

UNITED STATES OF AMERICA
OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

Notice 2003-1

In the Matter of:)

Federal Home Loan Mortgage)
Corporation)

NOTICE OF CHARGES

TAKE NOTICE that on such date and at such place as determined by the presiding officer, a hearing will commence pursuant to 12 U.S.C. §§ 4631 *et seq.* and 12 C.F.R. §§ 1780 *et seq.*, concerning the charges set forth herein, to determine whether an order to cease and desist and for other relief should be issued against the Federal Home Loan Mortgage Corporation ("Freddie Mac" or "the Enterprise").

WHEREAS, Freddie Mac has executed a "Stipulation and Consent to the Issuance of a Consent Order," dated December 9, 2003, that is accepted by the Director ("Director") of the Office of Federal Housing Enterprise Oversight ("OFHEO"), and by such Stipulation and Consent, the Enterprise has consented to the issuance of a "Consent Order" (Order No. 2003-02), dated December 9, 2003, by the Director;

WHEREAS, the Stipulation and Consent to the Issuance of a Consent Order states that it does not inhibit, estop, bar or otherwise prevent the Director from taking any action affecting the Enterprise in connection with OFHEO's ongoing

regulatory oversight of the Enterprise with respect to matters relating to third parties not affiliated with the Enterprise, including separated senior officers of the Enterprise;

NOW, THEREFORE, in support of this Notice of Charges ("Notice"), the Director states the following:

In the course of an examination into the affairs of Freddie Mac, the Director has determined that Freddie Mac: (1) has engaged in conduct that violates the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 ("Safety and Soundness Act of 1992"), 12 U.S.C. §§ 4501 *et seq.*, the Federal Home Loan Mortgage Corporation Act ("Freddie Mac Corporation Act"), 12 U.S.C. §§1451 *et seq.*, and orders, rules and regulations under such Acts; and (2) has engaged in conduct that is unsafe or unsound.

JURISDICTION

At all times relevant to the charges set forth herein:

1) OFHEO, whose primary mission is to ensure the capital adequacy and safety and soundness of the government sponsored enterprises it regulates, is an independent entity established within the Department of Housing and Urban Development by the Safety and Soundness Act of 1992.

2) The Director is charged with ensuring that the enterprises OFHEO regulates operate safely and soundly and with adequate capital. In this regard, the Director is authorized to make such determinations, take such actions, and perform such functions as the Director determines necessary, including the institution of

administrative and enforcement actions pursuant to the Safety and Soundness Act of 1992 seeking: (i) cease and desist orders; and (ii) such other relief relating to the government sponsored enterprises OFHEO regulates and the enterprises' present and former executive officers and directors. 12 U.S.C. § 4513(b)(5).

3) Freddie Mac is a government sponsored enterprise regulated by OFHEO. 12 U.S.C. §§ 4501 *et seq.*

4) Freddie Mac is required to conduct its operations in a safe and sound manner. *See, e.g.*, 12 U.S.C. § 4513.

BACKGROUND

5) Freddie Mac is one of the world's largest sources of mortgage financing.

6) On or about March 6, 2002, Freddie Mac hired PricewaterhouseCoopers ("PwC") as its independent public accountant ("IPA") for the year ending December 31, 2002, replacing Arthur Andersen as its IPA. PwC began its audit engagement in or about March 2002. In the course of its work, PwC uncovered several areas that required further investigation, including transactions that were executed by Freddie Mac in 2000 and 2001 to "smooth" earnings.

7) In January 2003, Freddie Mac announced that it expected to restate its financial results for 2001 and 2002, and possibly for 2000. At the same time, Freddie Mac also announced that it had to delay release of its audited 2002 financial statement. Subsequently, Freddie Mac released unaudited earnings figures for 2002.

8) On June 6, 2003, at the request of Freddie Mac's Board of Directors ("Board"): (a) its Chairman and Freddie Mac's Chief Executive Officer, Leland Brendsel, retired; (b) its Vice-Chairman and Freddie Mac's President and Chief Operating Officer, David Glenn, was terminated for cause; and (3) Freddie Mac's Executive Vice President and Chief Financial Officer, Vaughn Clarke, resigned.

9) On November 21, 2003, Freddie Mac announced the results of its restatement. For the year ended December 31, 2000, the restated net income was \$1.119 billion higher than previously reported. For the year ended December 31, 2001, the restated net income was \$989 million lower than previously reported. For the year ended December 31, 2002, the restated net income was \$4.326 billion higher than previously reported.

**BRENDEL AND CLARKE ENGAGED IN CONDUCT THAT
WARRANTED THEIR TERMINATIONS FOR CAUSE**

10) Mr. Brendsel, from at least 1996, and Mr. Clarke, from at least 2000, engaged in conduct or permitted conduct under their supervisory authority, that resulted in unsafe and unsound practices that failed to meet accepted standards of prudent operations in the conduct of Freddie Mac's affairs. These practices resulted in Freddie Mac violating, and causing to be violated, laws, rules or regulations, including the Safety and Soundness Act of 1992, the Freddie Mac Corporation Act, and the orders, rules and regulations promulgated under such Acts. These violations and Messrs. Brendsel's and Clarke's conduct caused, and were likely to cause, a loss to the Enterprise.

**Brendsel And Clarke Established, Implemented And
Oversaw Rigid Financial Objectives That Promoted
and Resulted in Earnings Management**

11) Messrs. Brendsel and Clarke established, implemented and oversaw rigid financial objectives relating to the management of Freddie Mac's earnings. From at least 1996 and until at least mid-2002, with the direction and approval and/or under the supervisory authority of Messrs. Brendsel and/or Clarke, these objectives (collectively, "financial objectives") focused on, and were driven by, particular earnings outcomes: (a) attaining annual mid-teens earnings growth; (b) attaining "steady" and "stable" earnings growth; (c) achieving quarterly and annual earnings per share figures that met or exceeded financial analysts' expectations, but that did not exceed expectations by more than a few cents; and (d) minimizing earnings volatility by "smoothing" the time pattern of net interest income ("NII").

**Brendsel and Clarke Established A "Tone At The Top"
That Led to Unsafe and Unsound Practices**

12) Beginning in the early 1990s, Freddie Mac began to publicly forecast that its normal business operations would bring about annual earnings growth in or about the mid-teens. In or about, and from at least, 1996, Mr. Brendsel converted this forecast into an annual goal of mid-teens earnings that became an increasingly rigid objective. This rigid objective of annual mid-teens earnings growth was developed, mandated and overseen by the top levels of management, including Messrs. Brendsel and Clarke.

13) As economic conditions made it more difficult to attain annual mid-teens earnings growth, rather than alter the annual mid-teens earnings growth

objective, Messrs. Brendsel and Clarke and others insisted that Freddie Mac personnel find ways to meet this objective.

14) Messrs. Brendsel and Clarke and others constrained the flow of certain information to the Board, OFHEO and the public, through, *inter alia*, "dry runs" of presentations that were to be made to the Board and the deletion and omission of information from reports, in order to portray Freddie Mac as a safe and sound entity and to obfuscate certain unsafe and unsound practices it employed in pursuit of its financial objectives.

15) The pursuit and achievement of the financial objectives contributed to operational risks that Messrs. Brendsel and Clarke felt no need to address as long as the financial objectives were met.

16) The pursuit and achievement of the financial objectives were such a high priority that Mr. Brendsel rewarded employees for achievement of the objectives and penalized employees for failure to achieve them through, *inter alia*, the bonus compensation "scorecard" that was developed, reviewed and/or approved by Mr. Brendsel. The scorecard was designed so that bonus compensation, which could, and in certain instances did, exceed fixed compensation, was based in substantial part on achieving these objectives.

