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Federal Housing Finance Agency
Office of Inspector General



Management Alert: Need for Increased Oversight by FHFA, as Conservator, to Ensure that Freddie Mac's Policies and Procedures for Resolution of Executive Officer Conflicts of Interest Align with the Responsibilities of the Nominating and Governance Committee of the Freddie Mac Board of Directors

This report contains redactions of information that is privileged or confidential.

Management Alert • OIG-2017-005 • September 27, 2017



OFFICE OF INSPECTOR GENERAL

Federal Housing Finance Agency

400 7th Street SW, Washington, DC 20219

September 27, 2017

TO: Melvin L. Watt, Director

FROM: Laura S. Wertheimer, Inspector General

A handwritten signature in black ink, appearing to read "Laura S. Wertheimer".

SUBJECT: Management Alert—Need for Increased Oversight by FHFA, as Conservator, to Ensure that Freddie Mac’s Policies and Procedures for Resolution of Executive Officer Conflicts of Interest Align with the Responsibilities of the Nominating and Governance Committee of the Freddie Mac Board of Directors

The Federal Housing Finance Agency (FHFA) Office of Inspector General (OIG) recently completed an administrative investigation of a conflict of interest issue involving an entity within our oversight authority. Based on the findings from that investigation, we commenced evaluations to assess FHFA’s oversight, as conservator, over the boards of directors of Fannie Mae and Freddie Mac of the execution of their responsibilities relating to potential conflicts of interest disclosed by executive officers.

In the course of our evaluation of FHFA’s oversight of the Freddie Mac Board of Directors’ (Board) execution of its responsibilities, we learned that the Board added a provision to the charter of its Nominating and Governance Committee (NGC) in June 2016, charging the NGC with the responsibility to “review and address any conflicts of interest involving directors or executive officers.”

The revised NGC Charter contains no delegation of these responsibilities and does not authorize the NGC to task any Freddie Mac employee with executing these responsibilities. We confirmed that Freddie Mac had not revised its conflict of interest-related policies, as of mid-June 2017, to recognize the NGC’s authority and responsibility to “review and address” conflicts of interest or to establish a formal process to present potential conflicts of interest involving executive officers to the NGC for its review and resolution. As a result, Freddie Mac’s existing policies and procedures that address resolution of conflicts of interest involving executive officers do not align with the responsibilities of the NGC, and the divergence creates a significant risk that the NGC will not be able to meet its obligations under its charter. In our view, this risk warrants oversight from FHFA, the conservator of Freddie Mac.

Background

FHFA's Governance Regulation Tasks the Board of Directors of Each Enterprise with Management of That Enterprise

FHFA was created by the Housing and Economic Recovery Act of 2008 as the supervisor for Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. In September 2008, Fannie Mae and Freddie Mac were placed into conservatorship by FHFA because FHFA determined that their financial condition threatened their ability to operate in a safe and sound manner.¹ As conservator, FHFA succeeded to all rights, titles, powers, and privileges of the company, and of any shareholder, officer, or director of the company with respect to the Enterprises and their assets. FHFA reconstituted the Enterprises' respective boards and much of their senior management.

FHFA's governance regulation directs that the management of each Enterprise "shall be by or under the direction of its board of directors."² FHFA, as conservator, delegated to the board of each Enterprise a significant portion of day-to-day management and risk controls and its regulations authorize the boards to delegate execution of day-to-day operations to Enterprise employees. The Enterprise boards, however, retain "ultimate responsibility" for oversight of Enterprise operations and that responsibility is "non-delegable."³ Pursuant to this regulation, the board of directors shall remain reasonably informed of an Enterprise's operations, and each Enterprise director shall act in the best interests of the Enterprise and exercise reasonable inquiry in the execution of these duties.⁴ Those responsibilities, both under FHFA regulation and under applicable law, are understood to include:

- Setting the "tone at the top" for the entity and the standard that "good corporate governance and rigorous compliance are essential";⁵
- Selecting the "right CEO" for the entity who "'gets it' in terms of understanding the importance of tone at the top and a strong corporate culture";⁶

