

EXHIBIT

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**REPORT TO THE BOARD OF DIRECTORS
OF
THE FEDERAL HOME LOAN MORTGAGE CORPORATION**

**INTERNAL INVESTIGATION
OF
CERTAIN ACCOUNTING MATTERS
DECEMBER 10, 2002 – JULY 21, 2003**

**BY
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JULY 22, 2003

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EXECUTIVE SUMMARY

A. INDEPENDENCE OF INVESTIGATION

This has been an independent investigation initiated by, and carried forward at the direction of, the Board of Directors. All employees of the Company were instructed by the Board to cooperate fully with our investigation. Our Firm had no prior attorney-client relationship with the Company, and did not represent any of the Directors at the time of our commencing this investigation.

B. SCOPE

No limitations have been placed on us in the conduct of our investigation – we have “followed the facts” where they have led and have talked to relevant employees as often as we considered appropriate. Although the Board asked us to investigate the transactions and matters discussed in Parts II and III of the Report, there was no limitation on the scope of our investigation. Thus, as additional matters were discovered by us or referred to us by the independent auditors or the Company, we were able to investigate these as we deemed appropriate.

Our investigation included (i) review of over 250,000 pages of hard copy documents (600 boxes of documents remain to be reviewed); (ii) over 200 interviews; (iii) review of electronic documents and files, including the imaging of hard drives, evaluations of e-mails, and conducting key word searches yielding two terabytes of electronic evidence; (iv) listening to over 11,000 minutes of tapes of telephone conversations; and (v) examinations of relevant employee performance reviews and personnel files.

C. ROLE OF THE BOARD

The Board has fully engaged with and supported this process. Between January 1 and July 21, 2003, the Board and its independent committees have met over 40 times, of which at

least 17 were entirely or partially in “executive session” with counsel. Since March 17, 2003, the Ad Hoc Committee on Financial Management has met weekly to oversee the progress of the restatements. Since May 13, 2003, the Governance Committee has met weekly to oversee the implementation of internal control and remediation efforts headed by Martin Baumann, the new Chief Financial Officer.

D. ANONYMOUS LETTERS

Part II of the Report concerns our investigation into allegations of wrongdoing made in two anonymous letters. In general, we found that the more serious allegations in these letters were unfounded.

E. TRANSACTIONS AND ACCOUNTING POLICIES RELATING TO THE RESTATEMENTS

A separate phase of our investigation – discussed in Part III – involved a series of transactions and policies identified by the Company and its new auditors as involving possible accounting and financial reporting issues that may have gone beyond simple error. With respect to these transactions and policies, our investigation found issues of (i) accounting policy and financial reporting, (ii) internal control adequacy, (iii) former management’s governance practices, and (iv) disclosure policy. More specifically, our findings may be summarized as follows:

1. Several of the transactions and policies (CTUG, Swaptions Portfolio Valuation, and J-Deals) were entered into in late 2000 and early 2001 in response to changes in accounting rules, most notably SFAS 133. These transactions and policies were entered into in order to defer income recognition and/or to avoid volatility in financial results. In general, these transactions and policies resulted in unintentional misapplications of GAAP, and were supported by Arthur Andersen. There were, however, disclosure shortcomings with respect to these transactions and policies. In addition, in the case of the Swaptions Portfolio Valuation, the misapplication of GAAP resulted from a results-oriented, reverse-engineered and opportunistic approach to achieving an accounting objective.
2. The Linked Swaps were entered into in late 2001. They had minimal business purpose beyond deferral of unexpected excess Net Interest Income into 2002 and

later periods. Other principal problematic issues with Linked Swaps are as follows:

- Arthur Andersen was not consulted prior to the trades being implemented.
 - Trader tapes indicate an awareness of the lack of bona fide business purpose and a desire for secrecy.
 - Management failed to unwind the transactions after becoming aware of the accounting controversy.
 - There was inadequate disclosure both to the Board and to the public.
3. Other accounting policies and transactions, such as GSCC, PC Smoothing, and MODERNS, were determined (i) not to have been undertaken for the purpose of deferring income and (ii) to have resulted in good faith accounting errors.
 4. The Blaylock trades involved a circumvention of internal controls in order to achieve favorable portfolio quality objectives.
 5. Our investigation of the Round Robin Settlements revealed no accounting, business, or governance issues.

In several cases, such as CTUG, J-Deals and GSCC, had the transactions been structured or executed differently, it may have been possible to achieve the accounting objectives.

Notwithstanding the various accounting errors, we did not find that the Company entered into transactions having an effect on the timing of earnings recognition at the expense of the Company's risk management policies and practices.

F. RESERVES AND RESERVE ADJUSTMENTS

We also investigated practices with respect to reserves and reserve adjustments. Corporate Accounting made reserve adjustments and altered the models that supported reserve policy, with a view to presenting a steady, nonvolatile pattern of earnings growth. These reserve adjustments frequently did not comply with GAAP and were driven more by the desire to achieve earnings targets than by a balanced assessment of the underlying probable losses. One

case - the SFAS 91 Reserve – involved a knowing use of a non-GAAP reserve. The loan loss reserve was maintained at a very conservative level, beyond permissible limits under SFAS 5.

G. DISCLOSURE PROCESSES

The Company's disclosure processes, especially as regards sensitive transactions such as Linked Swaps and those designed as a response to SFAS 133, tended to produce generalized disclosures of strategies, rather than transparent disclosures of transactions. As a result, disclosure processes and practices fell below the standards required of a registered public company.

H. CONTROLS AND GOVERNANCE

With respect to several of the transactions and policies we investigated, in particular CTUG, Swaptions Portfolio Valuation, Linked Swaps, the Blaylock trades, and inputs to the SFAS 91 amortization engine, we found weaknesses in the Company's internal controls and governance processes.

I. ROLE OF ARTHUR ANDERSEN

In general, the Company's then-independent auditors, Arthur Andersen, were aware of the transactions, were closely involved in the planning and details, and agreed with the Company's accounting treatment. In that regard, the engagement partner and advisory partner cooperated with us, and we have had access to their workpapers. We found no pattern of systematic withholding of information from the auditors. In some cases, such as reserve adjustments, the Company's accounting decisions were viewed by both the Company and Arthur Andersen as simply not material. In all cases, the former engagement partner from Arthur Andersen stands by the Company's accounting, including one case (CTUG) in which he was unaware of a transactional short-cut in execution. During the period of late 2000 to late 2001, we believe the Company became overly reliant on Arthur Andersen with respect to basic

accounting decisions and policies. Several former members of Arthur Andersen's audit team are now employees of the Company. We understand these employees are now supervised by the new Chief Financial Officer, Martin Baumann.

