Report of the Special Examination of Freddie Mac

December 2003

I. INTRODUCTION

On January 22, 2003, Freddie Mac announced that the Enterprise would restate its financial results for 2002, 2001, and possibly 2000. That restatement occurred on November 21, 2003. The restatement resulted from the evaluation by management—conducted in conjunction with the external auditor of Freddie Mac, PricewaterhouseCoopers—of certain accounting policies previously used by management and approved by the previous external auditor of the Enterprise, Arthur Andersen. Those issues involved primarily the hedge accounting treatment of certain transactions, including those occasioned by the implementation of Statement of Financial Accounting Standards (FAS) No. 133, *Accounting for Derivative Instruments and Hedging Activities*. The restatement resulted in a cumulative increase in retained earnings of $5 billion and in regulatory core capital of $5.2 billion.

On June 7, 2003, Armando Falcon, the Director of the Office of Federal Housing Enterprise Oversight (OFHEO), ordered a special examination to be conducted into the events leading to the public announcement on June 9, 2003, of the termination, resignation, and retirement of three principal executive officers of Freddie Mac. On that date, the Enterprise announced the retirement of former Board Chairman and Chief Executive Officer Leland Brendsel, the termination of former President and Chief Operating Officer David Glenn, and the resignation of former Executive Vice President—Chief Financial Officer Vaughn Clarke. The special examination was ordered to expand and supplement an ongoing OFHEO examination of the financial condition of the Enterprise and the decision of Freddie Mac to restate its financial reports for 2000, 2001, and 2002.

Over the months during which OFHEO was conducting its examination of the restatement process, the agency became increasingly concerned about facts that came to light regarding weaknesses in controls and personnel in accounting areas and about the disclosure of misconduct on the part of Freddie Mac employees. The Director concluded that the initiative of the Enterprise in removing three members of the management team only went part of the way toward correcting serious problems with management practices

and controls. The special examination was tasked with reviewing those events leading to the restatement that revealed deficiencies in accounting practices and controls as well as employee misconduct discovered by Freddie Mac on or before June 4, 2003. The Director instructed the special examination to make recommendations to him as to additional steps that needed to be taken to help ensure the continuing safe and sound operations of the Enterprise.

By letter dated June 7, 2003, Director Falcon instructed the Board of Directors of Freddie Mac to provide its full cooperation with the special examination and to make available to the special examination all communications to the Board and management regarding deficiencies in accounting practices or its investigation of employee misconduct. The Director also instructed the Board to provide an explanation of its rationale for the compensation packages the Enterprise proposed for the three individuals in light of the circumstances surrounding their departures. That compensation is subject to the approval of OFHEO.

Director Falcon also informed the Board of Directors that, in the case of personnel terminated for misconduct, OFHEO would object to any re-employment of these individuals, and that OFHEO may hold them liable for indemnification to Freddie Mac for losses that may have resulted from their conduct.

Finally, the Director instructed the Board to provide to OFHEO, for review and approval, plans to address reform of Board oversight of the supervision of accounting practices by management; personnel and systems changes; plans for implementing accounting services quality controls; and a program for routine communications by the Board with OFHEO on the progress of the plan of remediation.

The special examination reviewed documents generated by the operations of Freddie Mac or obtained by OFHEO over ten years in the course of its regular examination process. Documents, including emails and audio tapes, were produced by the Enterprise pursuant to OFHEO subpoena. OFHEO also obtained, pursuant to subpoena, testimony under oath from numerous employees and members of the Board of

Directors of Freddie Mac. OFHEO is cooperating with the Securities and Exchange Commission and the Office of the United States Attorney for the Eastern District of Virginia.

During the months of August and September 2003, the special examination provided recommendations to the Director for action concerning members of the current management of Freddie Mac and the former management of the Enterprise. Certain information provided to the Director has been excluded from this report to ensure the continuing integrity of the examination and regulatory processes. This report presents the conclusions and recommendations of the special examination.

III. IMPROPER MANAGEMENT OF EARNINGS

The term "earnings management" came into widespread use among accountants, lawyers, and others following a now famous September 1998 speech by the then Securities and Exchange Commission Chairman, Arthur Levitt[36] The term is perhaps unfortunate, in that almost all business activity is designed to enhance earnings, and the essence of good corporate management is maximizing profit (earnings) for shareholders. As used in this report, it means inappropriate manipulation of reported accounting results through various devices.

This chapter reviews how Freddie Mac manipulated its reported earnings and disclosed other financial information in a misleading way in 1999 through 2002. The chapter provides a chronology of relevant events, reviews the strategies that the Enterprise employed to manipulate earnings, and indicates that the Board was made aware of transactions whose sole purpose was to shift income. The chapter also examines how the executive compensation program of Freddie Mac, particularly compensation tied to earnings per share, influenced accounting and management practices at the Enterprise during the period.

The special examination concludes that excessive attention and dedication of corporate resources of a government-sponsored enterprise to management of earnings for the purpose of meeting securities market expectations, without an additional, overriding business purpose, is an unsafe and unsound practice.

Strategies Employed by Freddie Mac

As discussed in Chapter II, in the period covered by the special examination, senior management at Freddie Mac placed an inordinate emphasis on achieving steady, stable growth in earnings per share. The Enterprise used a number of strategies in an effort to shift earnings among quarters and years so as to achieve that objective. A useful way to

[36] Arthur Levitt, "The Numbers Game," Address, the NYU Center for Law and Business, September 29, 1998.

The Role of the Executive Compensation Program of Freddie Mac

The special examination analyzed whether executive compensation, particularly compensation tied to earnings per share, may have contributed to the improper accounting and management practices at Freddie Mac. The special examination concludes that it did. The special examination considered compensation matters from a broad safety and soundness perspective.[167]

Corporate Performance and Executive Compensation

The direct compensation of Freddie Mac executive officers includes three key components: base salary, an annual cash bonus, and long term stock incentives—for example, stock options and restricted stock.[168] The Freddie Mac charter act requires that a "significant portion of potential compensation" for executive officers of the Enterprise be based on the performance of the Corporation.[169] Corporate performance-based compensation for executive officers generally comprises a larger share of direct compensation than that for other employees.[170] Approximately 54 percent of the total cash compensation (salaries, bonuses, and other compensation) paid by Freddie Mac to executive officers for performance in 2001 was based on corporate performance for that year.[171]

At the beginning of each performance year, it was the practice of Freddie Mac to establish a "target bonus" incentive for each executive that was a percentage of the salary of that executive. For example, an executive with a salary of $400,000 might have a target bonus equal to 50 percent of salary—that is, $200,000. The sum of the various

