

OFHEO understands that both Enterprises are in the process of developing and upgrading their records management systems to comport with changing technology. To that end, both during the 120-day implementation period and afterwards, OFHEO encourages each Enterprise to submit relevant materials to and confer with its EIC as needed to ensure that its record retention program is compliant.

III. Final Regulation

Except with respect to the technical and clarifying revisions of the proposed language as described above, OFHEO has determined to issue the regulation as proposed.

Regulatory Impact

Executive Order 12866, Regulatory Planning and Review

This regulation does 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. Nevertheless, this regulation was submitted to the Office of Management and Budget for review under other provisions of Executive Order 12866 as a significant regulatory action.

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 regulation under the Regulatory Flexibility Act. The General Counsel of OFHEO certifies that the regulation, as herein 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.

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. This regulation sets forth minimum record retention requirements with which the Enterprises must comply for Federal supervisory purposes and address the safety and soundness authorities of the agency. This regulation does 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 State and Federal levels of government. Therefore, OFHEO has determined that this final regulation has no federalism implications that warrant the preparation of a Federalism Assessment in accordance with Executive Order 13132.

List of Subjects in 12 CFR Part 1732

Government-Sponsored Enterprises, Reporting and recordkeeping requirements, Records.

■ Accordingly, for the reasons stated in the preamble, OFHEO adds part 1732 to subchapter C of 12 CFR chapter XVII to read as follows:

Subchapter C—Safety and Soundness

PART 1732—RECORD RETENTION

Subpart A—General

Sec.
1732.1 Purpose and scope.
1732.2 Definitions.
1732.3–4 [Reserved]

Subpart B—Record Retention Program

1732.5 Establishment and evaluation of record retention program.
1732.6 Minimum requirements of record retention program.
1732.7 Record hold.
1732.8–1732.9 [Reserved]

Subpart C—Supervisory Action

1732.10 Supervisory action.

Authority: 12 U.S.C. 4513(a), 4513(b)(1), 4513(b)(5), 4514, 4631, 4632, and 4632.

Subpart A—General

§ 1732.1 Purpose and scope.

In furtherance of the safety and soundness authorities of OFHEO, this part sets forth minimum requirements in connection with the record retention program of each Enterprise. The requirements are intended to ensure that complete and accurate records of an Enterprise are readily accessible by OFHEO for examination and other supervisory purposes. Such access shall be by reasonable means, consistent with the nature and availability of the records and existing information technology.

§ 1732.2 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, Public Law 102–550, section 1301, Oct. 28, 1992, 106 Stat. 3672, 3941 through 4012 (1993) (12 U.S.C. 4501 *et seq.*).

(b) *Active record* means a record that is necessary to conduct the current business of an office or business unit of an Enterprise and, therefore, is readily available for consultation and reference.

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

(d) *Electronic record* means a record created, generated, communicated, or stored by electronic means.

(e) *Employee* means any officer or employee of an Enterprise or any conservator appointed by OFHEO.

(f) *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.

(g) *E-mail* means electronic mail, which is a method of communication in which:

(1) Usually, text is transmitted (but sometimes also graphics and/or audio information);

(2) Operations include sending, storing, processing, and receiving information;

(3) Users are allowed to communicate under specified conditions; and

(4) Messages are held in storage until called for by the addressee, including any attachment of separate electronic files.

(h) *Inactive record* means a record that is seldom used but must be retained by an Enterprise for fiscal, legal, historical, or vital records purposes.

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

(j) *Record* means any information whether generated internally or received from outside sources by an Enterprise or employee maintained in connection with Enterprise business, regardless of the following:

(1) Form or format, including hard copy documents (*e.g.*, files, logs, and reports) and electronic documents (*e.g.*, e-mail, databases, spreadsheets, PowerPoint presentations, electronic reporting systems, electronic tapes and back-up tapes, optical discs, CD–ROMS, and DVDs), and voicemail records;

(2) Where the information is stored or located, including network servers, desktop or laptop computers and handheld computers, other wireless devices with text messaging capabilities, and on-site or off-site at a storage facility;

(3) Whether the information is maintained or used on Enterprise-owned equipment, or personal or home computer systems of an employee; or

(4) Whether the information is active or inactive.

(k) *Record retention schedule* means a schedule that details the categories of records an Enterprise is required to retain and the corresponding retention periods. The record retention schedule includes all media, such as microfilm and machine-readable computer records, for each record category. Reproductions are also included for each record category if the original of the official record is not available.