J. ROLE OF CORPORATE ACCOUNTING

The errors in accounting that led to the restatements resulted in large part from (i) inadequacies of Corporate Accounting in responding to the complex accounting rules applicable to derivative transactions, most notably SFAS 133 and SFAS 125, and (ii) initiatives within Corporate Accounting, led by the Controller and overseen by the Chief Financial Officer, with respect to reserves. The lack of technical skill and depth in Corporate Accounting extended, during relevant periods, to the key offices of Controller and Chief Financial Officer. The challenge of achieving correct accounting was exacerbated by rapid growth in the Company's Retained Portfolio and sophisticated strategies utilized to manage the Retained Portfolio. This combination of events caused the Company to undertake complex transactions in order to achieve the Company's goal of reporting steady, nonvolatile earnings growth, which transactions the Company could not and did not account for correctly.

K. ROLE OF F&I

The Funding and Investments Division ("F&I") designed, developed, and executed many of the transactions in question. While being aware that the objective of these transactions was to defer earnings, as well as understanding their relationship with reserve "fine-tuning" adjustments, F&I representatives in general, we believe, were relying in good faith on Corporate Accounting and/or Arthur Andersen to provide the necessary accounting advice and to ensure that transactions were accounted for in accordance with GAAP. We did observe instances of communications and controls failures at F&I.

L. ROLE OF SENIOR MANAGEMENT

It was well understood throughout the organization that the tone of “steady Freddie” came from its Chief Executive Officer: Employees in F&I, Corporate Accounting and other business units were expected to take actions that would help achieve the goal of steady, nonvolatile earnings growth. The Board was aware of this strategy, but the flow of information was controlled by former Chief Executive Officer Leland Brendsel and Vice Chairman David Glenn in such a way that the accounting challenges involved in executing this strategy were not fairly presented. This was a contributing factor to the accounting and disclosure problems. Finally, as Board and Audit Committee members became increasingly concerned over the depth and expertise in Corporate Accounting and the Board became increasingly direct and specific in its demands for action (in the fall of 2001 and spring of 2002), Brendsel and Glenn failed to take prompt corrective action. Glenn’s alterations of his diaries have no bearing on our understanding of, or findings related to, the matters we have been investigating.

INTRODUCTION

This Report to the Board of Directors of the Federal Home Loan Mortgage Corporation ("Freddie Mac" or the "Company"), by Baker Botts L.L.P., contains the results of our investigation into certain accounting and financial reporting matters. We anticipate continuing our investigation substantially throughout the anticipated restatement by Freddie Mac of its 2000 and 2001 financial statements and the release of financial statements for 2002. To the extent that new information comes to light or additional issues are investigated, the Report will be modified appropriately. However, we believe the Report to be a thorough, complete, balanced, and fair discussion of the matters we were asked to investigate, based on the facts known to date.

The Report is divided into three parts: first, background information regarding our investigation and the Company; second, our investigation into allegations of wrongdoing made in two anonymous letters; and third, the investigation of certain accounting issues related to the restatements.

PART I. BACKGROUND AND REASONS FOR THE INTERNAL INVESTIGATION

A. PHASE ONE: THE ANONYMOUS LETTERS

On December 6, 2002, the senior management of Freddie Mac received two anonymous letters alleging three separate accounting, public reporting, and internal control irregularities at Freddie Mac.¹ In general terms, the allegations were that (i) Freddie Mac had prepared its financial statements for 1999 using projections that overestimated its income by hundreds of millions of dollars; (ii) Freddie Mac had mishandled cash collateral posted by the counterparties to its derivative transactions; and (iii) Freddie Mac personnel had mishandled a billing error relating to the fees assessed to one of its customers, Bank of America.

On December 10, 2002, Baker Botts was engaged by the Audit Committee of the Board to investigate the allegations made by the anonymous letters.² Baker Botts presented its findings to the Audit Committee on January 16, 2003 and to the Board on January 21, 2003. We reported to the Audit Committee that the allegations in the anonymous letters were false in most material respects. Our findings are described in detail in this Report.

During the course of the Phase One investigation, we also came across additional issues – mostly relating to elections by the Company to treat known, balance-sheet accounting errors by smoothing the reversals of the errors over the course of future periods – that we

¹ The first anonymous letter came by facsimile from the Chairman and Chief Executive Officer of Fannie Mae, to Leland Brendsel, Chairman and Chief Executive Officer of Freddie Mac. Although the anonymous letters were dated October 23, 2002, they were not received until December 6, 2002. Also, the anonymous letters indicate broad dissemination to government agencies, media, trade associations, and individuals. To date, however, we are not aware that a copy has been received directly by Freddie Mac or any of the other, indicated recipients, other than the Chairman and Chief Executive Officer of Fannie Mae and, with respect to the second letter, the Chairman and Chief Executive Officer of Bank of America.

² Baker Botts, in time, engaged FTI Consulting, Inc. (“FTI”) as its forensic accounting consultants to assist in this investigation.

believed required further inquiry. Our findings on these additional issues were presented to the Audit Committee on February 1, 2003 and to the Board on February 12, 2003.

B. PHASE TWO: ACCOUNTING ISSUES RELATED TO THE RESTATEMENTS

Throughout the Phase One investigation, Baker Botts and FTI met with the Company's independent auditors, PricewaterhouseCoopers LLP ("PwC") to brief them on the evidence being developed and to share information regarding additional issues that might affect PwC's work on the 2002 audit. As our Phase One work was being completed, the Company made its decision to restate financial statements for 2001 and 2000.³ PwC identified to the Audit Committee eight transactions or policies that might raise issues beyond simple accounting error.⁴ These transactions are referred to as: (i) the Coupon Trade-Up Giant or "CTUG"; (ii) Swaptions Portfolio Valuation; (iii) the J-Deals; (iv) Linked Swaps; (v) SFAS 91 Reserve; (vi) Loan Loss Reserve; (vii) certain transactions involving the Government Securities Clearing Corporation ("GSCC"); and (viii) PC Smoothing. Three of these transactions – CTUG, Swaptions Portfolio Valuation, and J-Deals – related to the Company's efforts to implement SFAS 133 in 2000 and 2001. Two of them – the SFAS 91 and Loan Loss Reserve – related to the Company's practices concerning the creation and use of reserves to achieve reported earnings in the range of analysts' expectations. One of the issues – Linked Swaps – concerned efforts to affect reported operating earnings. The final two transactions – GSCC and PC Smoothing – concerned business practices that seemed reasonable and appropriate but which raised accounting questions.

³ The Company announced its intention to restate financial statements for 2001 and possibly 2000 on January 27, 2003. A number of quantitatively significant "errors" that will be corrected in the restatement were not brought to our attention because they were not thought to raise any issue beyond accounting errors.