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[167] The special examination reviewed executive compensation for various officers involved in transactions and events under consideration. It did not limit the scope of the review to executive officers covered under the OFHEO regulation on executive compensation. 12 CFR Part 1770.
[168] "Employee Compensation Policies and Practices at Freddie Mac," Report to Congress, June 30, 2003, p. 5. The use of stock options as a form of compensation by Freddie Mac and Fannie Mae has been criticized by former Federal Reserve Board Chairman Paul Volcker and former U.S. Comptroller General Charles Bowsher, both of whom maintain such stock option use is "inappropriate." "Volcker hits Fannie Mae, Freddie Mac Stock Option Use," Reuters, October 2, 2003.
[169] Section 303(c) of the Federal Home Loan Mortgage Corporation Act, 12 U.S.C. 1452 (c).
[170] Report to Congress, "Employee Compensation Policies and Practices at Freddie Mac," June 28, 2002, Freddie Mac, p. 6.
[171] *Id.*, p. 11.

target bonuses for executives became known as the target "bonus pool."[172] Freddie Mac then used a corporate scorecard as a basic metric to determine the actual amount of total funding in the bonus pool. Depending on how well the Enterprise performed when assessed by certain metrics—for example, profitability, core capabilities, and strategic positioning—the scorecard produced a bonus funding percentage that was well above 100 percent ("above plan"); just above, at, or just below 100 percent ("on plan"; or well below 100 percent ("below plan").[173] That process generally resulted in Freddie Mac determining that it was "on plan" or "above plan,"[174] which resulted in bonus plan funding ranging from 125 percent to 185 percent (See Table 4). The eventual bonuses paid to executives, particularly Mr. Brendsel, Mr. Glenn, and certain F&I executives, were substantial (See Table 5).

Earnings Per Share (EPS) Targets: A Key Scorecard Factor

The actual metrics of the corporate scorecard determined the overall amount of bonus pool funds available for awards.[175] Accordingly, the components of that scorecard, and the weight assigned to those components, were of direct interest to all Freddie Mac executives.[176] Hitting "on-plan" targets for operating earnings per share (EPS) in the

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[172] Bonus targets for Executive and Senior Vice Presidents are set by the Board of Directors Human Resources Committee in March of the performance year, "Freddie Mac Executive Bonus Plan Step-By-Step Summary of Process and Execution," August 6, 2003, OF 0000476.

[173] *Id.*, OF 0000477.

[174] For the years examined, Freddie Mac always determined itself to be "on plan" or "above plan." While Freddie Mac missed a major threshold in 1999 and the bonus funding was limited to 30-50 percent, the corporate performance was nonetheless viewed as "on plan." OF 0000036.

[175] "Freddie Mac Executive Bonus Plan Step-by-Step Summary of Process and Execution," Freddie Mac, August 6, 2003, OF 0000480.

[176] Freddie Mac Executive Vice President, Chief Operating Officer Paul Peterson noted why the scorecard was of interest to executive officers. OFHEO Interview, Paul Peterson, August 27, 2003, p. 146.

> Q: Is any part of your compensation, salary, bonus, and part of your compensation tied to meeting earnings per share targets?
>
> A: Well, the corporate score card had an earnings objective on it. In fact, I think it probably counted for about 40 percent of the funding of the bonus plan. So my own IOPs relative to how I was compensated were based on my score card and my contract that I would have had with David Glenn and I would have been rated relative to that.

Former General Counsel Maud Mater also indicated familiarity with the role meeting earnings per share targets played in determining compensation. OFHEO Interview, Maud Mater, July 30, 2003, pp. 221-222.

A September 2002 report by the Conference Board Commission on Public Trust and Private Enterprise recommended that performance-based incentives support long-term strategic objectives established by the Board of Directors. The Commission recommendations included such measurements as cost-of-capital, return on equity, economic value added, market share, quality goals, compliance goals, revenue and profit growth, cost containment, and cash management.[218]

Executive Compensation and Earnings Management

> The system for financial rewards to management is frequently skewed toward participation in the growth of an entity's worth in the marketplace, especially, although not exclusively, for top management. At many levels within an entity, financial incentives based directly or indirectly on accounting results can be significant. At some point in the continuum, the motivation behind earnings management may become strong enough to result in fraud.[219]

The size of the bonus pool at Freddie Mac was tied, in part, to meeting or exceeding an annually specified earnings per share target for the current year, and was not tied directly to meeting an analyst-based target future range of earnings. Nonetheless, the actions by Freddie Mac executives to move "front loaded" earnings from one quarter to a future quarter had the effect of helping to ensure that the EPS compensation goals would be easily met in future quarters,[220] as well as to possibly bolster the value the stock on which options would presumably be exercised in future quarters.

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[218] Findings and Recommendations—Part 1: Executive Compensation. The Conference Board Commission on Public Trust and Private Enterprise, September 17, 2002, p. 9.

[219] Public Oversight Board, Panel on Audit Effectiveness. Report and Recommendations, August 12, 2000, p. 80. Available online at: http://www.pobauditpanel.org/download.html.

[220] Mr. John McCoy, Chairman of the Freddie Mac Human Resources Committee, indicated that one result of moving earnings forward could be increased earnings per share targets.

> Q: Do you think that actions to move earnings to future quarters could have the effect, intentional or not, of ensuring that earnings per share compensation goals would be easily met in future quarters?
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> A: The simple answer is yes. In reality, since the bonus program was based on earnings per share and what level the earnings per share was, if the income was moved and somebody then increased the requirement for earnings per share to be that much higher, then the answer would be no."

OFHEO Interview, John McCoy, September 24, 2003, p. 70.

There is a growing perception that reported earnings are increasingly "noisy" as a performance indicator.[221] Income-decreasing accounting choices by corporate managers to maximize the value of bonus awards have been observed elsewhere. For example, if "true" earnings in a quarter are too low to trigger bonus awards or so high that the cap on bonuses is exceeded, management may manipulate reported earnings downward in order to increase earnings in future quarters.[222] When flexible accounting rules are permitted, managers can shift income between years and thereby increase total bonus payoffs.[223] In addition, managers who anticipate large options awards may make income-decreasing accrual choices as a means to decrease the exercise price of their stock option awards.[224]

The peril of tying a major amount of compensation to increases in the growth of Freddie Mac earnings per share should be considered in the context of a February 1, 2001 meeting described by Mr. Glenn in his journal. In that meeting, attended by Mr. Parseghian and Mr. Dossani, it appears that Mr. Parseghian maintained that there was a possibility that, due in part to the fact that earnings are front loaded, the Enterprise

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[221] Nwaeze, E.T., Yang, S. and Jennifer Yin, "The Role of Cash Flows in Executive Compensation: A Re-examination," Unpublished manuscript, April 2002, p. 4.