17) In or about October or November 2000, at a Managing Committee meeting chaired by Mr. Brendsel, Mr. Clarke made a presentation in which he expressed the view that the Enterprise would not be able to continue to achieve annual mid-teens earnings growth. Mr. Brendsel's response to Mr. Clarke's

presentation conveyed that Mr. Brendsel would not deviate from his annual mid-teens earnings growth objective and that he expected others to ensure that it would be achieved. Mr. Brendsel exacted a commitment from each of his senior managers that they would pursue the annual mid-term earnings growth objective.

In Order To Achieve These Objectives, Brendsel and Clarke Sacrificed Risk Management To Attain Earnings Growth

18) To achieve the objective of annual mid-teens earnings growth, Messrs. Brendsel and Clarke and others implemented strategies that sacrificed its risk management goals including increases in the Enterprise's "tolerance for risk."

Brendsel and Clarke Pursued These Financial Objectives Despite Internal Control Weaknesses, A Deficient Operational Risk Framework, And Accounting Department Weaknesses

19) Messrs. Brendsel and Clarke pursued Freddie Mac's financial objectives without regard to the adequacy of its internal controls and operational risk. The internal control and operational risk challenges ignored by Messrs. Brendsel and/or Clarke included: (a) the repeated Internal Audit findings that Freddie Mac's internal controls for accounting financial reporting were deficient; (b) weaknesses in its Corporate Accounting department, which Freddie Mac relied on for opinions regarding proper accounting treatment; and (c) reliance on the external auditor to perform tasks that should have been performed by Corporate Accounting, thereby compromising the external auditor's independence and ability to provide independent opinions regarding Freddie Mac's accounting treatments. The failures to address these challenges were a contributing factor in the events that resulted in the restatement of, and the delay in release of, audited financial statements.

With Brendsel's and Clarke's Knowledge and Approval And/Or Under Their Supervisory Authority, Transactions And Strategies Were Executed Solely For Their Accounting Impact And Without Business Purpose

20) In order to ensure that Freddie Mac's financial objectives were met, transactions and strategies that were not accounted for in accordance with generally accepted accounting principles ("GAAP") or otherwise improper were executed, with Messrs. Brendsel's and Clarke's direction and approval and/or under their supervisory authority, for the accounting impact the transactions and strategies would have on Freddie Mac's financial statements. For example:

a) In November and December 2000, with Messrs. Brendsel's and Clarke's direction and approval and/or under their supervisory authority, Freddie Mac's Funding & Investment Division ("F&I") entered into a series of four transactions known as "Coupon Trade-up Giants" ("CTUGs"). Messrs. Brendsel and Clarke participated in meetings at which the CTUG transactions were discussed. These transactions were designed to smooth earnings and to minimize the volatility of earnings. Ultimately, PwC determined that these transactions were not accounted for properly. The improper accounting for the CTUGs contributed to the restatement of Freddie Mac's financial statements.

b) In December 2000, with the direction and approval and/or under the supervisory authority of Messrs. Brendsel and Clarke, F&I changed its methodology for the valuation of its swaptions so that it could meet its financial objectives; specifically, the methodology change enabled Freddie

Mac to offset almost all of its then-remaining FAS 133 transition gain (more than \$700 million). The memorandum detailing the valuation methodology change purportedly was from F&I but was actually written by the head of Market Risk Oversight, who was tasked with independently overseeing F&I's activities. The head of Market Risk Oversight's subsequent approval of the valuation methodology change was, in effect, an approval of his own work and a circumvention of an internal control designed to ensure an independent assessment of F&I's activities. In February 2001, just two months later – but after the desired accounting effect was achieved – Freddie Mac reverted to its pre-December 2000 valuation methodology. The change in methodology in December improperly valued the swaptions, contributing to the restatement of Freddie Mac's financial statements.

c) “Operating earnings” was a supplemental performance measure that Freddie Mac began to utilize with its first quarter 2001 reporting. According to Freddie Mac, the “operating earnings” measure presented a more accurate depiction of Freddie Mac's financial performance than the GAAP measure because, in part, it factored out certain effects such as the impact of the implementation of FAS 133. In August and early September 2001, notwithstanding Freddie Mac's adoption of the “operating earnings” measure and with Mr. Brendsel's direction and approval and/or under his supervisory authority, F&I entered into a series of pay-fixed and received-fixed swaps that had minimal or no business purpose but had the effect of

shifting operating earnings from 2001 to future years. The Arthur Andersen engagement partner learned of these swaps after the ninth set was executed and expressed concern about the trades to Mr. Clarke. Mr. Clarke resisted suggestions that the trades be unwound. Eventually, these swaps were unwound, but only after the desired accounting impact was achieved. The Investment Committee of the Board was informed that swaps were undertaken to shift income to future time periods but Freddie Mac management, including Mr. Brendsel, omitted the quantitative impact from the written presentation materials. Freddie Mac management also omitted the quantitative impact and other details of the trades from the quarterly written disclosure of unusual transactions to the Audit Committee of the Board. The linked swaps were not accounted for properly, contributing to the restatement of Freddie Mac's financial statements.

d) From at least 1998 until mid-2002, with Mr. Brendsel's direction and approval and/or under his supervisory authority, Freddie Mac determined the levels of its reserves, including the loan loss reserve, in a manner not in accordance with GAAP. In addition, from 1994 until mid-2002, Freddie Mac also carried a FAS 91 amortization reserve, a reserve that was inconsistent with the very purpose of FAS 91 and, therefore, not in accordance with GAAP. With Mr. Brendsel's direction and approval, and/or under his supervisory authority, Freddie Mac used its reserves as "cookie jar"

reserves, enabling Freddie Mac to manage its earnings in a way that helped the Enterprise achieve its financial objectives.

Brendsel Relied Inappropriately On A Quantitative Materiality Standard Without Regard To Qualitative Considerations

21) With Mr. Brendsel's direction and approval and/or under his supervisory authority, Freddie Mac permitted accounting treatments, including the use of reserves to manage earnings, that were not in accordance with GAAP to persist so long as they did not result in at least a 5% impact on earnings.

FREDDIE MAC'S FAILURE TO TERMINATE FOR CAUSE MR. BRENDEL, AND TO TERMINATE FOR LOSS OF CONFIDENCE MR. CLARKE, CONSTITUTES AN UNSAFE AND UNSOUND CONDITION

22) Messrs. Brendsel and Clarke engaged in conduct that threatened the safety and soundness of the Enterprise.

23) The Board's decision not to terminate for cause Mr. Brendsel, and to terminate for loss of confidence Mr. Clarke, and to instead request Mr. Clarke's resignation and Mr. Brendsel's retirement on or about June 6, 2003, was reckless and imprudent and would, if unchanged, provide Messrs. Brendsel and Clarke with substantial monetary and/or other benefits to which they should not be entitled had they been terminated for cause.

CLAIM FOR RELIEF

24) The Director realleges and herein incorporates by reference the allegations set forth in paragraphs 1 through 23, above.

25) By its conduct, Freddie Mac violated the 1992 Safety and Soundness Act's prohibition against operating in an unsafe and unsound manner by failing to terminate for cause Messrs. Brendsel and Clarke.

PRAYER FOR RELIEF

i) The Director prays for relief in the form of an order directing Freddie Mac to convert Mr. Brendsel's termination to a termination for cause.

ii) The Director prays for relief in the form of an order prohibiting Freddie Mac from making, or causing to be made, any payments, to Mr. Brendsel that would exceed such payments that Mr. Brendsel would be entitled to if he had been terminated for cause under his September 7, 1990 Employment Agreement with Freddie Mac.

iii) The Director prays for relief in the form of an order directing Freddie Mac to convert Mr. Clarke's termination to a termination for loss of confidence.

iv) The Director prays for relief in the form of an order prohibiting Freddie Mac from making, or causing to be made, any payments that exceed the payments that Mr. Clarke would be entitled to if he had been terminated for loss of confidence under Freddie Mac Policy Number 3-254.1 Series III, Human Resources, Severance-Officers (May 15, 2001), specifically including any severance pay, restricted stock award or bonus.