⁴ Some of these transactions and policies had been discovered by Baker Botts and FTI during Phase One, others by PwC or the Company during the audit of the 2002 financial statements, as to which PwC has not yet opined.

On January 27, 2003, the outside Directors of Freddie Mac retained Baker Botts to investigate the circumstances surrounding these eight transactions and related accounting policies. On March 6, 2003, Baker Botts and FTI made an interim report to the outside Directors on the matters being investigated, and we more fully reported our findings on the eight identified transactions and accounting policies to the Audit Committee on April 29, 2003 and to the Board on May 1, 2003. As detailed below, we concluded that six of these items – CTUG, Swaptions Portfolio Valuation, J-Deals, Loan Loss Reserve, PC Smoothing, and GSCC – involved the unintentional misapplication of generally accepted accounting principles (“GAAP”) based at least in part on the advice and concurrence of the Company’s prior auditor, Arthur Andersen LLP (“Arthur Andersen”). One of the issues – the SFAS 91 Reserve – involved a known departure from GAAP, which the Company and Arthur Andersen deemed immaterial. Linked Swaps involved a deliberate effort to smooth a non-GAAP metric, operating earnings, which had little practical effect on the Company’s GAAP reporting.

During the course of our Phase Two investigation, we looked into several additional transactions and practices identified by PwC. These items are: MODERNs, the Blaylock trades, and Round Robin Settlements. As reported herein, none of these items appear to raise comparable accounting issues. MODERNs was a transaction designed to shift credit risk through an entity that the Company subsequently determined needed to be consolidated for financial reporting purposes. The Blaylock trades were a series of pre-arranged transactions designed to permit the transfer of attractive assets from the Company’s Securities Sales and Trading Group (“SS&TG”) to the Retained Portfolio. Round Robin Settlements are a net settlement method that is recognized within the industry, and they do not appear to raise any issues of substance.

Some common themes emerged that are essential to an understanding of almost all of the issues we investigated. The story that developed during our investigation is one replete with accounting error, often resulting from judgments and decisions by employees who lacked the expertise to appreciate the significance, gravity of, or rigor required by, the accounting decisions they were making. The events exhibit an approach by senior management to maintaining a public corporate image at the expense of good management practices and effectiveness of internal controls. The management approach also created an environment that interdicted transparent communication to the Board and, ultimately, to the public and the markets.⁵ The result was a pattern of financial accounting and disclosure practices that fell below the standards required of a registered public company.

At this writing, the story is not one of rampant criminal misconduct, or abuse of authority for personal gain, but of serious failures by senior management to discharge responsibilities entrusted to and placed upon them by the Board. Specifically, senior management encouraged the use of complex, capital-market transactions and, to a lesser extent, reserve adjustments, for purposes of achieving strong, steady earnings growth and reported earnings that were within 2¢-3¢ a share of analyst expectations. Senior management also knew that Corporate Accounting lacked the necessary skill and resources to assure that the Company's activities in this regard remained within the bounds of GAAP.⁶

⁵ The Company's senior management at all relevant times included Leland Brendsel, Chairman and Chief Executive Officer, David Glenn, Vice Chairman and Chief Operating Officer, and the Chief Financial Officer, who was in control of financial reporting and disclosure policy. During this period, the Chief Financial Officers were: Richard Daniels, 1994-96; John Gibbons, 1996-2000; and Vaughn Clarke, 2000-03.

⁶ David Glenn's diaries document concerns over the Company's accounting capabilities. According to Glenn's diaries, Arthur Andersen expressed directly to Glenn their concerns that Corporate Accounting lacked expertise and depth. Moreover, the notes of Glenn's Chief of Staff, Robert Ryan, quote the following concerns expressed by Arthur Andersen at meetings attended by Glenn on April 3 and 5, 2001: (i) Arthur Andersen having taken over details of corporate accounting; (ii) compensation levels too low for critical talent; (iii) complacency in the closing process; (iv) the stigma of working in Corporate Accounting; (v) turnover in the department; (vi) lack of leadership; and (vii) "not much depth in skills and personnel."

C. THE FACT-FINDING INVESTIGATION

This internal investigation has been a fact-finding investigation. That is, we have examined documents and interviewed participants to inquire into circumstances surrounding transactions and accounting. The Board has directed us to perform this internal investigation without placing limitations on where it might lead. We were instructed to "follow the facts" with respect to the transactions that concerned the independent auditors and the Company and potentially raised issues beyond simple disagreements between accountants. Our purpose has not been to test whether the accounting was correct because the Company has already determined that the accounting was in error. Nor have we characterized conduct by the legal consequences that regulatory authorities or courts might consider. Instead, the Board has sought a complete picture of the facts and circumstances surrounding the transactions in question, including such matters as the purpose of the transactions, the cause of the errors, the persons involved and the nature of their relationship to the transactions, the tone from the top and the management processes that led to the transactions, relative levels of responsibility, and any other factor that would influence the Board's judgment about remediation and the future direction of the Company.

Our investigation had five major components: (i) review of hard copy documents; (ii) review of electronic documents and files; (iii) interviews with relevant parties; (iv) analysis of trader tapes; and (v) examination of personnel files. With respect to hard copy documents, we reviewed over 250,000 pages, consisting largely of documents provided to us by Freddie Mac employees. FTI conducted a forensic accounting analysis of financial documentation obtained from Corporate Accounting and other business units. In addition to Company documents, we reviewed Arthur Andersen workpapers from 1999, 2000 and 2001. Part of our ongoing

investigation includes the review of all Freddie Mac-related documents secured from numerous employee offices from June 9 through June 20, 2003.⁷

The electronic evidence process similarly included several elements. First, we imaged the hard drives of numerous Freddie Mac employees who were involved in the eight transactions and reviewed the files and e-mails from those hard drives. Second, we evaluated the e-mails of those employees, which the Company stored on its network servers.⁸ Finally, we obtained access to the F&I, Legal and Corporate Accounting servers. Through the use of various keyword searches, we were able to identify numerous relevant memoranda, presentations, and other files from these servers. In sum, the total amount of data included in the electronic evidence portion of our investigation was two terabytes.

Baker Botts and FTI conducted over 200 interviews of Freddie Mac employees, senior management and members of the Board.⁹ Given the nature of the investigation, many employees were interviewed several times, particularly after relevant documents were identified during the document review process. We continue to interview employees for issues discovered more recently.