¹ See James B. Lockhart, FHFA Director, Statement at News Conference Announcing Conservatorships of Fannie Mae and Freddie Mac (Sept. 7, 2008) (online at www.fhfa.gov/Media/PublicAffairs/Pages/Statement-of-FHFA-Director-James-B--Lockhart-at-News-Conference-Announcing-Conservatorship-of-Fannie-Mae-and-Freddie-Mac.aspx); Henry M. Paulson, Jr., Treasury Secretary, Statement on Treasury and Federal Housing Finance Agency Action to Protect Financial Markets and Taxpayers (Sept. 7, 2008) (online at www.treasury.gov/press-center/press-releases/Pages/hp1128.aspx).

² See 12 C.F.R. § 1239.4(a) (2017).

³ *Id.*

⁴ See *id.*; 12 C.F.R. § 1239.4(b)(1) (2017).

⁵ See Mary Jo White, Chair, Securities and Exchange Commission, "A Few Things Directors Should Know About the SEC," (June 23, 2014) (online at www.sec.gov/news/speech/2014-spch062314mjw).

⁶ *Id.*

- “Creating a robust compliance culture” by ensuring that senior management establishes “strong corporate compliance programs,” “regular training of employees,” “effective and accessible codes of conduct,” and “procedures that ensure complaints are thoroughly and fairly investigated. . . . Ignoring the misconduct of a high performer or a key executive will not cut it”;⁷
- Insisting that senior management provide timely, high-quality, and credible information respecting the issues presented to it so it can fulfill its oversight responsibilities,⁸ and holding management accountable if it fails to provide such information;⁹ and
- Asking “the difficult questions,” especially when suspicious or problematic information is presented, “insist[ing] on answers when questions arise,” and “never ignor[ing] red flags.”¹⁰

In June 2016, the Board Revised its NGC Charter to Include Responsibility to “Review and Address” Conflicts of Interest Involving Directors and Executive Officers

FHFA’s governance regulation directs each Enterprise board to create committees charged with specific responsibilities, one of which is corporate governance.¹¹ By order issued in November 2008, FHFA, as conservator, established four standing committees for each Enterprise board, of which one is the “Nominating/Governance Committee.” This regulation further requires each Enterprise board to “adopt a formal written charter for each committee that specifies the scope of a committee’s powers and responsibilities, as well as the committee’s structure, processes, and membership requirements.”¹² It instructs that committees of each board of directors of

⁷ *Id.*

⁸ *See id.*; Martin Lipton, *Risk Management and the Board of Directors*, Harvard Law School Forum on Corporate Governance and Financial Regulation (Feb. 15, 2017) (online at <https://corpgov.law.harvard.edu/2017/02/15/risk-management-and-the-board-of-directors-4/>).

⁹ The Board has at times sought additional information from management when existing reporting was insufficient. For example, we found in an evaluation survey report that Freddie Mac’s Audit Committee requested in October 2015 itemized reporting on the Enterprise’s progress in remediating individual Matters Requiring Attention (MRAs), FHFA’s most serious examination findings. Management previously provided the Audit Committee with high-level summary reports in which information about MRAs was pooled with information about other deficient, unsafe, or unsound practices giving rise to supervisory concern, making it quite difficult, if not impossible, for the Board to identify the most serious supervisory matters and to oversee management’s progress in remediating those deficiencies. *See* OIG, *Directives from the Audit Committee of the Freddie Mac Board of Directors Caused Management to Improve its Reporting about Remediation of Serious Deficiencies from October 2015 through September 2016*, at 1-2, 5-6 (Mar. 22, 2017) (online at www.fhfa.gov/Content/Files/ESR-2017-003.pdf).

¹⁰ *See* Mary Jo White, Chair, Securities and Exchange Commission, “A Few Things Directors Should Know About the SEC,” (June 23, 2014) (online at www.sec.gov/news/speech/2014-spch062314mjw).