[222] Pengji, G. and R. Shrieves, "Earnings Management and Executive Compensation: A Case of Overdose of Option or Underdose of Salary," p. 5. Presented to EFA 2002 Berlin Conference, Humboldt University, Berlin, July 29, 2002. The authors note on page 4 that actions to decrease reported earnings in a given period which result in an increase in earnings in a future period may imply that there is a dynamic aspect to earnings management, manifested by such actions as the establishment of "cookie jar" reserves; Holthausen, R.W, Larcker,D.F. and R.G. Sloan, "Annual Bonus Schemes and the Manipulation of Earnings," *Journal of Accounting and Economics,* 19 (1995) pp. 29-74.
See also, Healy, P.M. and J.M. Wahlen. "A Review of Earnings Management Literature and Its Implications for Standard Setting," Preliminary Draft, November, 1998. Available online at http://papers.ssrn.com/sol3/delivery.cfm/99031602.pdf?abstractid=156445; and Bollinger, G. and Kast, M. "Executive Compensation and Analyst Guidance: The Link Between CEO Compensation and Expectations Management,' Preliminary Draft, June, 2003. Available online at http://www.sirif.org.uk/papers/p861.pdf. Regarding the manipulation of "true" earnings based on bonus incentives, see Lin, Z.X an M. Shih, "Variation of Earnings Management Behaving Across Economic Settings, and New Insights into Why Firms Engage in Earnings Management," Unpublished manuscript, National University of Singapore, p. 21. Available online at http://207.36.165.114/Denver/Papers/variation of earnings management behavior.pdf

[223] Naciri, A. "Earnings Management and Bank Provision for Loan Losses," Working Paper 04-2002, Centre de Recherche en Gestion, January 2002, p. 5. Regarding smoothing of earnings, the author notes, on page 7: "To perform smoothing of earnings, managers sometimes pay more attention to the accounting consequences of major decisions than to the economics. It is believed that managers devote such attention to earnings because they believe that it is what matters most to shareholders. Reports that please shareholders serve a manager's self interest. Managers appreciate a lot of their bonuses and other perquisites are tied to reported earnings."

[224] Baker, T., Collins, D and A. Reitenga, "Stock Option Compensation and Earnings Management Incentives," December, 2002, p. 23.

would not be able to sustain double-digit earnings growth within a few years.[225] If Mr. Parseghian was correct in that assessment, the earnings per share target in the corporate scorecard, which was in the mid-to-high teens in the years examined, would not be met in the out years, absent a revision of the target or a change in corporate strategy.[226] That is a matter that likely would be of interest to executives anticipating bonuses.

The problematic nature of the approach to giving employees incentives used by Freddie Mac in the period covered by the restatement has been recognized by the Enterprise. According to Human Resources Committee Chair John McCoy, earnings per share will not be a factor in the corporate scorecard in 2003.[227]

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[225] Diary excerpts, David Glenn, DG 0147.

[226] On or about the time of the meeting described by Mr. Glenn (from February 1, 2001 through February 8, 2001), Mr. Parseghian sold a substantial amount of restricted stock (87,454 shares) and exercised options on 278,880 shares. Freddie Mac Securities Transaction by Directors and Executive Officers. Filings—Form 4, FM B000086.

[227] "Well, each score card is different based on what's going on that year. The scorecard that we looked at the other day has no earnings measure in it for this year, and the rewards are basically for getting the restatement done, getting the first and second and third quarters announced this year, for working on the remediation, for changing the structure of the company." OFHEO Interview, John McCoy, September 24, 2003, pp. 47-48.

IV. COUNTERPARTIES

Numerous financial institutions, including some of the largest investment banks on Wall Street, were counterparties to transactions initiated by Freddie Mac in order to shift and smooth the reported earnings of the Enterprise. Those transactions had little legitimate business purpose and were structured to achieve a certain accounting result and to mislead investors about the finances of Freddie Mac.

OFHEO has not concluded its investigation of the role of the counterparties in those improper transactions. The agency is reviewing whether the counterparties met their obligations to ensure that they were not part of a scheme to mislead investors and whether they encouraged improper conduct in any way. In addition, OFHEO will examine the willingness of the counterparties to accommodate Freddie Mac in order to maintain other profitable business relationships. For example, all of the counterparties to the linked swaps are members of the Reference Notes Securities Auction Dealer Group, which underwrites the largest debt issues of Freddie Mac and is a source of substantial underwriting income for its members.[228] The counterparties on the linked swaps also rank highly among the dealers that Freddie Mac uses for its normal derivatives activities, as indicated in Table 7, which shows linked swaps counterparties in italics. Corrective actions that OFHEO could take with respect to a culpable counterparty range from imposing conditions or limits on its future business relationships with Freddie Mac and Fannie Mae to prohibiting it from doing business with the Enterprises in the future.

There is evidence to date that one or more of the counterparties to the transactions that Freddie Mac undertook to manage earnings may not have acted properly. Transcripts of recorded telephone conversations between the staffs of the Enterprise and various broker/dealers appear to indicate that those counterparties did not adequately determine if transactions had a legitimate business purpose or were part of a scheme to mislead investors. In at least one instance, a trader at a counterparty—Morgan Stanley—suggested to a Freddie Mac trader a plausible-sounding business purpose for a pair of

[228] Members of that group are listed at http://www.freddiemac.com/debt/html/refnoteaucdealerlist.html.

linked swaps[229] that were executed for the sole purpose of moving large amounts of operating income into the future. Given that many of the deals generated substantial commissions with minimal risk, the counterparties may have had a strong disincentive to inquire about the actual purposes of the transactions.

Table 7. Freddie Mac Derivatives Counterparties by Notional Amount Outstanding As of April 30, 2003 ($ Millions)	
JP Morgan Chase Bank	78,213
Lehman Brothers Special Financing Inc	63,969
Credit Suisse First Boston International	60,187
Citibank NA	54,830
Goldman Sachs Capital Markets, LP	50,333
Morgan Stanley Capital Services, Inc	48,893
Deutsche Bank AG	38,952
UBS AG	28,983
Merrill Lynch Capital Services, Inc	28,885
BNP Paribas	28,156
Bear Stearns Capital Markets, Inc	24,167
ABN Amro Bank, NV	22,975
Barclays Bank plc	22,761
Wachovia Bank, NA	13,082
Bank of America, NA	11,812
Greenwich Capital Derivatives, Inc	5,372
HSBC Bank USA	4,918
Dresdner Bank AG	3,988
Kreditanstalt fur Wiederaufbau	2,500
Bank One, NA	1,788
Bank of New York	1,658
Commerzbank AG	690
General Re Financial Products Corp	607
AIG Financial Products Corp	43

Source: Freddie Mac Investment Committee Standard Reports, Board of Directors Meeting, June 6, 2003, OF 5041348.