⁷ We have secured all files from the Office of the Chairman and the Office of the Vice Chairman and others. These 600 boxes of documents from approximately 20 offices are stored in secure conference rooms, accessible only by Baker Botts and FTI, at Freddie Mac. As of the date of this report, this review is ongoing and will be complete by the end of August. There are three outstanding document issues. First, we are completing our review of the 600 boxes of documents secured from the 20 employee offices as described above. Second, on June 17, 2003, we sent an e-mail to each person interviewed inquiring whether that person "maintained a diary, notebook, journal or other record of your business activities (including notes of meetings you have attended)." The e-mail also requested any other "documents or notes that may be relevant to the issues we discussed with you during your interview." Approximately 60% of people responded that they may have some responsive documents. We expect the process of collecting these documents to begin shortly. Finally, we have received a 2000-page index of files stored offsite. We will review this list to determine whether any of these files are relevant. Those files will be retrieved from offsite storage and reviewed.

⁸ Because the Company only archives e-mails for 60 days and most of the investigated transactions occurred several years earlier, very few relevant e-mails were identified beyond those which had been printed out contemporaneously.

⁹ All employees interviewed were informed that Baker Botts had been retained by the Audit Committee and that the conversations were covered by the attorney-client privilege which was waivable by the Audit Committee.

We also listened to recordings of telephone conversations by traders at F&I and SS&TG who were involved in a number of the transactions under investigation. We reviewed all tapes available and transcribed those tapes most relevant to our investigation. In total, we reviewed over 11,000 minutes of trader tapes.

The investigative team also examined relevant employee performance reviews and personnel files. These documents, which include compensation information, were analyzed to determine whether employees had a personal financial motivation to engage in the transactions at issue.

Our findings rely heavily on our mental impressions and judgments, which are based on facts gathered without judicial process. The investigative team did not have the authority to take sworn testimony or compel production of documents. Nor have our forensic tools included the scientific testing of documents, signatures, alterations and the like. Our assessment of the demeanor and credibility of persons has, on the other hand, influenced our findings. On the whole, and with exceptions noted below (some of which have received extensive publicity), we have received the full cooperation of the Company and its management.

D. ROLE OF THE BOARD

The Board has been fully engaged throughout this process, and we have enjoyed the cooperation of the outside Directors. Between January 1 and July 21, 2003, the non-management members of the Board and/or their independent committees met over forty times, at least seventeen of which were entirely or partially in "executive session" with counsel. Since March 17, 2003, the Ad Hoc Committee on Financial Management has met weekly to oversee progress of the reaudit. Since May 13, 2003, the Board's Governance Committee also has met weekly to oversee the implementation of internal controls and governance reforms proceeding

under the new Chief Financial Officer, Martin Baumann. In addition, we had frequent access to the Lead Director, George Gould, the Chairman of the Audit Committee, Thomas W. Jones, and Shaun O'Malley, who became the Non-Executive Chairman of the Board on June 6, 2003. Other Board members have been available to us whenever needed.

With respect to the involvement of the Board in the issues we investigated, we found that senior management's approach to governance was such that the information flow to the Board was tightly scripted and controlled. In those instances where information relevant to the investigated transactions was contained in Board materials, the information was delivered in a manner tending to ensure that it escaped notice and would not generate questions. Accounting issues were always presented to the Board in a manner that represented, expressly or by clear implication, that they were in compliance with GAAP.

The Board's primary sources of independent information on the condition of Corporate Accounting were Arthur Andersen's annual Management Letters and the quarterly reports of Freddie Mac's internal auditor. An August 2000 internal audit report touching on the particular issues discussed herein downgraded controls from "satisfactory" to "marginal" based in part on the Company's preparation for Y2K and SFAS 133. In response to the report, the Audit Committee demanded a management response, which included a commitment from the Company's Controller, Greg Reynolds, to develop and implement a comprehensive solution to these control issues by December 2000.

During the relevant period, Arthur Andersen's Management Letters did not note any material deficiencies. The Management Letter addressing Fiscal Year 2001, dated March 1,

2002, notes a “reportable condition”¹⁰ regarding the reconciliation of the Company’s Guaranteed Mortgage Securities (“GMS”), but states that the condition had been rectified prior to December 31, 2001. By the time this letter was received, Corporate Accounting’s failure to respond adequately to questions from the Audit Committee on the GMS issue had already caused the Board to take action. Members of the Audit Committee became vocal in their views that Corporate Accounting required improvement and that senior management should be judged on their improvement of the control environment.¹¹ As a result, management was directed to “make significant improvement in data quality, accounting and reporting.” Moreover, senior management made a “no surprises” commitment, which included a representation that “All External Disclosures Will Be Complete and Accurate.” More specifically, management made a written presentation to the Board which stated:

The CEO, President and Chief Financial Officer will be responsible for strengthening and clarifying accountabilities and competency levels in the area of financial reporting and controls.

Approximately 25% of the senior management [2002] bonuses will be determined by success in meeting these initiatives, as assessed by the Audit Committee.

Senior management’s failure to meet these expectations, as evidenced by the reaudit announcement in January 2003, resulted in no bonuses being paid to them for 2002.

E. REGARDING THE COMPANY

An outsider approaching Freddie Mac, as the investigative team did, with the means and intention of gaining some insight into its institutional processes and corporate culture,

¹⁰ A “reportable condition” is a significant deficiency in the design or operation of the internal control structure that, in the auditor’s judgment, could adversely affect the Company’s ability to record, process, summarize and report financial data consistent with the assertions of management in the financial statements.

¹¹ The current Chair of the Audit Committee, Thomas W. Jones, was in large part responsible for the Board’s decision to tie senior management incentive bonuses to improvements in the controls environment.

finds a strong sense of mission.¹² We were often told that “managing risk is job one.” In that regard, the Company prides itself on managing interest rate risk and credit (or counterparty) risk. In that regard also, the transactions and accounting policies at issue were, at the time, considered by many employees of the Company at various levels of responsibility to be important, but not the core business of Freddie Mac. Employees proved generally willing to discuss the transactions and accounting policies that were the subject of our investigation, and generally expressed the view that, at the time, the Company believed it was effecting, booking, and reporting its financial condition and results of operations in compliance with GAAP and with the appropriate involvement of its then-outside auditors, Arthur Andersen.

F. DAVID GLENN’S NOTEBOOKS

We believed we were substantially completed with our investigation of the original eight transactions or policies and well underway with respect to certain additional issues at the time of the highly publicized events of June 4-6, 2003, and the ensuing senior management changes.¹³ Although we had no evidence that alteration or destruction of relevant materials extended beyond one senior executive, out of an abundance of caution we secured the offices of 20 Freddie Mac employees. This action has resulted in our coming into possession of an extensive amount of additional documentary material, which is still being reviewed at the time of

¹² The Company’s mission prominently stated in its Annual Report is as follows:

A shareholder-owned corporation whose people are dedicated to improving the quality of life by making the American dream of decent, accessible housing a reality. We accomplish this mission by linking Main Street to Wall Street—purchasing, securitizing and investing in home mortgages, and ultimately providing homeowners and renters with lower housing costs and better access to home financing. Since our inception, Freddie Mac has achieved 31 consecutive years of profitability and financed one out of every six homes in America.