MISCELLANEOUS

Freddie Mac is directed to file a written answer to this Notice within thirty (30) days from the date of service of this Notice in accordance with 12 C.F.R. Part 1780. The original and one copy of any answer shall be filed with the Office of Compliance, Office of Federal Housing Enterprise Oversight, 1700 G Street, N.W., Washington, DC 20552. A copy of any answer shall also be served with the Office of the General Counsel, Office of Federal Housing Enterprise Oversight, Washington, DC 20552 and with the OFHEO attorney whose name appears on the accompanying certificate of service. **Failure to answer within the time period shall constitute a waiver of the right to appear and contest the allegations contained in this Notice, and may, upon OFHEO's motion, cause the administrative law judge and/or the Director to find the facts in this Notice to be as alleged, upon which an appropriate order may be issued.**



Armando Falcon, Jr.
Director
Office of Federal Housing Enterprise Oversight
1700 G Street, N.W.
Washington, DC 20552

Date: December 17, 2003

UNITED STATES OF AMERICA
OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

Notice No. 2003-2

In the Matter of:)

Leland C. Brendsel)
_____)

NOTICE OF CHARGES

TAKE NOTICE that on such date and at such place as determined by the presiding officer, a hearing will commence pursuant to 12 U.S.C. §§ 4631 *et seq.* and 12 C.F.R. §§ 1780 *et seq.*, concerning the charges set forth herein, to determine whether an order to cease and desist, to impose a civil money penalty in the amount of \$5,800,000 and for other relief should be issued against Leland C. Brendsel, former Chief Executive Officer and former Chairman of the Board of Directors of the Federal Home Loan Mortgage Corporation ("Freddie Mac" or "the Enterprise").

In the course of an examination into the affairs of Freddie Mac, the Director ("Director") of the Office of Federal Housing Enterprise Oversight ("OFHEO") has determined that Mr. Brendsel: (1) has engaged in conduct that violates the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 ("Safety and Soundness Act of 1992"), 12 U.S.C. §§ 4501 *et seq.*, the Federal Home Loan Mortgage Corporation Act ("Freddie Mac Corporation Act"), 12 U.S.C. §§ 1451 *et seq.*, and orders, rules and regulations under such Acts; and (2) has engaged in

conduct that has caused or is likely to cause a loss to the Enterprise. The Director also has determined that such violations and conduct: (1) are part of a pattern of misconduct; and/or (2) involved recklessness and caused, or would be likely to cause, a material loss to the Enterprise.

In support of this Notice of Charges ("Notice"), the Director states the following:

JURISDICTION

At all times relevant to the charges set forth herein:

1) OFHEO, whose primary mission is to ensure the capital adequacy and safety and soundness of the government sponsored enterprises it regulates, is an independent entity established within the Department of Housing and Urban Development by the Safety and Soundness Act of 1992.

2) The Director is charged with ensuring that the enterprises OFHEO regulates operate safely and soundly and with adequate capital. In this regard, the Director is authorized to make such determinations, take such actions, and perform such functions as the Director determines necessary, including the institution of administrative and enforcement actions pursuant to the Safety and Soundness Act of 1992 seeking: (i) cease and desist orders; (ii) the imposition of civil money penalties; and (iii) such other relief relating to the government sponsored enterprises OFHEO regulates and the enterprises' present and former executive officers and directors. 12 U.S.C. § 4513(b)(5).

3) Freddie Mac is a government sponsored enterprise regulated by OFHEO. 12 U.S.C. §§ 4501 *et seq.*

4) Mr. Brendsel was employed by Freddie Mac since 1982. From 1987 until June 6, 2003, Mr. Brendsel was Chief Executive Officer ("CEO") of Freddie Mac. From 1989 until June 6, 2003, Mr. Brendsel was the Chairman of Freddie Mac's Board of Directors ("Board").

5) As CEO and Board Chairman, Mr. Brendsel:

a) had primary responsibility for the overall success or failure of the Enterprise;

b) was responsible for providing leadership for the formulation and achievement of the Enterprise's vision, mission, strategy, financial objectives and goals;

c) was responsible for ensuring that effective and qualified management were retained by the Enterprise;

d) was responsible for ensuring that the Enterprise established appropriate controls, policies and procedures that were adequate to protect corporate assets; and

e) was responsible for directing the conduct and affairs of the Enterprise in furtherance of the safe and sound operation of the Enterprise.

BACKGROUND

6) Freddie Mac is one of the world's largest sources of mortgage financing.

7) On or about March 6, 2002, Freddie Mac hired PricewaterhouseCoopers ("PwC") as its independent public accountant ("IPA") for the year ending December 31, 2002, replacing Arthur Andersen as its IPA. PwC began its audit engagement in or about March 2002. In the course of its work, PwC uncovered several areas that required further investigation, including transactions that were executed by Freddie Mac in 2000 and 2001 to "smooth" earnings.

8) In January 2003, Freddie Mac announced that it expected to restate its financial results for 2001 and 2002, and possibly for 2000. At the same time, Freddie Mac also announced that it had to delay release of its audited 2002 financial statement. Subsequently, Freddie Mac released unaudited earnings figures for 2002.

9) On June 6, 2003, at the request of Freddie Mac's Board of Directors, Leland Brendsel retired from Freddie Mac.

10) On November 21, 2003, Freddie Mac announced the results of its restatement. For the year ended December 31, 2000, the restated net income was \$1.119 billion higher than previously reported. For the year ended December 31, 2001, the restated net income was \$989 million lower than previously reported. For the year ended December 31, 2002, the restated net income was \$4.326 billion higher than previously reported.

**MR. BRENDSEL HAS ENGAGED IN CONDUCT THAT VIOLATED
THE SAFETY AND SOUNDNESS ACT OF 1992 AND THE
CORRESPONDING REGULATORY PROHIBITIONS
AGAINST UNSAFE AND UNSOUND PRACTICES**

11) From at least 1996, Mr. Brendsel engaged in conduct that violated and caused to be violated, statutes, rules and regulations, including the Safety and Soundness Act of 1992, the Freddie Mac Corporation Act, and the orders, rules and regulations promulgated under these Acts. Mr. Brendsel's conduct caused, and was likely to cause, a loss to the Enterprise. Mr. Brendsel's violations and conduct are part of a pattern of misconduct and/or involved recklessness and caused, or would be likely to cause, a material loss to the Enterprise.

Mr. Brendsel Established, Implemented And Oversaw Rigid Financial Objectives That Promoted and Resulted in Earnings Management

12) Leland Brendsel established, implemented and oversaw rigid financial objectives relating to the management of its earnings. These objectives (collectively, "financial objectives") focused on, and were driven by, particular earnings outcomes:

a) From at least 1996 and until at least mid-2002, with Mr. Brendsel's direction and approval and/or under his supervisory authority, Freddie Mac pursued an objective of attaining annual mid-teens earnings growth.

b) From at least 1996 and until at least mid-2002, with Mr. Brendsel's direction and approval and/or under his supervisory authority, Freddie Mac pursued an objective of attaining "steady" and "stable" earnings growth.

c) From at least 1998 and until at least mid-2002, with Mr. Brendsel's direction and approval and/or under his supervisory authority, Freddie Mac pursued an objective of achieving quarterly and annual earnings per share figures that met or exceeded financial analysts' expectations, but that did not exceed expectations by more than a few cents.

d) From at least 1999 and until at least mid-2002, with Mr. Brendsel's direction and approval and/or under his supervisory authority, Freddie Mac pursued an objective of minimizing earnings volatility by "smoothing" the time pattern of net interest income ("NII").