[229] Audio tape transcript, Ray Powers (AUD_80), August 14, 2001, OF 2001659.

The remainder of this chapter provides some details on the role of counterparties in three groups of transactions: the linked swaps, the Coupon Trade-Up Giants (CTUGs), and the Blaylock trades.

The Linked Swaps

In August 2001, Freddie Mac entered into eight pairs of interest rate swap transactions. As described earlier in this chapter, the terms of each pair of swaps substantially offset each other. For each pair, there was a swap that began immediately where the Enterprise paid a fixed rate to the counterparty and received a floating rate, coupled with a forward swap starting one to nine months later where Freddie Mac paid a floating rate and received fixed. Each of the swaps had a notional amount of $5 billion, thus resulting in a total notional value of $80 billion for the eight pairs of swaps.

In September 2001, Freddie Mac entered into a ninth pair of swaps that were similarly offsetting. Those swaps were distinct, however, in that the interest rate on them had a leverage factor of five—thus, they are called "leveraged swaps." The notional value of that last pair of swaps was $20 billion, but with the leverage factor of five, they had the same effect as swaps with a notional value of $100 billion.

Although the nine pairs of swaps were purported to reduce interest rate risk by a small amount, it is clear that the main purpose of the transactions was to shift operating income from 2001 to future periods. Table 8 shows each pair of swaps and the associated counterparty.

Table 8. Linked and Leveraged Swaps		
Linked Swaps		
Date	**Notional Amount**	**Counterparty**
8/14/2001	$10 Billion	Morgan Stanley
8/15/2001	$10 Billion	UBS Warburg
8/16/2001	$10 Billion	Lehman Brothers
8/17/2001	$10 Billion	Merrill Lynch
8/20/2001	$10 Billion	Goldman Sachs
8/22/2001	$10 Billion	UBS Warburg
8/23/2001	$10 Billion	Merrill Lynch
8/27/2001	$10 Billion	UBS Warburg
Leveraged Linked Swap		
9/7/2001	$20 Billion Leveraged x 5 (Unleveraged Equivalent = $100 Billion)	Goldman Sachs

Source: Attachment for Freddie Mac Accounting Policy Memo on KRD Swaps, via e-mail from Pamela Poisson, May 8, 2002 (OF 1706935).

The present value of the spread on the linked swap transactions between Freddie Mac and Morgan Stanley was $300,000. Because the terms of the two swaps substantially offset each other, the transaction posed essentially no risk to Morgan Stanley. One individual commented at the time that the earnings would result from a riskless trade. Given that the other pairs of swaps shown in Table 4 had similar terms, it is not unreasonable to assume that the counterparties to those transactions made similar amounts on deals that posed little or no financial risk.

The Morgan Stanley linked swaps, like seven of the other sets of linked swaps executed by Freddie Mac, involved a $5 billion pay-fixed swap commencing immediately, coupled with a $5 billion pay-floating swap commencing at a later date but with the same maturity date as the first swap. Ray Powers, an Enterprise employee who executes derivatives trades, called Morgan Stanley on August 14, 2001, to get pricing for those offsetting transactions. The request of Mr. Powers was unusual, and Brendan Lavelle, the Morgan Stanley trader who would have to approve the transaction, called Mr. Powers. That call was captured on the telephone recording system used by Freddie Mac to record calls on its trading floor. A portion of the transcript of the call follows:

Mr. Lavelle (Morgan Stanley): We've been trained whenever people come in and start doing this kind of stuff, we gotta ask why. Like not why, but like, everything's...yeah. I don't want to be taken off in handcuffs here for doing something that's not kosher.

Mr. Powers (Freddie Mac): How much are you making off this trade? (Laughs)

Mr. Lavelle: I don't know.

Mr. Powers: You haven't even looked at it. (Laughs)

Mr. Lavelle: I'm just...You know what I'm saying...I mean, I don't mind if there's an accounting reason for you to do this and it makes you guys money. That's fine. You know, we're okay with it.

Mr. Powers: That's where we are. We have an accounting reason for doing it. And, um, we're basically...we're offsetting some...

Mr. Lavelle: I mean you could tell me there's some asset liability reasons for you to be doing this, and I'm okay with that.

Mr. Powers: Yeah, I think that's as much as I'd...I don't want to tell you...

Mr. Lavelle: I don't want to be like taken into a courtroom, though, Ray, is what I'm saying, okay?

Mr. Powers: Yeah...No, no, no. This is not.... This is basically an asset liability, cash flow management issue.

Mr. Lavelle: Okay, I'm with you.

Mr. Powers: The thing is...because of the shape of the curve, um the geography of our carry in terms of the calendar gets screwed up. So all of a sudden, we have an uneven carry picture to manage and we strive for stability.

Mr. Lavelle: What you're trying to do is...yeah you're evening out the cash flow.

Mr. Powers: Exactly.

Mr. Lavelle: Okay. Alright, I'm with you.

> Mr. Powers. Otherwise, like we'd have all of our portfolios, our 30-year portfolio with all the carry in this year.
>
> Mr. Lavelle: If that's what you want to do, I'm, we're okay with that and we're happy to do it with you, so we can do a lot of this if you want.[230]

Note that Mr. Lavelle seemed to suggest a business purpose to his customer, Mr. Powers: "I mean you could tell me there's some asset liability reasons for you to be doing this, and I'm okay with that." Once the customer agreed with his suggestion, Mr. Lavelle said "we're okay with that and we're happy to do it with you, so we can do a lot of this if you want." After the conversation, Mr. Lavelle approved the trade.

Soon after the swaps were executed, they attracted the attention of David Wong, an operations officer at Morgan Stanley with compliance responsibilities. Mr. Wong had many other operational roles at the firm that may have prevented him from being fully focused on his compliance duties. In his compliance capacity, Mr. Wong asked another Morgan Stanley employee about the linked swaps and told him to do no more of these trades without asking him first. Mr. Powers of Freddie Mac soon called again to price some more interest rate swaps with offsetting terms. The management of Morgan Stanley decided to handle that situation by pricing the transactions unattractively, instead of just saying no to their valued customer, because it was less confrontational.

Transcripts of recorded telephone conversations reveal that other counterparties who engaged in linked swap transactions with Freddie Mac were just as eager to please their customer as Morgan Stanley was. An employee from Goldman Sachs, in a phone conversation with Nazir Dossani, Peter Federico, and Ray Powers of the Enterprise, told them that "obviously we're, we're extremely appreciative of the opportunity and you know and you guys kind of coming to us with this inquiry ...."[231] The inquiry had to do with linked swaps with a leverage ratio of five, which was multiplied against the interest rates of the swaps to minimize their notional value. Another Goldman Sachs employee on the same call almost apologizes for doing his job: "Uh, I guess just one last question

[230] Audio tape transcript, Ray Powers (AUD_80), August 14, 2001, OF 2001659.