(l) *Retention period* means the length of time that records must be kept before they are destroyed. Records not authorized for destruction have a retention period of ''permanent.''

(m) *Vital records* means records that are needed to meet operational responsibilities of an Enterprise under emergency or disaster conditions (emergency operating records) or to protect the legal and financial rights of an Enterprise. Emergency operating records are the type of vital records essential to the continued functioning or reconstitution of an Enterprise during and after an emergency. A vital record may be both an emergency operating record and a legal and financial rights record.

§§ 1732.3–1732.4 [Reserved]

Subpart B—Record Retention Program

§ 1732.5 Establishment and evaluation of record retention program.

(a) *Establishment.* An Enterprise shall establish and maintain a written record retention program and provide a copy of such program to the OFHEO Examiner-in-Charge of the Enterprise within 120 days of the effective date of this part, and annually thereafter, and whenever a significant revision to the program has been made.

(b) *Evaluation.* Management of the Enterprise shall evaluate in writing the adequacy and effectiveness of the record retention program at least every three years and provide a copy of the evaluation to the board of directors and the OFHEO Examiner-in-Charge of the Enterprise.

§ 1732.6 Minimum requirements of record retention program.

(a) *Requirements.* The record retention program established and maintained by an Enterprise under § 1732.5 shall:

(1) Be reasonably designed to assure that retained records are complete and accurate;

(2) Be reasonably designed to assure that the format of retained records and the retention period—

(i) Are adequate to support litigation and the administrative, business, external and internal audit functions of the Enterprise;

(ii) Comply with requirements of applicable laws and regulations; and

(iii) Permit ready access by the Enterprise and, upon request, by the examination and other staff of OFHEO by reasonable means, consistent with the nature and availability of the records and existing information technology;

(3) Assign in writing the authorities and responsibilities for record retention activities;

(4) Include policies and procedures concerning record holds, consistent with § 1732.7;

(5) Include an accurate, current, and comprehensive record retention schedule that lists records by major categories, subcategories, record type, and retention period, which retention period is appropriate to the specific record and consistent with applicable legal, regulatory, fiscal, and operational and business requirements;

(6) Include adequate security and internal controls to protect records from unauthorized access and data alteration; and

(7) Provide for adequate back-up and recovery of electronic records.

(b) *Training.* The record retention program shall provide for training of and notice to all employees on a periodic basis on their record retention responsibilities, including instruction regarding penalties provided by law for the unlawful removal or destruction of records. The record retention program also shall provide for training for the agents or independent contractors of an Enterprise, as appropriate, consistent with their respective roles and responsibilities to the Enterprise.

§ 1732.7 Record hold.

(a) *Definition.* For purposes of this part, the term ''record hold'' means a requirement, an order, or a directive from an Enterprise or OFHEO that the Enterprise is to retain records relating to a particular issue in connection with an actual or a potential OFHEO examination, investigation, enforcement proceeding, or litigation of which the Enterprise has received notice from OFHEO.

(b) *Notification by Enterprise.* The record retention program of an Enterprise shall:

(1) Address how employees and, as appropriate, how agents or independent

contractors consistent with their respective roles and responsibilities to the Enterprise, will receive prompt notification of a record hold;

(2) Designate an individual to communicate specific requirements and instructions, including, when necessary, the instruction to cease immediately any otherwise permissible destruction of records; and,

(3) Provide that any employee and, as appropriate, any agent or independent contractor consistent with his or her respective role and responsibility to the Enterprise, who has received notice of a potential investigation, enforcement proceeding, or litigation by OFHEO involving the Enterprise or an employee, or otherwise has actual knowledge that an issue is subject to such an investigation, enforcement proceeding or litigation, shall notify immediately the legal department of the Enterprise and shall retain any records that may be relevant in any way to such investigation, enforcement proceeding, or litigation.

(c) *Method of record retention.* The record retention program of an Enterprise shall address the method by which the Enterprise will retain records during a record hold. Specifically, the program shall describe the method for the continued preservation of electronic records, including e-mails, and the conversion of records from paper to electronic format as well as any alternative storage method.

(d) *Access to and retrieval of records.* The record retention program of an Enterprise shall ensure access to and retrieval of records by the Enterprise and access, upon request, by OFHEO, during a record hold. Such access shall be by reasonable means, consistent with the nature and availability of the records and existing information technology.

§§ 1732.8–1732.9 [Reserved]

Subpart C—Supervisory Action

§ 1732.10 Supervisory action.