**Mr. Brendsel Established A "Tone At The Top"
That Led to Unsafe And Unsound Practices**

13) Beginning in the early 1990s, Freddie Mac began to publicly forecast that its normal business operations would bring about annual earnings growth in or about the mid-teens. Beginning in or about, and from at least, 1996, Mr. Brendsel converted this forecast into an annual goal of mid-teens earnings that became an increasingly rigid objective. This rigid objective of annual mid-teens earnings growth was developed, mandated and overseen by Mr. Brendsel.

14) The pursuit and achievement of the financial objectives were such a high priority that Mr. Brendsel rewarded employees for achievement of the objectives and penalized employees for failure to achieve them. For example, Mr. Brendsel helped develop, review and approve the annual "scorecard" which was used to determine the amount of funding of Freddie Mac's bonus pool. The scorecard was designed so that bonus compensation, which could, and in certain

instances did, exceed fixed compensation, was based in substantial part on achieving these objectives.

15) As economic conditions made it more difficult to attain annual mid-teens earnings growth, rather than alter his annual mid-teens earnings growth objective, Mr. Brendsel insisted that Freddie Mac personnel find ways to meet this objective.

16) In or about October or November 2000, at a Managing Committee meeting chaired by Mr. Brendsel, the Chief Financial Officer made a presentation in which he expressed the view that the Enterprise would not be able to continue to achieve annual mid-teens earnings growth. This view had been previously expressed by other attendees of the meeting, including at least one attendee who expressed this view to Mr. Brendsel. Mr. Brendsel's response to the Chief Financial Officer's presentation conveyed that Mr. Brendsel would not deviate from his annual mid-teens earnings growth objective and that he expected others to ensure that it would be achieved. Mr. Brendsel exacted a commitment from each of his senior managers that they would pursue the annual mid-teens earnings growth objective.

17) The pressure to achieve these financial objectives led to the unsafe and unsound practices discussed herein.

**In Order To Achieve These Objectives, Mr. Brendsel
Sacrificed Risk Management To Attain Earnings Growth**

18) In order to achieve Mr. Brendsel's objective of annual mid-teens earnings growth, Freddie Mac implemented strategies that sacrificed its risk

management goals. For example, in 2001, when its objective of annual mid-teens earnings growth was thought to be unattainable within the Enterprise's risk management framework, management proposed an increase in the Enterprise's "tolerance for risk" in order to allow itself an opportunity to meet its objective. Mr. Brendsel approved and/or oversaw under his supervisory authority the increase in risk tolerance.

Mr. Brendsel Pursued These Financial Objectives Despite Internal Control Weaknesses, A Deficient Operational Risk Framework, And Accounting Department Weaknesses

19) The pursuit and achievement of the financial objectives contributed to operational risk challenges that Mr. Brendsel felt no need to address as long as the financial objectives were met.

20) Under Mr. Brendsel's direction and approval and/or under his supervisory authority, Freddie Mac pursued its financial objectives without regard to the adequacy of its internal controls and operational risk. This constituted an unsafe and unsound practice. For example:

a) Mr. Brendsel failed to properly address repeated Internal Audit findings, spanning several years, that Freddie Mac's internal controls for accounting financial reporting were deficient. Weak internal controls were a contributing factor in the events that resulted in the restatement of, and the delay in release of, audited financial statements.

b) Mr. Brendsel failed to properly address weaknesses in its Corporate Accounting department, which Freddie Mac relied on for opinions

regarding proper accounting treatment. Mr. Brendsel allowed deficiencies in the Corporate Accounting department's resources and accounting skills to persist for several years. Mr. Brendsel also hired a Chief Financial Officer he knew lacked critical qualifications for the position. The deficiencies were reported to management, including Mr. Brendsel, by Freddie Mac business units, the Internal Audit department and the external auditor. These deficiencies were contributing factors in the events that resulted in the restatement of, and the delay in release of, audited financial statements.

c) Freddie Mac relied on the external auditor to perform tasks that should have been performed by Corporate Accounting, thereby compromising the external auditor's independence and ability to provide independent opinions regarding Freddie Mac's accounting treatments. Mr. Brendsel failed to properly address the situation by ensuring the external auditor's independence. This failure was a contributing factor in the events that resulted in the restatement of, and the delay in release of, audited financial statements.

With Mr. Brendsel's Direction And Approval And/Or Under His Supervisory Authority, Transactions And Strategies Were Executed For Their Accounting Impact And With Minimal Or No Business Purpose

21) In order to ensure that financial objectives set by Mr. Brendsel were met, Freddie Mac engaged in transactions and strategies that were not accounted for in accordance with generally accepted accounting principles ("GAAP") or were

otherwise improper, and that were executed for the accounting impact the transactions would have on its financial statements. For example:

a) In November and December 2000, with Mr. Brendsel's direction and approval and/or under his supervisory authority, Freddie Mac's Funding & Investment Division ("F&I") entered into a series of four transactions known as "Coupon Trade-up Giants" ("CTUGs"). Mr. Brendsel chaired the November 22, 2000 meeting at which the CTUG transactions were discussed. Each transaction had two steps, each with a different financial objective. The first step moved securities from the held-to-maturity portfolio to the trading portfolio, which was designed to offset (in the amount of approximately \$700 million) time value gains in its derivative portfolio that would be realized as a result of the implementation of Financial Accounting Standard 133 ("FAS 133"). Freddie Mac was required to implement FAS 133 effective January 1, 2001. This first step, which was permissible under FAS 133, would help Freddie Mac achieve some of its financial objectives, but was counter to another financial objective— minimizing earnings volatility. Thus, the CTUG transactions had a second step, which moved 90% of these securities from the trading portfolio to the available-for-sale portfolio, through a third-party, in order to reduce earnings volatility. In part to avoid the requirement that the Board's Securitization Committee approve all transactions that exceed \$11 billion, the \$30 billion CTUGs were divided into two \$10 billion transactions, one \$4 billion transaction and one \$6 billion transaction. Although all

transactions over \$5 billion were to be reported to the Securitization Committee, management reported only a single \$10 billion transaction. Furthermore, because the size of the transactions exceeded individual trader limits, trader limit exceptions were obtained in order to execute the transactions. Ultimately, PwC determined that these transactions were not accounted for properly. The improper accounting for the CTUGs contributed to the restatement of Freddie Mac's financial statements.

b) In December 2000, with Mr. Brendsel's direction and approval and/or under his supervisory authority, F&I changed its methodology for the valuation of its swaptions so that it could reverse engineer a valuation that was lower than the valuation using prevailing market rates. The decision to change the methodology was driven by Freddie Mac's desire to meet its financial objectives; specifically, the methodology change enabled Freddie Mac to offset almost all of its then-remaining FAS 133 transition gain (more than \$700 million). The memorandum detailing the valuation methodology change purportedly was from F&I but was actually written by the head of Market Risk Oversight, who was tasked with independently overseeing F&I's activities. The head of Market Risk Oversight's subsequent approval of the valuation methodology change was, in effect, an approval of his own work and a circumvention of an internal control designed to ensure an independent assessment of F&I's activities. The methodology change was not disclosed to the Board or its Committees. In February 2001, just two months later – but

after the desired accounting effect was achieved – Freddie Mac reverted to its pre-December 2000 valuation methodology. The change in methodology in December improperly valued the swaptions, contributing to the restatement of Freddie Mac's financial statements.

c) "Operating earnings" was a supplemental performance measure that Freddie Mac began to utilize with its first quarter 2001 reporting. According to Freddie Mac, the "operating earnings" measure presented a more accurate depiction of Freddie Mac's financial performance than the GAAP measure because, in part, it factored out certain effects such as the impact of the implementation of FAS 133. Notwithstanding Freddie Mac's adoption of the "operating earnings" measure, in August and early September 2001, with Mr. Brendsel's direction and approval and/or under his supervisory authority, F&I entered into a series of pay-fixed and received-fixed swaps that had minimal or no business purpose but had the effect of shifting operating earnings from 2001 to future years. Sixteen separate trades, comprising eight sets of "linked swaps," were entered into in August 2001. A ninth set, which was a leveraged link swap, was entered into on September 7, 2001. F&I did not notify or obtain the approval of Freddie Mac's Corporate Accounting Department or Freddie Mac's independent public accountant, Arthur Andersen, prior to the execution of these nine sets of "linked swaps." The Arthur Andersen engagement partner learned of these swaps after the ninth set was executed. The Investment Committee of the