We recognize that the state in which the entity is incorporated, federal law, and stock exchange listing standards impose specific requirements on boards of directors. Those requirements are beyond the scope of this evaluation.

¹¹ *See* 12 C.F.R. § 1239.5(b) (2017).

¹² *See* 12 C.F.R. § 1239.5(c) (2017).

an Enterprise “shall comply with the charter, independence, composition, expertise, duties, responsibilities, and other requirements set forth under rules issued by the [New York Stock Exchange].”¹³

The Freddie Mac board has charged its NGC with corporate governance responsibilities and has adopted a “formal written charter” for the NGC that is posted on Freddie Mac’s public facing website.¹⁴ The charter for the Freddie Mac NGC identifies the authority reserved by the Board to its NGC.

As required by FHFA regulation, the Freddie Mac board has established and administers a code of conduct and ethics.¹⁵ In its codes of conduct for employees and directors, Freddie Mac recognizes that situations can arise where its directors and employees have personal interests—financial or otherwise—that may conflict, or appear to conflict, with the best interests of the Enterprise or the individual’s responsibilities to Freddie Mac. Prior to July 2016, Freddie Mac’s Ethics and Business Practices Department (Ethics Office) and Chief Compliance Officer (CCO) were authorized to review and resolve potential conflicts of interest involving executive officers, with some exceptions. One of those exceptions, for example, involved the policy for related person transactions, which charged the NGC with responsibility to review and approve related party transactions for directors and certain executive officers.

In June 2016, the Board determined to vest responsibility in its NGC to “review and address any conflicts of interest involving directors or executive officers.” The Board amended the NGC Charter, effective July 2016, to charge the NGC with this expanded authority. In June 2017, the Board clarified the NGC Charter to specify that the term “conflicts of interest” include any “actual or potential” conflicts of interest, including those involving family members of executive officers and directors or entities in which they have an interest.¹⁶ The NGC Charter does not delegate the NGC’s responsibilities to any Freddie Mac employee, including the CCO or employees in the Ethics Office.

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¹³ See 12 C.F.R. § 1239.5(b) (2017).

¹⁴ See Freddie Mac, Board Committee Charters (online at www.freddiemac.com/governance/board-committees.html).

¹⁵ The Office of Federal Housing Enterprise Oversight (OFHEO) adopted regulations in 2005 that required the Enterprises to “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” 12 C.F.R. § 1710.14 (2015). In November 2015, FHFA issued a final rule that replaced the OFHEO regulation, but retained the same fundamental requirements. See 12 C.F.R. § 1239.10 (2017).

¹⁶ See Freddie Mac, *Charter of the Nominating and Governance Committee of the Board of Directors of the Federal Home Loan Mortgage Corporation*, at 5, section 10 (July 24, 2017) (online at www.freddiemac.com/governance/pdf/nominating_committee_charter.pdf).

In its technical comments to a draft of this management alert, FHFA asserted that there was never “any intent for the [Freddie Mac] board to reserve to the NGC the exclusive authority for the review of conflicts of interest or to have the board or NGC be involved in the day-to-day resolution of conflicts of interest.” According to FHFA, the July 2016 amendment to the NGC Charter did not represent the reservation of exclusive authority to NGC to review and resolve actual or potential conflicts of interest involving executive officers. [REDACTED]

Freddie Mac’s Current Policies Do Not Recognize the Authority and Responsibility of the NGC to “Review and Address” Conflicts of Interest of Freddie Mac Executive Officers

We confirmed that, as of mid-June 2017, Freddie Mac had not revised its policies and procedures to acknowledge the authority of the NGC to “review and address” executive officer conflicts or to establish a reporting process through which executive officer conflicts of interest are presented to the NGC for its review and resolution.