¹³ Exhibit A describes Glenn’s alterations of his diaries and missing pages.

this Report. Although we expect that the vast majority of this material will be irrelevant to our investigation, and have no reason to believe that our findings will change significantly as a result of any relevant material that is found, this Report is subject to change as a result. We also continue to follow up on leads that may yield significant findings.

PART II. INVESTIGATION OF THE ANONYMOUS LETTERS: PHASE ONE OF THE INVESTIGATION¹⁴

A. LETTER ONE

The first anonymous letter, addressed to the Division of Enforcement of the United States Securities and Exchange Commission (“SEC”),¹⁵ alleges two, unrelated issues. The first issue involves the Company’s use of a predictive model called “NIMFEST” in preparing its 1999 financial statements. The second issue concerns the Company’s practices with respect to the handling of cash collateral posted by counterparties to its derivatives transactions. These issues are addressed in turn below.

1. Issue 1: NIMFEST

The first anonymous letter alleges knowing misstatements of year-end 1999, quarterly 2000 and year-end 2000 financial results. The letter alleges that “an internally-developed financial modeling application” used to forecast earnings and capital requirements – the “NIMFEST”¹⁶ model – had been substituted for actual 1999 results in the audited financial statements for that year. It is alleged that (i) this was done in response to pressures to accelerate the release date for 1999 earnings; (ii) the NIMFEST model was known to be of questionable reliability; (iii) as a result, 1999 reported earnings were overstated “by several hundred million dollars”; and (iv) as a further result, quarterly and annual 2000 earnings were understated. Finally, it is alleged that adjustments in 2000 required to offset the overstatement of 1999

¹⁴ The two documents share a common format, common voice, and common concluding passages. The Company has made no attempt of which we are aware to identify the author of the anonymous letters, and identification of the author was not the objective of our investigation.

¹⁵ As noted, to our knowledge, the first anonymous letter was not mailed by the author to the Office of Federal Housing Enterprise Oversight (“OFHEO”) or the SEC.

¹⁶ NIMFEST is an acronym for “Net Interest Margin Forecast Earnings Stress Test,” a forecasting model developed and utilized by the Company.

earnings were "smoothed" out over the course of 2000, and that management never intended to disclose or explain these required adjustments.¹⁷

Our investigation reveals a less sinister and more nuanced story. Although the author clearly had access to considerable information regarding the Company's 1999 financial close process, most of the allegations made by the author are not supported by the facts. Most importantly, there is no evidence that the Company's 1999 earnings release overstated net income in the amount of several hundred million dollars. To the contrary, the evidence indicates that the Company's 1999 earnings release in fact understated net income, and by an amount of only approximately \$2.2 million. This income statement variance was not in fact "smoothed out" over a period of months, but was instead corrected in its entirety by adjusting entries entered in the month of January 2000. More specifically, our findings with respect to the NIMFEST issue are as follows.

The basic allegation that the Company relied on NIMFEST as part of the 1999 financial close process is essentially correct. Our investigation found no evidence, however, that the decision to use NIMFEST was the result of any unusual pressures to accelerate the 1999 earnings release. Instead, the investigation shows that the driving force behind the NIMFEST decision was a sincere concern with the potential disruptive effects of Y2K. Like many companies at the time, Freddie Mac sought to mitigate the uncertainties surrounding Y2K by taking proactive steps in advance. A Y2K Program Office was set up to address the issue Company-wide. It identified five critical business processes, including External Financial Reporting, and directed each of these critical business processes to prepare a business continuity

¹⁷ The author acknowledges that he "cannot say whether these actions were fully disclosed to Chairman Leland Brendsel and/or David Glenn," but asserts that the information was "commonly discussed" throughout various business units.

plan ("BCP") to address Y2K and other disaster situations. NIMFEST was part of the BCP developed for External Financial Reporting.

The NIMFEST plan adopted as the Company's BCP for External Financial Reporting¹⁸ involved a modified version of NIMFEST, which served in part as a "data aggregator," and in part in the standard NIMFEST forecast capacity. The Company's plan was to close its books for the first eleven months of 1999 through standard general ledger processes. For the month of December, actual data from the Company's operations (as that information became available) was to be fed into the NIMFEST model, and this information was to be used both as the direct basis for reporting financial results, and as a basis for extrapolating results for the remainder of December. The Company thus always contemplated that it would rely on forecasted data for a period of only a few days.¹⁹

As noted, all of the evidence indicates that the dominant rationale for the Company's decision to use NIMFEST in this fashion was sincere concern over the potential disruptive effects of Y2K. Faced with the perceived threat that the Company's ordinary accounting systems would not function reliably after the turn of the year, the Company sought to create a method that would allow its financial statements to be released, as promptly and accurately as possible, even if the most dire Y2K predictions came to pass.²⁰ The Company saw

¹⁸ Both former Chief Financial Officer John Gibbons and former Controller Greg Reynolds acknowledge that they made or approved the decision to use NIMFEST as part of the 1999 close process. The decision was also widely known and regularly reported throughout the Company.

¹⁹ In fact, the NIMFEST calculations used as the basis for the Company's year-end 1999 earnings release were completed on January 5, 2000, and were based on actual results through December 31, 1999, and some estimates where necessary (mainly for balance sheet accounts).

²⁰ In the eyes of some, NIMFEST was an especially attractive alternative in light of the perceived unreliability of the Company's standard general ledger close process. There were concerns about the age and reliability of some of the Company's manual and automated accounting systems, such as the FACS interface and systems such as MIDAS that fed data into the general ledger. The Company had also experienced substantial turnover in its Corporate Accounting staff, and there were concerns about the quality and the depth of the internal accounting personnel. In hindsight, it may be suggested that the Y2K challenge, and the NIMFEST solution, served to gloss over these more

NIMFEST as the best solution to the uncertainties it was facing, and once that solution was adopted, it was carefully vetted within the Company and with its external auditors, who ultimately signed off on the process. In a workpaper dated September 30, 1999, Arthur Andersen "concluded that the NIMFEST close process is a reasonable method used to accurately report the Company's December financial position and results of operations."²¹

Although concerns about the timing of the earnings release clearly played some role,²² none of the witnesses identified unusual pressures to accelerate the earnings release as a factor in the decision to adopt the NIMFEST close process. We likewise found no evidence that the decision was influenced by personal financial motives or other wrongful objectives. The Company and all of its employees appear to have been well motivated throughout.