Board was informed that swaps were undertaken to shift income to future time periods but Freddie Mac management (including Mr. Brendsel) omitted the quantitative impact from the written presentation materials. Freddie Mac management also omitted the quantitative impact and other details of the trades from the quarterly written disclosure of unusual transactions to the Audit Committee of the Board. The linked swaps were not accounted for properly, contributing to the restatement of Freddie Mac's financial statements.

d) From at least 1998 until mid-2002, with Mr. Brendsel's direction and approval and/or under his supervisory authority, Freddie Mac determined the levels of its reserves, including the loan loss reserve, in a manner not in accordance with GAAP. In addition, from 1994 until mid-2002, Freddie Mac also carried a FAS 91 amortization reserve, a reserve that was inconsistent with the very purpose of FAS 91 and, therefore, not in accordance with GAAP. FAS 91 required that Freddie Mac recognize loan fees, premiums and discounts as an adjustment to yield over the life of the loan. When estimated prepayments of loans differed from actual prepayments, FAS 91 required that a catch-up adjustment be made to the income statement, which resulted in increased volatility. To reduce volatility, Freddie Mac created a "FAS 91 reserve" that would absorb the differences between estimated and actual prepayments rather than book the catch-up adjustments to the income statement as required by FAS 91. With

Mr. Brendsel's knowledge and approval, and/or under his supervisory authority, Freddie Mac used its reserves as "cookie jar" reserves, enabling Freddie Mac to manage its earnings in a way that helped the Enterprise achieve its financial objectives.

Mr. Brendsel Relied Inappropriately On A Quantitative Materiality Standard Without Regard To Qualitative Considerations

22) With Mr. Brendsel's direction and approval and/or under his supervisory authority, Freddie Mac permitted accounting treatments that were not in accordance with GAAP to persist so long as they did not result in at least a 5% impact on earnings. For example, management was aware that reserves were used to manage earnings in violation of GAAP, but disregarded such noncompliance because they impacted earnings per share by only a "few cents."

23) With Mr. Brendsel's direction and approval and/or under his supervisory authority, Freddie Mac permitted for several years the loan loss reserve level to exceed the amount permitted under GAAP, resulting in an eventual \$250 million adjustment to the reserve level.

Mr. Brendsel Constrained The Flow Of Certain Information To The Board

24) Mr. Brendsel constrained the flow of certain information to the Board, OFHEO and the public in order to portray Freddie Mac as a safe and sound entity and to obfuscate certain unsafe and unsound practices it employed in pursuit of its financial objectives. For example:

a) Mr. Brendsel presided over and/or attended "dry runs" of presentations that were to be made to the Board. At these dry runs, Mr. Brendsel sometimes directed that information relating to Freddie Mac's pursuit of the financial objectives, including information relating to the strategies implemented in pursuit of the financial objectives, be deleted from presentation materials.

b) With Mr. Brendsel's direction and approval and/or under his supervisory authority, certain details of the strategies implemented in pursuit of the financial objectives were deleted from reports provided to the Board.

WITH MR. BRENDSSEL'S DIRECTION AND APPROVAL AND/OR UNDER HIS SUPERVISORY AUTHORITY, FREDDIE MAC VIOLATED THE 1992 SAFETY AND SOUNDNESS ACT AND THE FREDDIE MAC CORPORATION ACT BY FAILING TO SUBMIT TO OFHEO FINANCIAL STATEMENTS PREPARED IN ACCORDANCE WITH GAAP

25) Freddie Mac was required, annually, to submit an annual report to OFHEO that includes financial statements prepared in accordance with GAAP. From at least 2000 through 2002, with Mr. Brendsel's direction and approval and/or under his supervisory authority, Freddie Mac failed to submit to OFHEO financial statements prepared in accordance with GAAP.

**MR. BRENDSEL'S VIOLATIONS AND CONDUCT HAVE
CAUSED AND WERE LIKELY TO CAUSE A MATERIAL
LOSS TO THE ENTERPRISE AND HAVE BEEN
SUBSTANTIALLY INJURIOUS TO THE ENTERPRISE**

26) Mr. Brendsel's violations of the 1992 Safety and Soundness Act and his conduct have caused and were likely to cause a material loss to the Enterprise including, but not limited to harm to, the reputation and integrity of the Enterprise in the financial marketplace and the unanticipated expenses incurred, and to be incurred, including legal, consulting, investigative and auditing costs, and have been substantially injurious to the Enterprise.

**MR. BRENDSEL WAS UNJUSTLY ENRICHED AS A RESULT
OF HIS CONDUCT AND VIOLATIONS**

27) In 2000 and 2001, Mr. Brendsel participated in Freddie Mac's bonus compensation plan. Mr. Brendsel received a \$1,700,000 bonus under that plan for 2000 and a \$2,123,448 bonus under that plan for 2001. During this time, Mr. Brendsel's conduct in meeting financial objectives, failing to address accounting improprieties and other matters alleged herein resulted in losses to the Enterprise. In such circumstances, the bonus payments constitute unjust enrichment.

**MR. BRENDSEL'S CONDUCT AND VIOLATIONS WARRANTED HIS
TERMINATION FOR CAUSE**

28) Mr. Brendsel's conduct and violations of federal regulatory standards warrant that he should have been terminated for cause pursuant to his employment agreement.

First Claim For Relief

29) The Director realleges and herein incorporates by reference the allegations set forth in paragraphs 1 through 28, above.

30) From at least June 4, 1999 to May 2, 2002, Mr. Brendsel engaged in conduct and/or violated the 1992 Safety and Soundness Act and the orders, rules and regulations under the Act and that violation and/or conduct involved recklessness and caused and would be likely to cause a significant loss to the Enterprise.

Second Claim For Relief

31) The Director realleges and herein incorporates by reference the allegations set forth in paragraphs 1 through 28, above.

32) From at least June 4, 1999 to May 2, 2002, Mr. Brendsel engaged in conduct that caused and would be likely to cause a loss to the Enterprise, and that conduct was part of a pattern of misconduct.

Third Claim For Relief

33) The Director realleges and herein incorporates by reference the allegations set forth in paragraphs 1 through 28, above.

34) Mr. Brendsel violated the 1992 Safety and Soundness Act, and the order, rules and regulations under that Act, by failing to maintain and implement internal controls that provide for, *inter alia*, an organizational structure and assignment of responsibility for management, employees, consultants and

contractors that provide for accountability and controls and compliance with applicable laws, regulations and policies.

Fourth Claim For Relief

35) The Director realleges and herein incorporates by reference the allegations set forth in paragraphs 1 through 28, above.

36) Mr. Brendsel violated the 1992 Safety and Soundness Act, and the orders, rules and regulations under that Act, by failing to establish and implement internal and external audit programs that provide for, *inter alia*, independence of the audit function, adequate monitoring of internal controls, qualified personnel for the conduct and review of audit functions and adequate testing and review of audited areas.

Fifth Claim For Relief

37) The Director realleges and herein incorporates by reference the allegations set forth in paragraphs 1 through 28, above.

38) Mr. Brendsel violated the 1992 Safety and Soundness Act, and the orders, rules and regulations under that Act, and the Freddie Mac Corporation Act by failing to submit an annual report to OFHEO that includes financial statements prepared in accordance with generally accepted accounting principles.

Sixth Claim For Relief

39) The Director realleges and herein incorporates by reference the allegations set forth in paragraphs 1 through 28, above.