We reviewed a number of existing Freddie Mac policies and procedures relating to conflicts of interest involving executive officers, most of which were updated after the NGC Charter was revised.¹⁷ We found that these policies and procedures established a process for executive officers to raise conflicts of interest and a decision-making framework for Freddie Mac’s CCO and Ethics Office, and in certain cases CEO, to resolve most of these conflicts. For example, Freddie Mac’s policy and procedure governing employees’ outside activities directs that executive officers’ potential conflicts involving outside activities will be reviewed and resolved by the CCO, with the exception of certain enumerated outside activities that are presumed to be a conflict and require pre-approval from the CEO.¹⁸ In our view, the responsibility assigned to the CCO and CEO under this policy and procedure to review and approve executive officers’ outside activities-related conflicts is at odds with the responsibility of the NGC under its charter to “review and address any actual or potential conflicts of interest” involving an executive officer. None of the policies and procedures relating to conflicts of interest that we reviewed establish a process to report potential conflicts of interest involving executive officers to the NGC for it to

¹⁷ These policies and procedures included: Corporate Policy 1-140, *Code of Conduct* (June 6, 2017); Corporate Policy 3-202, *Business Courtesies* (Sept. 14, 2016); Corporate Policy 3-203, *Outside Activities and Family Member Activities* (Sept. 14, 2016); Corporate Policy 3-206, *Employee Trading* (Jan. 1, 2016); Compliance Division Desktop Procedure 1, *Outside Activities & Political Activities Disclosure Process* (Nov. 18, 2016); and Compliance Division Desktop Procedure 20, *Employee Trading Disclosure Process* (Jan. 23, 2017).

¹⁸ Freddie Mac’s policy governing outside activities requires all employees to disclose certain activities presumed to raise a conflict, such as board memberships with Freddie Mac business partners, for review and approval by the Ethics Office and the employee’s manager, i.e., the CEO in the case of executive officers. Ethics Office staff make determinations on potential conflicts, including required mitigation steps. See Policy 3-203, *Outside Activities and Family Member Activities*, at 1–2, Sections IV and VI (Sept. 14, 2016). The Ethics Office’s procedures implementing that policy specify that CCO approval is required for outside activities disclosures from officers at the Senior Vice President level and above and that the pre-approval of the employee’s manager is required for those activities presumed to be a conflict under Policy 3-203. See Desktop Procedure 1, *Outside Activities & Political Activities Disclosure Process*, at 3, Section V, and 4, Appendix A (Nov. 18, 2016).

review and address. We found that none expressly recognize that NGC has been charged with the authority to resolve executive officer conflicts of interest.¹⁹

In response to our request, Freddie Mac provided to us all documents relating to executive officer potential conflicts of interest and resolution of those issues during 2016. We received from Freddie Mac's Ethics Office a total of 10 case files that were opened between July and December 2016, after the NGC Charter was revised. Our review of these case files found that six involved pre-clearance requests from two executives to sell investments prohibited by Freddie Mac's Employee Trading Policy, which we concluded were not new disclosures of potential conflicts of interest that would have required review by the NGC.²⁰ Freddie Mac's Ethics Office approved these six pre-clearance requests. Business courtesy requests and conflicts of interest-related inquiries comprised 4 of the 10 case files and these four potential conflict matters were resolved by Freddie Mac's Ethics Office.²¹ The broad authority assigned to the NGC in the July 2016 charter amendment to "review and address any conflicts of interest involving directors or executive officers" suggests that these four matters should have been presented to the NGC for it to "review and address."

We asked for, and received, a case file from 2017 involving resolution of a potential conflict of interest disclosed by an executive officer in response to the Annual Code of Conduct Questionnaire for 2016. The executive disclosed a potential conflict of interest relating to a prospective nonprofit board membership. Our review of the case file found that Freddie Mac's Ethics Office determined that the executive officer's nonprofit board service presented no conflict and did not raise this potential conflict to the NGC for its resolution.