[231] Audio tape transcript, Peter Federico (AUD_3AF, AUD_3B0); Nazir Dossani (AUD_359, AUD_35A); Ray Powers (AUD_5A1, AUD_5A2); Sean Flanagan (AUD_3EA, AUD_3EB), September 10, 2001.

and uh, if you think it's impertinent, don't hesitate to tell me, but we're just curious, have you done any of these other levered trades away from us or is the amount that we've done thus far all?"[232] (The answer from Mr. Dossani was "I do not know the answer to that.")[233] Those transcripts show that the desire to keep an important customer happy overrode any obligation to exercise proper due diligence on the linked swaps.

Coupon Trade-Up Giants (CTUGs)

As discussed earlier in chapter III, the original plan for the CTUG transactions called for Freddie Mac to sell $30 billion in PCs to Salomon Smith Barney. Salomon Smith Barney would then sell and transfer those PCs to the securitization group of the Enterprise, which would then resecuritize the PCs into Freddie Mac Giant securities and send them back to the dealer. However, the Enterprise took some operational short cuts and simply securitized the PCs in-house rather than having Salomon Smith Barney do it.[234] Thus, only the Giant securities were sent to Salomon Smith Barney, not the precursor PCs. The dealer kept the Giant securities for fewer than three hours before sending them back to Freddie Mac. That round-trip was the basis for Freddie Mac moving its securities from the trading portfolio, where gains and losses in market value are immediately realized in income, to the available-for-sale portfolio, where market value changes are not realized in income, but go instead into Other Comprehensive Income.

Smriti Popenoe, a Freddie Mac employee in F&I, later said that the fee paid to Salomon Smith Barney for the transaction was either 1/16th or 1/64th of a point.[235] One 64th of a point on $30 billion would be approximately $4.7 million, which is a substantial amount of money for a trade with virtually no risk. Because the PCs were securitized into a Giant at the Enterprise and shipped to Salomon Smith Barney in that form, the role of the counterparty in the transaction appears highly questionable, and one can easily

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[232] *Id.*
[233] *Id.*
[234] Freddie Mac Accounting Policy Interpretation, "Reclassification of Securities from Trading to AFS 1Q01," from Sandy Kurtis, May 30, 2003, OF 1706872.
[235] Memorandum prepared by Baker Botts, Re: Smriti Popenoe Interview, February 27, 2003, OF 2000493.

understand why Freddie Mac was unable to obtain a "true sale" opinion for the transaction.[236] The value-added by Salomon Smith Barney in the transaction is certainly suspect.[237]

The Blaylock Transactions

As discussed in detail in Chapter V, Blaylock & Partners, a small broker-dealer, was an intermediary in at least ten trades in 2000 and 2001 where securities went from the Securities Sales & Trading Group (SS&TG) of Freddie Mac to the retained portfolio of the Enterprise. The trades were done at the behest of Funding & Investments because SS&TG had mortgage securities in its inventory that were either about to pass or had already passed through a 30-day window beyond which SS&TG could no longer sell the securities to F&I. Although Blaylock was not highly capitalized and presented a potential credit risk, the firm was designated by F&I as the counterparty to whom it wanted SS&TG to sell the securities.[238]

Approximately $752 million in mortgage-backed securities that had been held longer than 30 days by SS&TG were sold to F&I via Blaylock.[239] Transcripts of recorded phone conversations between a trader in SS&TG (Buck Buchanan) and F&I (Smriti Popenoe) indicate that the commission to Blaylock on a portion of those transactions was 0.25 percent.[240]

[236] Freddie Mac Accounting Policy Interpretation, "Reclassification of Securities from Trading to AFS 1Q01," from Sandy Kurtis, May 30, 2003. Footnote 1 of that document states that "the overall circumstances of the transaction were such that external legal counsel evidently was not comfortable providing a 'true sale' legal opinion." OF 1706872.

[237] See "Problems with Coupon Trade-Up Giants (CTUGs)," *supra*, for more details of this transaction.

[238] OFHEO Interview, Charles Foster, October 3, 2003, page 98.

[239] Baker Botts, "Executive summary of Blaylock transactions." FM B000324.

[240] Trader tape, (AUD_10E5), Buck Buchanan, February 14, 2001, FM A019096.

Smriti Popenoe: We'll do that up 3 and ¾ to me...
Buck Buchanan: Right
Smriti Popenoe: ...and I'll pay them a ¼.

Other Counterparties

Table 9 below identifies the counterparties associated with other transactions mentioned elsewhere in this report. The role of the counterparties in those transactions may warrant further investigation by OFHEO.

Table 9. Counterparties to Other Transactions	
Transaction	**Counterparty**
J-Deals[241]	Morgan Stanley
Third-party trades to move bonds from SS&TG to F&I[242]	Salomon Smith Barney[243]
$8 billion repurchase transaction[244]	Credit Suisse First Boston

Source: Freddie Mac.

In summary, many of the transactions employed by the management of Freddie Mac to shift income and achieve certain accounting results may not have been possible without the help of various broker/dealer counterparties. The interactions described above between employees of Freddie Mac and their Wall Street counterparts reveal that the efforts of some of these counterparties to determine the true business purposes of those transactions appear, at least initially, to have been half-hearted. Given the substantial financial rewards for making the transactions happen and the desire of the counterparties to keep a large customer happy, and given the significant role they played in the transactions, their activities should be the subject of further investigation by OFHEO.

[241] During the first quarter of 2001, Freddie Mac entered into four securitization transactions that became know as the "J-Deals" because their numbers all had "J" prefixes. The Enterprise entered into the deals in order to minimize the volatility associated with FAS 133 and EITF 99-20. Disclosure of the transactions by Freddie Mac was generally inadequate and the accounting staff of the Enterprise did not understand the complexity of EITF 99-20 sufficiently to properly structure the transactions. Baker Botts, "Executive Summary of J-Deals," OF 2010869 – OF 2010870.

[242] *See*, trades with Salomon Smith Barney discussion, *infra*, Chapter V, "Accounting and Auditing."

[243] The Salomon Smith Barney subsidiary of Citigroup is now known as Citigroup Global Markets, Inc. *See* http://www.hoovers.com/free/co/factsheet.xhtml?COID=11315.

[244] In 2002, Credit Suisse First Boston sold $8 billion of mortgage-backed securities to Freddie Mac, with a simultaneous agreement to repurchase the same type and amount of securities at a specified future date. The trade tickets for those transactions indicate that "CSFB simply does not have the balance sheet available to carry all that they are long." OF 2020600, OF 2020615. OFHEO is still investigating the circumstances surrounding the transactions.