40) Mr. Brendsel violated the 1992 Safety and Soundness Act, and the orders, rules and regulations under that Act, by failing to ensure that the Board remained reasonably informed of the condition, activities, and operations of the Enterprise.

Seventh Claim For Relief

41) The Director realleges and herein incorporates by reference the allegations set forth in paragraphs 1 through 28, above.

42) Mr. Brendsel violated the 1992 Safety and Soundness Act, and rules and regulations under that Act, by failing to ensure that the Board had in place adequate policies and procedures to assure its oversight of corporate strategy, major plans of action, risk policy, and corporate performance.

Eighth Claim For Relief

43) The Director realleges and herein incorporates by reference the allegations set forth in paragraphs 1 through 28, above.

44) Mr. Brendsel violated the 1992 Safety and Soundness Act, and rules and regulations under that Act, by failing to ensure that the Board had in place adequate policies and procedures to assure its oversight of the hiring and retention of qualified senior executive officers.

Ninth Claim For Relief

45) The Director realleges and herein incorporates by reference the allegations set forth in paragraphs 1 through 28, above.

46) Mr. Brendsel violated the 1992 Safety and Soundness Act, and rules and regulations under that Act, by failing to ensure that the Board worked with executive management to establish the Enterprise's strategies and objectives in an informed manner and that such strategies were implemented effectively with appropriate policies, controls, qualified executive management and Board oversight.

Tenth Claim For Relief

47) The Director realleges and herein incorporates by reference the allegations set forth in paragraphs 1 through 28, above.

48) Mr. Brendsel violated the 1992 Safety and Soundness Act's prohibition against operating in an unsafe and unsound manner by *inter alia*, establishing, implementing and overseeing rigid financial objectives that promoted and resulted in earnings management; setting a tone at the top that led to unsafe and unsound practices; sacrificing risk management by ignoring operational risk challenges; pursuing transactions and strategies executed with minimal or no business purpose; and relying on an inappropriate materiality standard.

PRAYER FOR RELIEF

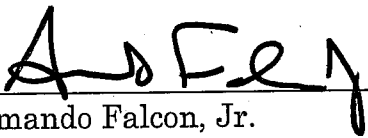
i) The Director prays for relief in the form of the imposition of civil money penalties, as provided for under 12 U.S.C. § 4636.

ii) The Director prays for relief in the form of an order directing Mr. Brendsel to make restitution to Freddie Mac in the amount of the bonuses paid to him in 2000 and 2001.

iii) The Director prays for relief in the form of an order prohibiting Mr. Brendsel from pursuing or accepting any payments that exceed payments that Mr. Brendsel would be entitled to if he had been terminated for cause under his September 7, 1990 Employment Agreement with Freddie Mac.

MISCELLANEOUS

Mr. Brendsel is directed to file a written answer to this Notice within thirty (30) days from the date of service of this Notice in accordance with 12 C.F.R. Part 1780. The original and one copy of any answer shall be filed with the Office of Compliance, Office of Federal Housing Enterprise Oversight, 1700 G Street, N.W., Washington, DC 20552. A copy of any answer shall also be served with the Office of the General Counsel, Office of Federal Housing Enterprise Oversight, Washington, DC 20552 and with the OFHEO attorney whose name appears on the accompanying certificate of service. **Failure to answer within the time period shall constitute a waiver of the right to appear and contest the allegations contained in this Notice, and may, upon OFHEO's motion, cause the administrative law judge and/or the Director to find the facts in this Notice to be as alleged, upon which an appropriate order may be issued.**



Armando Falcon, Jr.
Director
Office of Federal Housing Enterprise Oversight
1700 G Street, N.W.
Washington, DC 20552

Date: December 17, 2003

UNITED STATES OF AMERICA
OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

Notice No. 2003-3

In the Matter of:)
)
)
Vaughn A. Clarke)
_____)

NOTICE OF CHARGES

TAKE NOTICE that on such date and at such place as determined by the presiding officer, a hearing will commence pursuant to 12 U.S.C. §§ 4631 *et seq.* and 12 C.F.R. §§ 1780 *et seq.*, concerning the charges set forth herein, to determine whether an order to cease and desist, to impose a civil money penalty in the amount of \$2,600,000, and or other relief should be issued against Vaughn A. Clarke, former Executive Vice President and Chief Financial Officer of the Federal Home Loan Mortgage Corporation ("Freddie Mac" or "the Enterprise").

In the course of an examination into the affairs of Freddie Mac, the Director ("Director") of the Office of Federal Housing Enterprise Oversight ("OFHEO") has determined that Mr. Clarke: (1) has engaged in conduct that violates the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 ("Safety and Soundness Act of 1992"), 12 U.S.C. §§ 4501 *et seq.*, the Federal Home Loan Mortgage Corporation Act ("Freddie Mac Corporation Act"), 12 U.S.C. §§ 1451 *et seq.*, and orders, rules and regulations under such Acts; and (2) has engaged in

conduct that has caused or is likely to cause a loss to the enterprise. The Director also has determined that such violations and conduct: (1) are part of a pattern of misconduct; and/or (2) involved recklessness and caused, or would be likely to cause, a material loss to the Enterprise.

In support of this Notice of Charges ("Notice"), the Director states the following:

JURISDICTION

At all times relevant to the charges set forth herein:

1) OFHEO is an independent entity established within the Department of Housing and Urban Development by the Safety and Soundness Act of 1992, whose primary mission is to ensure the capital adequacy and safety and soundness of the government sponsored enterprises it regulates.

2) The Director is charged with ensuring that the enterprises OFHEO regulates operate safely and soundly and with adequate capital. In this regard, the Director is authorized to make such determinations, take such actions, and perform such functions as the Director determines necessary, including the institution of administrative and enforcement actions pursuant to the Safety and Soundness Act of 1992 seeking: (i) cease and desist orders; (ii) the imposition of civil money penalties; and (iii) such other relief relating to the government sponsored enterprises OFHEO regulates and the enterprises' present and former executive officers and directors. 12 U.S.C. § 4513(b)(5).

3) Freddie Mac is a government sponsored enterprise regulated by OFHEO. 12 U.S.C. §§ 4501 *et seq.*

4) From March 2000 until June 6, 2003, Mr. Clarke was Acting and then permanent Chief Financial Officer ("CFO") of Freddie Mac. Mr. Clarke was an Executive Vice President of Freddie Mac from November 15, 2000 until June 6, 2003.

5) As Executive Vice President and CFO, Mr. Clarke was responsible for, *inter alia*:

a) providing leadership for financial strategy implementation to allow for maximizing shareholder value while protecting the Enterprise's assets;

b) tracking financial performance against forecasts and to assess operational goals and financial goals;

c) managing the Enterprise's short- and long-term performance;
and

d) supervising the Corporate Accounting Department.

BACKGROUND

6) Freddie Mac is one of the world's largest sources of mortgage financing.

7) On or about March 6, 2002, Freddie Mac hired PricewaterhouseCoopers ("PwC") as its independent public accountant ("IPA") for the year ending December 31, 2002 replacing Arthur Andersen as its IPA. PwC began its audit engagement in or about March 2002. In the course of its work, PwC

uncovered several areas that required further investigation, including transactions that were executed by Freddie Mac in 2000 and 2001 to "smooth" earnings.

8) In January 2003, Freddie Mac announced that it expected to restate its financial results for 2001 and 2002, and possibly for 2000. At the same time, Freddie Mac also announced that it had to delay release of its audited 2002 financial statement. Subsequently, Freddie Mac released unaudited earnings figures for 2002.

9) On June 6, 2003, at the request of Freddie Mac's Board of Directors ("Board"), Mr. Clarke resigned from Freddie Mac.

10) On November 21, 2003, Freddie Mac announced the results of its restatement. For the year ended December 31, 2000, the restated net income was \$1.119 billion higher than previously reported. For the year ended December 31, 2001, the restated net income was \$989 million lower than previously reported. For the year ended December 31, 2002, the restated net income was \$4.326 billion higher than previously reported.