We likewise find no merit to the allegation that the Company elected to go with NIMFEST knowing it to be unreliable. Nor was the Company reckless with respect to this issue. Over the course of 1999, the NIMFEST close process was vetted with management and external auditors, and elaborate testing was performed. Although early testing showed significant variations between NIMFEST and actual general ledger results, the NIMFEST model was improved in light of these tests, and by the end of 1999, testing showed the model to be quite accurate in replicating general ledger results. An internal Arthur Andersen workpaper dated

pervasive problems in Corporate Accounting, which would continue to express themselves during the accounting challenges that would follow for the Company.

²¹ Robert G. Arnall, the Arthur Andersen engagement partner, confirmed in interview that it was and is his view that, under the circumstances, the NIMFEST close process was in accordance with GAAP.

²² If timing were no issue at all, the Company could simply have planned to wait out Y2K, and to go forward with external financial reporting and other critical business functions through standard processes, when and as they could be accomplished. But no one would identify that as a necessary, or even a responsible, approach to the uncertainties surrounding Y2K. Like most companies at the time, Freddie Mac sought proactive solutions that would allow it to achieve regular operational standards, including their timing, even in the face of the potential Y2K disruptions. Our investigation indicates that it was that defensive goal – rather than (as the anonymous letter suggests) an affirmative effort to accelerate processes beyond what the Company was able to accomplish in the past – that was the primary driver of the NIMFEST decision.

November 29, 1999, indicates that "all variances [from the Company's September testing] are within the target thresholds of the company. Therefore no further work is required." A November 17, 1999, written report to the Audit Committee from William I. Ledman, the Senior Vice President Information Systems and Services and head of the Company's Y2K readiness project, reflects that as of October 31, 1999, the BCP testing for External Financial Reporting was 100% complete, and all testing issues had been closed.

The most serious allegation regarding the NIMFEST close process – that it resulted in an overstatement of net income in the amount of several hundred million dollars – is simply unfounded. Contemporaneous documents show that a comparison of the NIMFEST-generated financial results with those later generated through standard general ledger processes was completed in late January 2000. This comparison showed a discrepancy of only \$2.2 million in the net income figures, with the NIMFEST-generated numbers having understated net income by that amount.²³

Contemporaneous documents likewise show that the \$2.2 million net-income variance between NIMFEST and the general ledger was "trued up" by adjusting accounting entries entered into the general ledger in December 1999 and reversed in January 2000. No part of that true-up process was carried over into subsequent accounting periods. There is no evidence of a "smoothing" process with respect to any income statement item as alleged in the anonymous letters.

²³ Adjustments to the 1999 financial statements – and, in particular, certain judgments with respect to reserves and an apparently after-the-fact decision to "prefund" the Freddie Mac Foundation in the amount of \$9.6 million – raise concerns that they appear to have been undertaken with an eye toward bringing the Company's reported financial statements more closely into line with analysts' estimates. These concerns are dealt with more generally in a separate section on that subject. Our investigation uncovered no evidence that the adjustments had the purpose or effect of minimizing or concealing the variance between the NIMFEST-generated financial statements and the figures resulting from the standard general ledger close.

The Company did not make any public disclosure²⁴ of its use of NIMFEST in closing its books in 1999. The relevant witnesses report that they did not regard the use of NIMFEST as material, particularly in light of the fact that the resulting income statement variances were so relatively insignificant.²⁵ Whatever the merits of that judgment, it does appear to have been a judgment that was made in good faith. There does not appear to be credible evidence to support a conclusion that the Company was deliberately attempting to conceal its use of NIMFEST in closing the 1999 books.

Disclosure was made to OFHEO of the Company's use of a special year-end financial close process, as well as the adjustments coming out of that process when compared to the final, general ledger close.²⁶

Although the most serious NIMFEST-related allegations in the anonymous letter thus appear unfounded, a critical look at the evolution of the decision to use NIMFEST raises a number of issues. The evidence establishes that part of the Company's attraction to the

²⁴ Freddie Mac securities are exempt from registration under the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended. As such, rather than releasing Annual Reports and Quarterly Reports, Freddie Mac releases an annual Information Statement ("IS") and periodic Information Statement Supplements ("ISS").

²⁵ The \$2.2 million understatement represented 0.4% of Freddie Mac's net income for the fourth quarter of 1999.

²⁶ The following was disclosed to OFHEO as part of the Fourth Quarter 1999 submission in March 2000: "Year End Adjustments: Freddie Mac utilized a special year-end financial reporting process to mitigate our Y2K risk. Our proactive Y2K accounting process consisted of two year-end closes. The first phase involved aggregating business results into our financial statements, thereby enabling Freddie Mac to quickly identify and resolve potential problems prior to our earnings release on January 18, 2000. The second phase involved executing our standard G/L close process. Freddie Mac did not experience any system failures or data issues arising from Y2K. As expected, our dual close process resulted in one-time reconciling items to the data submission"

In the submission to OFHEO, the following items were noted to have differences due to the alternative close process: Mortgage Loan Data; GMS Portfolio; Investment Portfolio; and Debt Portfolio.

The following was disclosed to OFHEO as part of the First Quarter 2000 Submission in May 2000: "Year End Adjustment Reversal: As described in the fourth quarter 2000 submission and discussed previously with OFHEO, Freddie Mac's proactive Y2K dual close financial reporting process resulted in certain one time adjustments to the General Ledger. These adjustments were identified with several new codes which begin with the letter "T" in the General Ledger product field. These one-time adjustments automatically reversed for the first quarter 2000 report, as they were designed to do."

NIMFEST model was its distrust of the Company's standard financial reporting processes. There were known concerns with the Company's computer and manual accounting processes, as well as with the quality and the depth of the Company's accounting personnel. These problems do not appear to have been dealt with directly (and certainly not effectively) at the time, and as a result, they would continue to express themselves for the Company in the period ahead.

The NIMFEST story also raises broader issues of accounting and management judgment. Although the NIMFEST decision appears to have been well motivated – and was closely vetted by and ultimately approved by the Company's external auditors – the inevitable result of using an estimation model was that the Company would be relying on accounting entries that were unsupported in any traditional sense. While this judgment appears to have been a situational response to the unique concerns surrounding Y2K, it may also reflect (in part) a misapprehension within the Company – evidenced more clearly in other episodes discussed below – about how much flexibility is permissible under GAAP.

The Company's experience with NIMFEST also raises an important internal control issue. As for most companies, Y2K did not turn out to be the disabling event for Freddie Mac that many had feared. Early in January 2000, it appeared that the Company's systems were reliable and that the Company would therefore be able to close its books through the standard general ledger process. Indeed, the Company did complete a standard general ledger close within a week of the date its earnings were released relying on the NIMFEST model. No real consideration appears to have been given at that time to the possibility of either delaying the earnings release for a few days or accelerating the pace of the general ledger close – and thus doing away with the NIMFEST issue altogether. This decision deserved some scrutiny and should have been raised with senior management. Instead, the decision appears to have been made by default, by inertia, and by the force of prevailing momentum.