We also reviewed all available materials provided to the NGC and its minutes for meetings held from July 2016 through June 2017 and found no evidence that Freddie Mac management

¹⁹ Freddie Mac's policy on related person transactions details the NGC's approval authority for related party transactions involving the Chief Executive Officer, President, Chief Operating Officer, General Counsel, and their immediate family members. The policy charges the General Counsel with responsibility for reviewing and approving such transactions for the remainder of Freddie Mac's executive officers and their immediate family members. See Corporate Policy 1-142, *Review and Approval of Related Person Transactions*, at 2 (June 7, 2017).

²⁰ Freddie Mac's Employee Trading Policy imposes restrictions on employees' personal trading activity because "(a) personal Investments may create an actual or potential conflict of interest or result in the appearance of such a conflict, and (b) trading activity by Employees who are in possession of Material Non-Public Information may violate insider trading laws." The policy directs employees to "seek a remedy from The Ethics Office if...an actual or potential Conflict of Interest arises between your or your Related Persons' Investments and your employment obligations to Freddie Mac." Such remedy may include divestiture or recusal, and prior to divesting a prohibited investment, employees must seek pre-clearance from the Ethics Office. Based on the text of this policy, we conclude that while the underlying investment may pose a conflict of interest, the request for pre-clearance to sell the investment in most cases does not constitute a new disclosure of a potential conflict of interest. The Ethics Office's conflict analysis should occur when the executive officer first discloses ownership of the investment and remedy is sought. See Corporate Policy 3-206, *Employee Trading Policy*, at 1, 3, 4 (Jan. 1, 2016). In the case of these six pre-clearance requests, the executives' ownership of the investments was disclosed prior to their employment with Freddie Mac.

²¹ Freddie Mac's Corporate Policy 3-202, *Business Courtesies*, treats the acceptance of offers of business courtesies as a potential conflict of interest under certain circumstances. See Corporate Policy 3-202, *Business Courtesies*, at 1, 2, 4-5 (Sept. 14, 2016).

presented any conflict of issue involving an executive officer to the NGC to “review and address.” Freddie Mac provided no documents in response to our requests that reflect review and resolution of conflict of interest issues involving executive officers by the NGC outside of its formal committee meetings between July and December 2016. Review of minutes of these NGC meetings identified no instance in which any NGC member probed management to determine whether any executive officer had disclosed a potential conflict of interest and, if so, the reasons why management had not presented that conflict to the NGC.

FHFA asserts in its management response, which is reprinted in its entirety in the Appendix, that Freddie Mac “has consistently interpreted and applied the revised Charter and related documents in a manner that gives effect to” board-approved reservations and delegations of authority to management. FHFA maintains that these delegations of authority “empower[] management to resolve [conflict of interest] matters among executive officers” FHFA’s effort to read out of existence the direction in the NGC Charter is unavailing. The Board’s resolution delegating authority to management states that *any* delegation to management shall be subject to, and in accordance with, Freddie Mac’s governing documents, which Freddie Mac defines to include the NGC Charter.

Conclusion

Approximately a year after the Freddie Mac board revised the NGC Charter to charge the NGC with the authority to “review and address” conflicts of interest involving executive officers, we found no evidence that Freddie Mac has updated its policies and procedures to track to the revised charter. As a result, Freddie Mac’s current policies and procedures that address resolution of conflicts of interest involving executive officers are not aligned with the NGC’s responsibilities, and the divergence creates a significant risk that the NGC will not be able to meet its obligations under its charter. Under FHFA’s corporate governance regulations, the Board retains ultimate responsibility for oversight of the Enterprise’s operations, a responsibility that cannot be delegated to Freddie Mac management.²² FHFA further expects that the board of directors “shall remain reasonably informed of the condition, activities, and operations of the entity.”²³

Freddie Mac currently does not have a formal structure in place for escalating executive officer conflict matters to the NGC or routine reporting to the NGC on executive officers’ existing conflicts and their mitigation. The lack of such a reporting structure limits the ability of the NGC to oversee the operations and outcomes of Freddie Mac’s ethics program. Accordingly, Freddie Mac should revise its policies and procedures to ensure that the NGC receives the information it needs to satisfy all its duties and responsibilities under its charter and FHFA’s corporate governance regulations.