VI. DISCLOSURE

The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 ("the Act") established OFHEO as an independent office charged with exclusive and autonomous regulatory authority to ensure that the Enterprises maintain adequate capital and operate safely and in accordance with the Act.[346] OFHEO is explicitly authorized to, among other things, "establish capital standards, *require financial disclosure*, prescribe adequate standards for books and records and other internal controls, conduct examinations when necessary, and enforce compliance with the standards and rules that [OFHEO] establishes."[347]

Generally, companies that raise money in public offerings of securities are required to register those offerings with the Securities and Exchange Commission (SEC) under the Securities Act of 1933 (Securities Act).[348] Additionally, such companies must register with the SEC pursuant to the Securities Exchange Act of 1934 (Exchange Act)[349] and file periodic reports. Pursuant to the terms of its federal charter act, Freddie Mac is exempt from all but the antifraud provisions of the federal securities laws.[350] Freddie Mac has announced that it will voluntarily register with the SEC pursuant to Section 12(g) of the Exchange Act upon the completion of the restatement of its financial condition and once it is again making timely filings of financial information. The Enterprise will, however, remain exempt from the registration requirements of the Securities Act.

Freddie Mac routinely issues public disclosure documents that closely track the format and type of content of the annual, quarterly, special reports, and proxy materials filed with the SEC by registered companies. Further, in numerous public statements

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[346] 12 U.S.C. 4513(a).
[347] 12 U.S.C. 4501(6), emphasis added.
[348] 15 U.S.C. 77f.
[349] 15 U.S.C.78*l*(g)(1).
[350] Federal Home Loan Mortgage Corporation Act, 12 U.S.C. 1455. Section 306(g) provides that "[a]ll securities issued or guaranteed by the Corporation ... shall, to the same extent as securities that are direct obligations of or obligations guaranteed as to principal or interest by the United States, be deemed to be exempt securities within the meaning of the laws administered by the Securities and Exchange Commission."

senior Freddie Mac officials maintained that the public disclosures of the Enterprise are best in class and "meet or exceed"[351] SEC reporting standards.

The special examination has demonstrated that Freddie Mac knowingly departed from good public disclosure practices so as to obfuscate particular Enterprise policies as well as specific capital market and accounting transactions used to implement them. As a result, the public disclosures of Freddie Mac during the period investigated by the special examination failed to comport with disclosures required of SEC registered companies that were assertedly adhered to by the Enterprise. The deliberate disdain of Freddie Mac for appropriate disclosure standards in the face of its asserted compliance with best practices misled investors and constituted conduct that undermined market awareness of the true financial condition of the Enterprise.

Disclosures Required by the SEC

Broadly, SEC registrants disclose information to the public through annual reports (Form 10-K), quarterly reports (Form 10-Q), and "special" reports (Form 8-K). Freddie Mac uses forms that are essentially similar to the SEC forms to disclose information to the public on an annual, quarterly, and event-driven basis.

Annual reports of SEC registrants contain audited financial statements and a section providing a discussion and analysis by management of financial condition and results of operations ("MD&A"). SEC rules covering the MD&A section, assertedly adhered to by Freddie Mac, require a company to discuss "any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing

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[351] For example, on July 12, 2002, Freddie Mac issued a press release, which stated:

> McLean, VA – Freddie Mac (NYSE: FRE) today announced yet another step in demonstrating its unparalleled financial transparency by initiating ongoing Securities and Exchange Commission (SEC) review of its financial disclosures under the same standards used for other publicly traded companies.
>
> "Freddie Mac has long been at the vanguard of disclosure practices," said Leland C. Brendsel, Chairman and CEO of Freddie Mac. "Because of the vital role we play in America's housing finance system, it is essential that investors, policymakers and regulators have confidence in our financial strength. Freddie Mac already meets or exceeds SEC reporting standards, and today's announcement leaves no doubt that Freddie Mac is subject to the same standards as every other public company."

operations."[352] The use by Freddie Mac of a variety of significant transactions that were specifically designed to "smooth" the earnings of the Enterprise resulted in financial statements that misled investors and the general public. Those transactions should have been fully disclosed. They were not.

Materiality

SEC Rule 10b-5 makes it unlawful for any person "to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading."[353] Consequently, a threshold test in determining whether an information item must be disclosed, in either the context of financial statements or corporate disclosure documents, must be a determination of whether the information is "material." OFHEO promotes corporate transparency in order to enhance safe and sound operations of the Enterprises. The agency looks to evolving best practices for disclosure that go beyond legal minimums in determining what information should be disclosed.

The special examination has established that the accommodating external auditor of Freddie Mac approved accounting treatments for an array of transactions that had little or no economic purpose but "smoothed out" spikes in earnings. In some cases, however, the interpretations of accounting rules left internal and external auditors admittedly uncomfortable with the accounting treatment accorded the transactions. In those cases the Enterprise went forward with its desired accounting interpretation, conferring with the outside auditors, and concluded that even if it the accounting treatment was questionable or wrong, the transactions were immaterial. Objections to adjustments of millions of dollars—for example, the creation of a FAS 91 reserve that is unsupported by Generally Accepted Accounting Principles (GAAP)[354]—were dismissed by auditors and management as immaterial to a company of the size of Freddie Mac.

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[352] Item 303(a)(3)(ii) of Regulation S-K, 17 CFR Part 229.
[353] 17 CFR § 240.10b-5, 15 U.S.C. 78j.
[354] *See,* FAS 91 reserve discussion, *infra,* Chapter III, "Improper Management Earnings."

VIII. RECOMMENDED ACTIONS

The special examination is drawn to several general conclusions, which in turn lead to specific recommendations.

General Recommendations

Freddie Mac should implement a comprehensive, Enterprise-wide initiative to establish a proper "tone at the top" and develop a corporate culture that rewards integrity and the acceptance of responsibility and individual accountability, and that penalizes failure to adhere to legal and regulatory requirements or professional standards of appropriate conduct. Furthermore, safe and sound operations require that Freddie Mac prudently plan for any future growth. Such planning includes taking steps to attract and retain personnel with the skills necessary to manage the growing risks associated with future growth. The Enterprise should have a plan for managing future growth. That plan should include provisions that specifically address anticipated problems that may arise as a result of growth and pay particular attention to anticipated staffing and systems needs to address those problems.