Finally, the January 2000 closing of the general ledger for December 1999 also revealed a \$630 million variance (overstatement of both assets and liabilities) between the NIMFEST-based balance sheet and the final general ledger-generated balance sheet. To correct this variance, a \$630 million entry was booked in December 1999 to the general ledger and reversed in January 2000. No tolerance thresholds for this balance-sheet variance existed in the BCP. The balance sheet effects apparently were considered immaterial,²⁷ and, as a result, Arthur Andersen did not conduct an exhaustive review to identify the source of variance. The Company made no further review.

Part of the \$630 million variance can be traced to the Cash and Cash Equivalent ("CCE") line item in the externally-released December 31, 1999 balance sheet, which overstated CCE by \$959 million, while understating Accounts Receivable and Guaranteed Mortgage Securities and other line items. NIMFEST reported CCE of approximately \$5 billion, whereas the final general ledger shows CCE of approximately \$4 billion.²⁸

Thus, there were overstatements and understatements resulting from the NIMFEST close of substantial sums. They were, however, balance sheet variances that were reversed in January, without material effect on Freddie Mac's total assets, which at the time totaled \$387 billion. The source of the error, while arising in the process of reconciliation of the NIMFEST-based balance sheet to the general ledger-generated balance sheet, does not appear to involve any intent to deceive. Nor does the Company's handling of those errors show an intent to evade correct disclosure.²⁹

²⁷ The \$630 million variance represented 0.2% of Freddie Mac's assets as of December 31, 1999.

²⁸ Certain balance sheet variances were, however, reported to OFHEO, as discussed above. Among the variances disclosed was the NIMFEST-related cash and cash equivalents difference of \$959 million.

²⁹ We do not foreclose governance and management issues. There is no suggestion that this error was discussed with senior management, let alone disclosed to the Audit Committee.

2. Issue 2: Cash Collateral

The first anonymous letter also makes a number of allegations regarding Freddie Mac's practices for handling cash collateral posted by counterparties to its derivatives transactions. These allegations are that: (i) cash collateral was commingled in violation of the security agreements between Freddie Mac and its counterparties; (ii) as a result of the commingling, Freddie Mac could not identify the parties posting the collateral or the amounts being posted; and (iii) these problems resulted in false financial reports and OFHEO submissions.

Our investigation determined that while cash collateral was commingled at certain times, by and large the allegations in the anonymous letter were unsupported by the facts. The Company's obligations regarding the handling of cash collateral were set forth in security agreements negotiated over a period of years, starting in 1993. Almost all of these agreements required the segregation of cash collateral. Up until 1999, most counterparties chose to post securities, rather than cash, as collateral. However, changes in the market conditions during 1999 made the Fed effective interest rate paid by Freddie Mac on cash collateral more attractive to its counterparties, and thus, Freddie Mac started to receive substantial deposits of cash as collateral. Because Freddie Mac did not have a mechanism in place for segregating cash collateral, counterparties desiring to post cash were instructed to send the funds to the Company's account at the Federal Reserve Bank of New York. The cash collateral was reinvested by Freddie Mac and counterparties were paid interest at the Fed effective rate. Any "excess" earnings generated by the reinvestment of the cash collateral were retained by Freddie Mac.

Our investigation determined that Freddie Mac's procedures for tracking cash collateral deposited into its Fed account and ensuring that interest was properly credited at the

Fed effective rate were fairly robust. These procedures included monthly reconciliations by Freddie Mac's back office in conjunction with the back offices of the various counterparties posting the collateral. We did not identify any situation where Freddie Mac was unable to track properly collateral deposits or interest owed. We also did not uncover any evidence suggesting that any of the counterparties were dissatisfied with the manner in which Freddie Mac handled cash collateral deposits or the interest paid.

However, the Company was aware that its practices were inconsistent with its contractual obligations under the security agreements. Specifically, the Company's in-house lawyers raised questions regarding the handling of cash collateral in 1999. Arthur Andersen also referred to the failure to segregate cash collateral in its internal controls letters dated March 3, 2000 and March 2, 2001.

While we believe that there is no evidence that Freddie Mac's cash collateral practices resulted in any false or misleading financial or regulatory reports,³⁰ they did create at least two accounting issues. Arthur Andersen's workpapers reflect that in the third quarter of 1999, Freddie Mac "discovered that collateral held from counterparties . . . had erroneously been included in cash holdings." The workpaper further states that "[i]n order to correct for this error,

³⁰ As part of its submission to OFHEO for September 30, 1999, Freddie Mac identified discrepancies between the balances from the source system and the general ledger of approx. \$2.3 billion. Included in notes to Schedules IV.11 and IV.12 is the following: "[t]he source system balance is greater than the GL because the source system is being used to track off balance sheet instruments that are being held as collateral for off balance sheet transactions. This collateral does not represent Freddie Mac owned assets and, as such, it is recommended that the collateral balance be excluded from the asset base for modeling purposes. The difference shown may be netted out of the balance of the instruments in the Fed Funds investment category on a pro rata basis to make this adjustment." From September 1999 up to and including December 2000, Freddie Mac continued to identify differences in these schedules to the submission.

In March 2001, Freddie Mac updated its disclosure to OFHEO, including the following disclosure, "In prior periods, a reconciling difference existed between source data files and the balance sheet. This difference was the result of including cash collateral held by Freddie Mac from swap counterparties. Beginning in the First Quarter 2001, a custodial account was established at Mellon bank for all cash collateral from swap counterparties. Going forward, this account will be managed in escrow fashion, and the counterparty collateral will be maintained off balance sheet. This eliminates the difference between the source data files and the balance sheet."

the Company reclassified the full balance \$1 billion to a collateral account, and reversed the associated interest income.” This, in turn, “resulted in a reduction to earnings by approximately \$30 million.” Because the amount was less than 4% of pretax earnings for the quarter and less than .9% of pretax estimated earnings for the year, Arthur Andersen concluded that the reclassification did not result in a material misstatement in any given quarter or year.