**FREDDIE MAC DEVELOPED RIGID FINANCIAL OBJECTIVES THAT
PROMOTED AND RESULTED IN EARNINGS MANAGEMENT THAT
MR. CLARKE IMPLEMENTED**

11) Freddie Mac established and implemented rigid financial objectives relating to the management of its earnings. These objectives (collectively, "financial objectives") focused on, and were driven by, particular earnings outcomes:

a) From at least 1996 and until at least mid-2002, Freddie Mac pursued an objective of attaining annual mid-teens earnings growth.

b) From at least 1996 and until at least mid-2002, Freddie Mac pursued an objective of attaining "steady" and "stable" earnings growth.

c) From at least 1998 and until at least mid-2002, Freddie Mac pursued an objective of achieving quarterly and annual earnings per share figures that met or exceeded financial analysts' expectations, but that did not exceed expectations by more than a few cents.

d) From at least 1999 and until at least mid-2002, Freddie Mac pursued an objective of minimizing earnings volatility by "smoothing" the time pattern of net interest income ("NII").

12) Beginning in the early 1990s, Freddie Mac began to forecast that its normal business operations would bring about earnings growth in or about the mid-teens. Beginning in or about, and from at least, 1996 or 1997, this forecast was converted into an annual goal of mid-teens earnings that became an increasingly rigid objective.

13) In his position as CFO, beginning in 2000, Mr. Clarke assumed responsibility for implementing and pursuing the attainment of the financial objectives. Senior managers were either rewarded for attaining or penalized for failing to achieve the objectives. In particular, Mr. Clarke's bonus compensation, which could, and in certain instances did, exceed fixed compensation, was based in significant part on achieving these objectives.

14) The pressure to achieve these financial objectives led to the unsafe and unsound practices discussed herein.

**MR. CLARKE HAS ENGAGED IN CONDUCT THAT VIOLATED
THE SAFETY AND SOUNDNESS ACT OF 1992 AND
REGULATORY PROHIBITIONS AGAINST UNSAFE AND
UN SOUND PRACTICES**

15) From at least 2000, Mr. Clarke engaged in conduct that violated and caused to be violated, statutes, rules and regulations, including the Safety and Soundness Act of 1992, the Freddie Mac Charter Act, and the orders, rules and regulations promulgated under these Acts. Mr. Clarke's conduct caused, and was likely to cause, a loss to the Enterprise. Mr. Clarke's violations and conduct are part of a pattern of misconduct and/or involved recklessness and caused, or would be likely to cause, a significant loss to the Enterprise.

**Mr. Clarke Established A "Tone At The Top"
That Led To Unsafe and Unsound Practices**

16) Mr. Clarke aggressively pursued Freddie Mac's financial objectives. With Mr. Clarke's direction and approval and/or under his supervisory authority, Freddie Mac took steps necessary to achieve these financial objectives. For example:

a) With Mr. Clarke's direction and approval and/or under his supervisory authority, the Corporate Accounting Department took steps necessary to ensure that earnings were as close to the financial analysts' consensus earnings forecast as possible.

b) Mr. Clarke communicated to Freddie Mac's Funding & Investment Division, "to the penny," the amount of earnings that Mr. Clarke wanted the Division to generate by the end of a quarter or year.

c) When a downward adjustment in a tax reserve was determined to be necessary late in a quarter, thereby causing earnings per share figures to increase by 5 or 6 cents, Mr. Clarke attempted to delay the adjustment until the following quarter and when that failed, sought the execution of transactions that would offset the increase.

Mr. Clarke Pursued These Financial Objectives Despite Internal Control Weaknesses, A Deficient Operational Risk Framework, And Accounting Department Weaknesses

17) The pursuit and achievement of the financial objectives contributed to operational risks that Mr. Clarke felt no need to address as long as the financial objectives were met.

18) Freddie Mac pursued its financial objectives, with Mr. Clarke's direction and approval and/or supervisory authority, without regard to the adequacy of its internal controls and operational risk. This constituted an unsafe and unsound practice. For example:

a) Mr. Clarke failed to properly address repeated Internal Audit findings, spanning several years, that Freddie Mac's internal controls for accounting financial reporting were deficient. Weak internal controls were a contributing factor in the events that resulted in the restatement of, and the delay in release of, audited financial statements.

b) Mr. Clarke failed to properly address weaknesses in the Corporate Accounting department, over which he exercised supervisory authority – the department on which Freddie Mac relied for opinions

regarding proper accounting treatment. Mr. Clarke allowed deficiencies in the Corporate Accounting department's resources and accounting skills to persist for a long period of time. Mr. Clarke hired a Controller that lacked critical qualifications for the position. The deficiencies were reported to management, including Mr. Clarke, by Freddie Mac business units, the Internal Audit department and the external auditor. These deficiencies were contributing factors in the events that resulted in the restatement of, and the delay in release of, audited financial statements.

c) Freddie Mac relied on the external auditor to perform tasks that should have been performed by Corporate Accounting, thereby compromising the external auditor's independence and ability to provide independent opinions regarding Freddie Mac's accounting treatments. Mr. Clarke failed to properly address the situation by ensuring the external auditor's independence. This failure was a contributing factor in the events that resulted in the restatement of, and the delay in release of, audited financial statements.

With Mr. Clarke's Direction And Approval And/Or Under His Supervisory Authority, Transactions And Strategies Executed For Their Accounting Impact And With Minimal Or No Business Purpose

19) With Mr. Clarke's direction and approval and/or under his supervisory authority, in order to ensure that Freddie Mac's financial objectives were met, it engaged in transactions and strategies that were not accounted for in accordance with generally accepted accounting principles ("GAAP") or otherwise improper, and

that were executed for the accounting impact the transactions would have on its financial statements. For example:

a) In November and December 2000, with Mr. Clarke's direction and approval and/or under his supervisory authority, Freddie Mac's Funding & Investment Division ("F&I") entered into a series of four transactions known as "Coupon Trade-up Giants" ("CTUGs"). Mr. Clarke attended meetings and participated in discussions involving the CTUGs. Mr. Clarke also made a December 8, 2000 presentation discussing the purpose and effect of the CTUGs. Each transaction had two steps, each with a different financial objective. The first step moved securities from the hold-to-maturity portfolio to the trading portfolio, which was designed to offset (in the amount of approximately \$700 million) time value gains in its derivative portfolio that would be realized as a result of the implementation of Financial Accounting Standard 133 ("FAS 133"). Freddie Mac was required to implement FAS 133, effective January 1, 2001. This first step, which was permissible under FAS 133, would help Freddie Mac achieve some of its financial objectives, but was counter to another financial objective – minimizing earnings volatility. Thus, the CTUG transactions had a second step, which moved 90% of these securities from the trading portfolio to the available-for-sale portfolio, through a third-party, in order to reduce earnings volatility. In part to avoid the requirement that the Board's Securitization Committee approve all transactions that exceed \$11 billion, the \$30 billion

CTUGs were divided into two \$10 billion transactions, one \$4 billion transaction and one \$6 billion transaction. Although all transactions over \$5 billion were to be reported to the Securitization Committee, management reported only a single \$10 billion transaction. Ultimately, PwC determined that these transactions were not accounted for properly. The improper accounting for the CTUGs contributed to the restatement of Freddie Mac's financial statements.