(a) *Supervisory action.* Failure by an Enterprise to comply with this part may subject the Enterprise or the board members, officers, or employees thereof to supervisory action by OFHEO under the Act, including but not limited to cease-and-desist proceedings, temporary cease-and-desist proceedings, and civil money penalties.

(b) *No limitation of authority.* This part does not limit or restrict the authority of OFHEO to act under its safety and soundness mandate, in accordance with the Act. Such authority includes, but is not limited to, conducting examinations, requiring reports and disclosures, and enforcing compliance with applicable laws, rules, and regulations.

Dated: October 23, 2006.

James B. Lockhart, III,

Director, Office of Federal Housing Enterprise Oversight.

[FR Doc. E6–18034 Filed 10–26–06; 8:45 am]

BILLING CODE 4220–01–P

DEPARTMENT OF TRANSPORTATION

Federal Aviation Administration

14 CFR Part 39

[Docket No. FAA–2005–21968; Directorate Identifier 2005–NM–077–AD; Amendment 39–14798; AD 2006–22–01]

RIN 2120–AA64

Airworthiness Directives; Boeing Model 757–200, –200CB, and –300 Series Airplanes

AGENCY: Federal Aviation Administration (FAA), Department of Transportation (DOT).

ACTION: Final rule.

SUMMARY: The FAA is adopting a new airworthiness directive (AD) for certain Boeing Model 757–200, –200CB, and –300 series airplanes. This AD requires repetitive detailed inspections for proper functioning of the girt bar leaf springs for the escape slides to ensure the leaf springs retain the sliders and the required 0.37-inch minimum engagement between the sliders and floor fittings is achieved at passenger doors 1, 2, and 4, and corrective actions if necessary. This AD results from a report that the escape slides failed to deploy correctly during an operator's tests of the escape slides. We are issuing this AD to prevent escape slides from disengaging from the airplane during deployment or in use, which could result in injuries to passengers or flightcrew.

DATES: This AD becomes effective December 1, 2006.

The Director of the Federal Register approved the incorporation by reference of certain publications listed in the AD as of December 1, 2006.

ADDRESSES: You may examine the AD docket on the Internet at *http://dms.dot.gov* or in person at the Docket Management Facility, U.S. Department of Transportation, 400 Seventh Street, SW., Nassif Building, Room PL–401, Washington, DC.

Contact Boeing Commercial Airplanes, P.O. Box 3707, Seattle, Washington 98124–2207, for service information identified in this AD.

FOR FURTHER INFORMATION CONTACT: Patrick Gillespie, Aerospace Engineer, Cabin Safety and Environmental Systems Branch, ANM–150S, FAA, Seattle Aircraft Certification Office, 1601 Lind Avenue, SW., Renton, Washington 98057–3356; telephone (425) 917–6429; fax (425) 917–6590.

SUPPLEMENTARY INFORMATION:

Examining the Docket

You may examine the AD docket on the Internet at *http://dms.dot.gov* or in person at the Docket Management Facility office between 9 a.m. and 5 p.m., Monday through Friday, except Federal holidays. The Docket Management Facility office (telephone (800) 647–5227) is located on the plaza level of the Nassif Building at the street address stated in the **ADDRESSES** section.

Discussion

The FAA issued a supplemental notice of proposed rulemaking (NPRM) to amend 14 CFR part 39 to include an AD that would apply to certain Boeing Model 757–200, –200CB, and –300 series airplanes. That supplemental NPRM was published in the **Federal Register** on May 19, 2006 (71 FR 29092). That supplemental NPRM proposed to require repetitive detailed inspections for proper functioning of the girt bar leaf springs for the escape slides to ensure the leaf springs retain the sliders and the required 0.37-inch minimum engagement between the sliders and floor fittings is achieved at passenger doors 1, 2, and 4, and corrective actions if necessary.

Comments

We provided the public the opportunity to participate in the development of this AD. We have considered the comments received.

Support for the Supplemental NPRM

Boeing supports the contents of the supplemental NPRM.

Request To Clarify Prohibition for Bending Girt Bar

One commenter, a private citizen, states that it is unclear what to do if the subject girt bar retention leaf springs are bent before the effective date of the AD. The commenter states that it is virtually impossible to determine if such springs were bent before. Therefore, the commenter requests that we clarify paragraphs (f) and (g) of the supplemental NPRM if the intent is to prohibit bending of the spring in the future. The commenter suggests that we revise the final rule to add the following words to paragraphs (f) and (g): ''* * *