²² See 12 C.F.R. § 1239.4(a) (2017).

²³ *Id.*

Recommendations

We recommend that FHFA, as conservator, direct:

1. the Freddie Mac Board to clarify the scope of NGC's responsibilities under its Charter that relate to conflicts of interest involving executive officers; and
2. Freddie Mac to revise its policies and procedures to align with the responsibilities assigned to the NGC and facilitate the NGC's execution of its responsibilities.

We provided FHFA an opportunity to respond to a draft of this management alert. FHFA provided technical comments, which we incorporated as appropriate. In its management response, FHFA agreed with our recommendations.



Federal Housing Finance Agency

MEMORANDUM

TO: Angela Choy, Assistant Inspector General for Evaluations

FROM: Bob Ryan, Acting Deputy Director, Division of Conservatorship *BR*

SUBJECT: Draft Management Alert: *Need for Increased Oversight by FHFA, as Conservator, to Ensure that Freddie Mac's Policies and Procedures for Resolution of Executive Officer Conflicts of Interest Align with the Responsibilities Reserved to the Nominating and Governance Committee of the Freddie Mac Board of Directors*

DATE: September 25, 2017

This Memorandum transmits the management response of the Federal Housing Finance Agency (FHFA) to the FHFA-OIG draft management alert referenced above (Alert). FHFA reviewed the draft Alert, shared a copy with Freddie Mac, and provided technical comments to the FHFA Office of Inspector General (FHFA-OIG) outlining FHFA's views as described below.

To the extent that the draft Alert interprets the Freddie Mac Board of Directors' (board) June 2016 revision to the Nominating and Governance Committee (NGC) Charter as a reservation of authority to the NGC alone to review and address conflict of interest (COI) matters involving executive officers and concludes that the NGC's authority and responsibilities cannot be exercised alongside a delegation to management, FHFA disagrees. The NGC Charter is intended to be considered together with relevant supporting corporate governance documents and board-approved codes and corporate policies. The board has given an express delegation of authority to Freddie Mac's Chief Executive Officer (CEO) to "carry out the day-to-day operations of the Company" and authorized the CEO to further delegate these responsibilities. The CEO has delegated to the Chief Compliance Officer (CCO) authority for "all activities related to maintaining an ethics program." Consistent with these board-approved or authorized delegations of authority are board-approved codes and corporate policies that also act as delegations and authorize the Freddie Mac Ethics Office and CCO to review and resolve executive officers'

conflicts of interest matters, with some exceptions for related party transactions. In addition, a board-approved resolution specifically identifies the matters on which the board reserves authority to itself and/or a board committee, but other than certain related party transactions, this reservation of authority does not include COI matters. Freddie Mac has consistently interpreted and applied the revised Charter and related documents in a manner that gives effect to these board-approved reservations, delegations, codes, and corporate policies by empowering management to resolve COI matters among executive officers, except for certain related party transactions.

The draft Alert identifies a gap between the Charter as revised in June 2016 and related corporate codes and policies governing COI matters for executive officers. FHFA agrees that the language of and interactions among these documents needs to be clarified and that appropriate procedures for routine reporting of COI matters for executive officers to the NGC should be adopted.

Recommendations

FHFA-OIG recommends that FHFA, as conservator, direct:

- 1. the Freddie Mac Board to clarify the scope of NGC's responsibilities under its Charter that relate to conflicts of interest involving executive officers; and*
- 2. Freddie Mac to revise its policies and procedures to align with the responsibilities assigned to the NGC and facilitate the NGC's execution of its responsibilities.*

Management Response to the Recommendations

FHFA agrees with both recommendations and will use its conservatorship governance process to work with Freddie Mac to implement them. FHFA expects to issue a directive to Freddie Mac no later than February 25, 2018.

cc: John Major, Internal Controls and Audit Follow-up Manager
Larry Stauffer, Acting Chief Operating Officer