The experience of Freddie Mac shows that the management of the Enterprise must dedicate itself to managing operations risk as effectively as possible. Freddie Mac is under a statutory mandate to operate in a safe and sound manner, which includes having systems and management structures in place to ensure that operations risk receives the same attention as credit and interest rate risks. An inadequate provision of resources to compliance and internal controls is unsafe and unsound. Specifically, the reliance of the Enterprise on manual processes to "work around" inadequately integrated information systems is a significant source of operations risk that Freddie Mac must resolve expeditiously.

OFHEO must determine whether the management of Freddie Mac has established an adequate remediation plan and is allocating the necessary resources to ensure that all of the remedial recommendations are promptly implemented. OFHEO should take steps to ensure that the following recommendations are implemented:

1. Freddie Mac Should Separate the Functions of the CEO and the Chairman of the Board

There is an inherent conflict between the role of leading those charged with overseeing and guiding management and the role of heading the management team. As the experience of Freddie Mac in recent years shows, when the CEO sets the agenda of Board meetings, controls information flowing to the Board and its committees, and selects nominees to the Board, the quality of Board oversight may be seriously diminished. In June of this year, the Enterprise divided the roles of CEO and Chairman. As Freddie Mac moves to fill the top management positions of the company, it should permanently implement this management structure.

2. Freddie Mac Should Develop Financial Incentives for Employees Based on Long-Term Goals, not Short-Term Earnings

The special examination recognizes that tying the compensation of employees to the performance of an Enterprise is good management and required by statute. However, the creation of compensation incentives that excessively focus the attention of management and employees on short-term earnings performance is improper. Freddie Mac should develop financial incentives that motivate employees to achieve the long-term objectives of the Enterprise. Incentives should not be focused on short-term earnings; such incentives may misdirect employees or otherwise lead to improper conduct.

3. OFHEO Should Establish a Regulatory System of Mandatory Disclosures for the Enterprises or Their Securities Exemptions Should be Repealed

The disclosure failures of Freddie Mac were extensive and damaging to the trust of the public in the future disclosures of the Enterprise. It is clear that the financial disclosures of an Enterprise should not be left to a system of voluntary commitments. Fannie Mae has registered with the Securities and Exchange Commission (SEC) under the Securities Exchange Act of 1934 (Exchange Act), and Freddie Mac has promised to do so as soon as possible. To address the issue of the adequacy of Enterprise disclosures completely,

OFHEO should implement mandatory regulations that provide for mandatory disclosure similar to that required of SEC-registered companies and build staff resources necessary to oversee compliance. Alternatively, the Congress should repeal the exemptions of the Enterprises from the Exchange Act and the Securities Act of 1933. Either option should result in the type of mandatory disclosure and oversight regime necessary to ensure safe and sound conduct.

4. OFHEO Should Consider Requiring a Periodic Change of the External Auditors at the Enterprises, Not Just a Change in Engagement Partner

The accounting problems at Freddie Mac were discovered only after Arthur Andersen, which had been the only external auditor of the Enterprise since it was chartered in 1970, was replaced by PricewaterhouseCoopers. Given the importance of auditor independence, OFHEO should study the feasibility of mandating a periodic change in the external audit firm to determine if that would enhance the safety and soundness of the Enterprises.

5. OFHEO Should Require Freddie Mac to Hold a Capital Surplus and Should Consider Limiting the Growth of the Retained Portfolio Until Freddie Mac Produces Timely and Certified Financial Statements

Until all reconciliation efforts have taken full effect, Freddie Mac remains exposed to substantial management and operations risk. Accordingly, OFHEO should require Freddie Mac to hold a specific surplus of up to 30 percent over its regulatory capital requirement—the greater of its minimum capital requirement or its risk-based capital requirement—until such time as the Director determines that the Enterprise has produced complete and accurate financial statements that are certified and current. In addition, those requirements would enhance the safety and soundness of Freddie Mac as the Enterprise implements its remediation plan.

Financial regulators frequently impose growth restrictions on institutions facing operational difficulties. OFHEO should consider requiring that the remediation plan of Freddie Mac include appropriate limits on the growth of its retained mortgage portfolio

until such time that the Director has determined that the Enterprise has made satisfactory progress in the implementation of its remediation plan.

6. OFHEO Should Establish a "Materiality" Standard for the Provision of Sufficient Information to the Board of Directors

Our review found instances where management failed to provide the Board with information it should have received in order to fulfill its oversight role. Therefore, OFHEO should establish, through formal guidance or regulation, a standard requiring the provision of adequate and appropriate information by management to the Board. That standard should draw upon the materiality standard in the accounting profession, which we believe is appropriate to the wider spectrum of reporting and disclosure issues facing the Enterprises. As a general matter, information should be provided by the management of an Enterprise to its Board and Board committees if a reasonable director would find the information important to the fulfillment of the director's fiduciary obligation.

7. Freddie Mac Should Impose Strict Term Limits on the Members of the Board of Directors

A Board of Directors capable of exercising independent judgment is essential to the safety and soundness of Freddie Mac. In order to promote the highest level of Board functioning, the Enterprise should adopt bylaws providing that no Director may serve on the Board for more than ten years or past the age of 72, whichever comes first.[487]

8. OFHEO Should Ensure that the Board Becomes More Actively Involved in Oversight of the Enterprise

The Board of Freddie Mac must be more involved in the oversight of the Enterprise, not just in times of crisis, but in the normal course of business. That will require the Board and Board committees to meet at least twice each quarter to ensure they can exercise adequate oversight of management. In addition, the Congress should enact legislation

[487] A transition period may be necessary to permit an orderly turnover of current Directors.

abolishing the presidentially appointed Board member positions. Also, representatives from OFHEO should periodically attend meetings of the Board.

9. Freddie Mac Should Establish a Formal Compliance Program

The failure of Freddie Mac to develop formal written policies or procedures regarding legal and accounting compliance has contributed to the development of an ineffective compliance program and frequently inadequate disclosures. The Enterprise should establish a comprehensive compliance program and create a position of Chief Compliance Officer to direct that program. The Chief Compliance Officer should report to the CEO and be responsible for ensuring that Freddie Mac complies with all regulatory requirements and internal controls and adheres to best practices. The Chief Compliance Officer should formally establish written internal controls and disclosure controls and procedures[488] for the Enterprise and provide for their periodic review and updating. The compliance program should designate areas of business to be covered and develop procedures for discharging compliance within such areas.

To support the compliance program, Freddie Mac should establish an easily accessible channel through which employees can report information about instances of potential non-compliance to a designated compliance official. The Enterprise should encourage employees to report such information and ensure that the anonymity of reporting employees is protected.

The Chief Compliance Officer should meet periodically with the Board of Directors as a way to ensure the Board is able to 1) assess adherence to the current policies and procedures of the Enterprise regarding compliance, 2) fine-tune such policies and procedures as needed, and 3) stay abreast of senior management judgments regarding "close-calls" when determining whether compliance is adequate.