b) In December 2000, with Mr. Clarke's direction and approval, F&I changed its methodology for the valuation of its swaptions so that it could reverse engineer a valuation that was lower than the valuation using prevailing market rates. The decision to change the methodology was driven by Freddie Mac's desire to meet its financial objectives; specifically, the methodology change enabled Freddie Mac to offset almost all of its then-remaining FAS 133 transition gain (more than \$700 million). The memorandum detailing the valuation methodology change purportedly was from F&I but was actually written by the head of Market Risk Oversight, who was tasked with independently overseeing F&I's activities. The head of Market Risk Oversight's subsequent approval of the valuation methodology change was, in effect, an approval of his own work and a circumvention of an internal control designed to ensure an independent assessment of F&I's activities. Mr. Clarke ultimately prepared a performance evaluation of the head of Market Risk Oversight that implicitly references the new policy as a

highlight of his performance. The methodology change was not disclosed to the Board or its Committees. In February 2001, just two months later – but after the desired accounting effect was achieved – Freddie Mac reverted to its pre-December 2000 valuation methodology. The change in methodology in December improperly valued the swaptions, contributing to the restatement of Freddie Mac's financial statements.

c) “Operating earnings” was a supplemental performance measure that Freddie Mac began to utilize with its first quarter 2001 reporting. According to Freddie Mac, the “operating earnings” measure presented a more accurate depiction of Freddie Mac's financial performance than the GAAP measure because, in part, it factored out certain effects such as the impact of the implementation of FAS 133. Notwithstanding Freddie Mac's adoption of the “operating earnings” measure, in August and early September 2001, F&I entered into a series of pay-fixed and received-fixed swaps that had minimal or no business purpose but had the effect of shifting operating earnings from 2001 to future years. Sixteen separate trades, comprising eight sets of “linked swaps,” were entered into in August 2001. A ninth set, which was a leveraged link swap, was entered into on September 7, 2001. F&I did not notify or obtain the approval of Freddie Mac's Corporate Accounting Department or Freddie Mac's independent public accountant, Arthur Andersen, prior to the execution of these nine sets of “linked swaps.” The Arthur Andersen engagement partner learned of these swaps after the

ninth set was executed and expressed concern about the trades to Mr. Clarke. Mr. Clarke resisted suggestions that the trades be unwound. Eventually, these swaps were unwound, but only after the desired accounting impact was achieved. The linked swaps were not accounted for properly, contributing to the restatement of Freddie Mac's financial statements.

WITH MR. CLARKE'S DIRECTION AND APPROVAL AND/OR UNDER HIS SUPERVISORY AUTHORITY, FREDDIE MAC VIOLATED THE 1992 SAFETY AND SOUNDNESS ACT AND THE FREDDIE MAC CORPORATION ACT BY FAILING TO SUBMIT TO OFHEO FINANCIAL STATEMENTS PREPARED IN ACCORDANCE WITH GAAP

20) Freddie Mac was required, annually, to submit an annual report to OFHEO that includes financial statements prepared in accordance with GAAP. From at least 2000 through 2002, with Mr. Clarke's direction and approval and/or under his supervisory authority, Freddie Mac failed to submit to OFHEO financial statements prepared in accordance with GAAP.

MR. CLARKE'S VIOLATIONS AND CONDUCT HAVE CAUSED AND WERE LIKELY TO CAUSE A MATERIAL LOSS TO THE ENTERPRISE

21) Mr. Clarke's violations of the 1992 Safety and Soundness Act and his conduct have caused and were likely to cause a material loss to the Enterprise including, but not limited to, harm to the reputation and integrity of the Enterprise in the financial marketplace and the unanticipated expenses incurred, and to be incurred, including legal, consulting, investigative and auditing costs.

**MR. CLARKE WAS UNJUSTLY ENRICHED AS A RESULT
OF HIS CONDUCT AND VIOLATIONS**

22) In 2000 and 2001, Mr. Clarke participated in Freddie Mac's bonus compensation plan. Mr. Clarke received a \$203,723 bonus under that plan for 2000 and a \$333,000 bonus under that plan for 2001. During this time, Mr. Clarke's conduct in meeting financial objectives, failing to address accounting improprieties and other matters alleged herein resulted in losses to the Enterprise. In such circumstances, the bonus payments constitute unjust enrichment.

**MR. CLARKE'S CONDUCT AND VIOLATIONS WARRANTED HIS
TERMINATION FOR LOSS OF CONFIDENCE**

23) Mr. Clarke was an at-will employee of Freddie Mac and did not execute an employment agreement with Freddie Mac. Mr. Clarke's willful misconduct was injurious to Freddie Mac and warranted his termination for loss of confidence on June 6, 2003, pursuant to Freddie Mac Policy Number 3-254.1 Series III, Human Resources, Severance-Officers (May 15, 2001), specifically including any severance pay, restricted stock award or bonus.

First Claim For Relief

24) The Director realleges and herein incorporates by reference the allegations set forth in paragraphs 1 through 23, above.

25) From at least March 2000 to May 2, 2002, Mr. Clarke engaged in conduct and/or violated the 1992 Safety and Soundness Act and the orders, rules and regulations under the Act and that violation and/or conduct involved

recklessness and caused and would be likely to cause a material loss to the Enterprise.

Second Claim For Relief

26) The Director realleges and herein incorporates by reference the allegations set forth in paragraphs 1 through 23, above.

27) From at least March 2000 to May 2, 2002, Mr. Clarke engaged in conduct that caused and would be likely to cause a loss to the Enterprise, and that conduct was part of a pattern of misconduct.

Third Claim For Relief

28) The Director realleges and herein incorporates by reference the allegations set forth in paragraphs 1 through 23, above.

29) Mr. Clarke violated the 1992 Safety and Soundness Act, and the orders, rules and regulations under that Act, and the Freddie Mac Corporation Act by failing to submit an annual report to OFHEO that includes financial statements prepared in accordance with generally accepted accounting principles.

Fourth Claim For Relief

30) The Director realleges and herein incorporates by reference the allegations set forth in paragraphs 1 through 23, above.

31) Mr. Clarke violated the 1992 Safety and Soundness Act's prohibition against operating in an unsafe and unsound manner by, *inter alia*, setting a tone at the top that led to unsafe and unsound practices; sacrificing risk management by

ignoring operational risk challenges; and pursuing transactions and strategies executed with minimal or no business purpose.

PRAYER FOR RELIEF

i) The Director prays for relief in the form of the imposition of civil money penalties, as provided for under 12 U.S.C. § 4636.

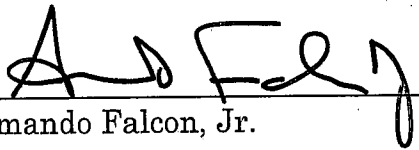
ii) The Director prays for relief in the form of an order directing Mr. Clarke to make restitution to Freddie Mac for bonuses paid to him for the years 2000 and 2001.

iii) The Director prays for relief in the form of an order prohibiting Mr. Clarke from pursuing or accepting any payments that exceed the payments that Mr. Clarke would be entitled to if he had been terminated for loss of confidence on June 6, 2003, under Freddie Mac Policy Number 3-254.1 Series III, Human Resources, Severance-Officers (May 15, 2001), specifically including any severance pay, restricted stock awards or bonus.

MISCELLANEOUS

Mr. Clarke is directed to file a written answer to this Notice within thirty (30) days from the date of service of this Notice in accordance with 12 C.F.R. Part 1780. The original and one copy of any answer shall be filed with the Office of Compliance, Office of Federal Housing Enterprise Oversight, 1700 G Street, N.W., Washington, DC 20552. A copy of any answer shall also be served with the Office of

the General Counsel, Office of Federal Housing Enterprise Oversight, Washington, DC 20552 and with the OFHEO attorney whose name appears on the accompanying certificate of service. **Failure to answer within the time period shall constitute a waiver of the right to appear and contest the allegations contained in this Notice, and may, upon OFHEO's motion, cause the administrative law judge and/or the Director to find the facts in this Notice to be as alleged, upon which an appropriate order may be issued.**

A handwritten signature in black ink, appearing to read "Armando Falcon, Jr.", written over a horizontal line.

Armando Falcon, Jr.
Director
Office of Federal Housing Enterprise Oversight
1700 G Street, N.W.
Washington, DC 20552

Date: December 17, 2003