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[488] The SEC has adopted rules requiring companies to include in their annual reports a report of management on the internal controls over financial reporting of the company pursuant to section 404 of the Sarbanes-Oxley Act of 2002. 68 Fed. Reg. 36636 (June 18, 2003).

OFHEO acknowledges the recent hiring by Freddie Mac of a Chief Compliance Officer and other related steps taken by the Enterprise, and will evaluate the sufficiency of those actions.

10. Freddie Mac Should Establish the Position of Chief Risk Officer

Certain problems arising at Freddie Mac can be attributed to imbalances of power within the organizational structure of the Enterprise. For example, the Funding & Investments Division (F&I) of Freddie Mac included many of the most highly paid employees of the Enterprise. That division wielded significant clout over the entire organization, and the Market Risk Oversight unit tasked with overseeing the activities of F&I did not have the requisite stature to be effective. The effectiveness of Market Risk Oversight was compromised in part by reporting to the Chief Financial Officer.

Freddie Mac should establish a position of Chief Risk Officer charged with enhancing the risk management of the Enterprise. The Chief Risk Officer should report directly to the CEO of Freddie Mac, which would give the Chief Risk Officer the stature to deal effectively with the business units. The heads of Market Risk Oversight, Credit Risk Oversight, and Operational Risk Oversight should all report directly to the Chief Risk Officer, so that those units would combine their efforts to oversee activities that pose multiple risks.

OFHEO acknowledges the recent creation by Freddie Mac of a Chief Enterprise Risk Oversight Officer position. OFHEO will evaluate the effectiveness of the new organizational structure for risk oversight, particularly with respect to resource allocation and efforts to hire a new Market Risk Oversight Officer.

11. Freddie Mac Should Document the Legitimate Business Purpose of Every Significant Derivative Transaction

The special examination found that Freddie Mac engaged in large derivative transactions that had little or no risk management purpose and whose only business purpose was to shift income to future periods. In order to prevent such transactions from occurring in the

future, Freddie Mac should document the business purpose of all of its significant derivative transactions. That information should be included as part of any hedge documentation for the derivative instrument.

12. Freddie Mac Should Establish and Maintain Superior Accounting Controls

The senior management and Board of Directors of Freddie Mac are responsible for establishing and maintaining a strong internal control system that will provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP. Management and the Board should identify and, most importantly, follow-up expeditiously on all control weaknesses, including those identified by OFHEO, management, Internal Audit, and the external auditor. Each business unit should take responsibility and be held accountable for ensuring that corrective actions are undertaken within established deadlines or seeking written approval from the Audit Committee to accept the risk of non-compliance. The Enterprise should make a superior accounting control system a top priority in terms of time and budget, and not attempt to use its external auditor for this purpose.

13. Freddie Mac Should Prevent Undue Reliance on the External Auditor

Freddie Mac should take measures to prevent undue reliance on its external auditor. The measures should include, but should not be limited to, adequate accounting staffing levels and expertise, sound and comprehensive accounting policies, and a comprehensive and fully operating internal control system. Those measures should provide for a control environment where reliance on the external auditor in day-to-day operations would not be needed or tolerated. Finally, the Board and senior management should review all consulting work performed by the external auditor to assure, at a minimum, compliance with the Sarbanes-Oxley Act of 2002.

14. Freddie Mac Should Strengthen and Clarify the Role of the Internal Audit Department

The Internal Audit (IA) Charter of Freddie Mac should be revised to address the responsibility of the IA Department regarding the reliability and integrity of financial and operational information. That Department should consult the applicable standards and develop the appropriate policies and procedures to accomplish that task. The process for audit corrective actions should be revised to identify a designated accountable party in the IA Department and incorporate hard deadlines for remedying identified weaknesses. The Department should designate a staff member to follow up with the responsible person in the business unit to ensure that the audit corrective actions have been completed by the deadline. That policy should also identify the appropriate procedures the IA Department should follow if the business unit does not comply and the consequences for the business unit. Finally, the IA Charter should be revised to indicate that the head of the Internal Audit Department (General Auditor) is responsible for full disclosure of control weaknesses, related risk exposures, and progress on remedial actions to the Audit Committee. Furthermore, the Charter should note that the General Auditor may be culpable for non-compliance in the event that an identified weakness is not reported to the appropriate level of management and the Board.

15. OFHEO Should Expand Its Capacity to Detect and Investigate Misconduct

A risk-based examination program is a key component of the supervisory framework of OFHEO. OFHEO should evaluate ways to strengthen the ability of its supervisory program to detect misconduct. For example, although OFHEO examiners regularly assess internal controls to determine if such controls are strong enough to prevent fraud, the effectiveness of the OFHEO examination program would and should be enhanced by including more substantive tests of the internal control framework. Those tests should include procedures to assess the risk of management actions to override Enterprise controls. The examination program should also include procedures to identify incentives or pressures to commit fraud, as well as opportunities to carry out fraud. OFHEO should

seek additional resources to assure that those procedures can be implemented as part of its supervisory framework.

16. OFHEO Should Conduct a Special Examination of the Accounting Practices of Fannie Mae

Freddie Mac management engaged in questionable and often improper accounting practices in an effort to produce steady, stable earnings growth. The success of management in doing so was expected to be rewarded by favorable opinions of Wall Street analysts that would, in turn, 1) result in the expansion of price/earnings multiples and improved performance of the stock and stock options of the Enterprise and 2) provide comfort to private credit rating agencies, thus securing continued high credit ratings of the debt offerings of Freddie Mac and, thereby, maintaining its low cost of capital. As substantial holders of stock and stock options of the Enterprise, Freddie Mac executives and Board members had a personal financial stake in the success of the operations of the Enterprise and that performance being reflected favorably in the price of its securities. The same incentives and motivating forces exist at Fannie Mae.

We recommend that OFHEO conduct a special examination of Fannie Mae to investigate those and any other transactions by the Enterprise, including any that have any unusual characteristics, that raise similar issues. OFHEO should retain and work with an independent forensic accounting firm to review the accounting policies, controls, and governance structure of Fannie Mae. The scope of that special examination should include a focus on transactions that significantly accelerate or defer the pattern of income recognition, or transactions undertaken for the purpose of allowing the Enterprise to explicitly change the character or classification of an asset or liability. In both cases, such transactions proved problematic at Freddie Mac; OFHEO should determine if similar problems exist at Fannie Mae.

Also, the special examination should pay particular attention to any transaction that was not executed at prevailing market prices or does not appear to have a valid business or risk management purpose or economic substance. Further, the scope of the

examination should cover any transaction executed without appropriate authorization or that has not been accurately recorded in the financial records of Fannie Mae.