The second issue arose in connection with the preparation of the 2000 IS. Because the collateral – which had risen to \$2 billion – was not segregated, Arthur Andersen advised Freddie Mac that it was required to include the amount on its balance sheet. This turn of events inspired Freddie Mac to investigate and ultimately execute a custodial arrangement with Boston Safe Deposit and Trust Company (“BSD”) which brought Freddie Mac’s cash collateral handling practices into compliance with the segregation requirements in its security agreements. The BSD agreement resulted in counterparties depositing cash collateral directly with BSD, where it was held in segregated accounts as required by the security agreements. Upon the execution of the BSD agreement on March 26, 2001, cash collateral was removed from Freddie Mac’s balance sheet.³¹ With the exception of the matter described below, we concluded that Freddie Mac’s collateral handling practices were in compliance with its contractual obligations under the security agreements from April 2001 forward.

The exception concerns the treatment of excess earnings generated by BSD’s reinvestment of the cash collateral. Under the BSD arrangement, Freddie Mac continued its practice of paying counterparties interest at the Fed effective rate. However, BSD was able to generate returns in excess of the Fed effective rate. These excess earnings were shifted to a

³¹ In the third quarter of 2002, cash collateral was moved back on the balance sheet based on the Company’s conclusion, with the concurrence of PwC, that the BSD agreement gave Freddie Mac too much control over the reinvestment of the collateral.

“surplus account” at BSD, which was controlled by Freddie Mac. This practice was inconsistent with a majority of the security agreements, which provided that all proceeds from the reinvestment of the collateral belonged to the party posting the collateral. This inconsistency was recognized by several in-house lawyers and accountants, resulting in a recommendation that the security agreements be amended to reflect Freddie Mac’s current practices regarding the retention of the excess earnings. Freddie Mac did not take the additional step of returning the amounts accumulated in the surplus account to the parties posting the collateral. Instead, a Freddie Mac in-house lawyer advised that Freddie Mac could claim the accrued surplus earnings once the party executed a contract modification. As a result, Freddie Mac took approximately \$1.9 million into earnings on September 30, 2002 based on executed contract modifications. As of year-end 2002, Freddie Mac held \$2.5 million in excess earnings relating to counterparties who had not yet signed modifications.

The Audit Committee was advised of this issue on January 16, 2003 and, we understand, instructed management immediately to return all surplus earnings, including amounts previously taken into earnings, to the counterparties regardless of whether or not they had executed modifications to their security agreements.

B. LETTER TWO: THE BANK OF AMERICA ALLEGATIONS

The Bank of America (“BOA”) allegations were contained in a separate anonymous letter sent to the Chairman of BOA dated October 23, 2002, but received on or about December 6, 2002. The letter alleges an undisclosed \$5.9 million billing error resulting from the manner in which loan delivery fees were assessed on loans delivered by BOA between October 2001 and February 2002. The letter alleges that once Freddie Mac discovered the error, it chose to resolve it unilaterally by offsetting the overbilled amount against future fees. The letter

further alleges that this action breached the agreement with BOA and resulted in false reports to OFHEO and an overstatement of earnings. Our investigation determined that these allegations were unfounded in all material respects.

The relevant facts are as follows. Since 2000, BOA and Freddie Mac have been exploring ways to reduce BOA's defect rate, *i.e.*, the fees assessed when BOA delivers loans below a specified quality level. The primary obstacle was that BOA was unable to identify defect loans at the point of delivery to Freddie Mac. In an attempt to solve this problem, Freddie Mac developed a manual loan scoring matrix that was presented to BOA as a tool for identifying defect loans at delivery. During the fourth quarter of 2001, BOA and Freddie Mac agreed to modify their existing contract to permit Freddie Mac to assess fees on loans scoring "defect" under this manual matrix. Pursuant to this agreement, the manual matrix was applied to loans delivered by BOA between October 2001 and February 2002. After delivery of the loans, Freddie Mac scored the loans under its proprietary system, LP-Emulator. In late March or early April 2002, Freddie Mac personnel working on the BOA account noticed that the scoring results under LP-Emulator did not correlate with the results produced by the manual matrix. The effect of the correlation failure was a net assessment of \$780,784 in defect fees to BOA, which would not have been assessed had the loans been scored solely under LP-Emulator. Although Freddie Mac has a strong argument under the contract modification (which bound BOA to the results generated by the manual matrix) that it was entitled to retain the net difference, Freddie Mac concluded that because the manual matrix had not functioned as intended, it would stop applying the manual matrix, starting with the February 2002 deliveries.

In June 2002, Freddie Mac disclosed the issue to BOA by providing a detailed schedule setting out the relevant facts and proposing a fee swap (in essence a credit that would be applied over time to future loans purchased) that would bring the fees in line with what would

have been charged had the loans been scored under LP-Emulator. BOA orally agreed to the proposed arrangement. As part of our investigation, we obtained confirmation from BOA via e-mail dated January 15, 2003, that the matter had been satisfactorily resolved through full disclosure by Freddie Mac of the issue and an agreement to Freddie Mac's proposal. Although the resolution created minor internal data integrity issues, specifically whether Freddie Mac's internal systems reflected the proper "scoring" of BOA loans purchased at various times, there were no issues with respect to OFHEO or regulatory reporting.³²

C. **BALANCE SHEET ISSUES OF 2000 DISCOVERED DURING THE PHASE ONE INVESTIGATION**

In the course of completing the Phase One investigation, we discovered two balance sheet issues which, although they had no apparent nexus with the 1999 close (or the specific matters alleged in the anonymous letters), raised concern about judgments made in Corporate Accounting, which we believed merited the attention of the Audit Committee.³³

1. **The GMS Paydown Entry**

In February 2000, as a part of the close of January 2000 financial statements, but after the reconciliation of the general ledger was completed for 1999, Corporate Accounting incorrectly booked an entry for \$799 million, affecting the "GMS Paydown" (an asset line-item) and "Principal and Interest due Investors" (a liability line-item). This error, which appears to have been a simple mistake, was discovered in April 2000. Although not materially affecting

³² We understand that Freddie Mac is considering whether to "restore" certain loans in the system, for which the fee adjustment with BOA has already been made.

³³ These issues came to light on or about January 16, 2003, approximately nine days prior to the Company's restatement announcement. We investigated these issues and presented our findings to the Audit Committee on February 1, 2003 and the Board on February 12, 2003.

GAAP financial reporting, the error affected the Monthly Volume Summary ("MVS")³⁴ in January 2000 by incorrectly increasing the size of the Total Mortgage Portfolio and Retained Portfolio balances by .09% and 2.5% respectively, overstating the Total Mortgage Portfolio growth rate by 1.1% and understating the Total Mortgage Portfolio liquidation rate by 1.2%.³⁵

Under Accounting Principles Board Opinion 20 and Statement of Financial Accounting Standard No. 16, if the error were material, the Company should have restated prior periods. There was no option under GAAP to correct the error going forward over time. In spite of the lack of support under GAAP, an initial decision was made to correct the error over three months through correcting entries of \$267 million each. In May a \$267 million entry was booked in time for the April 2000 close. Then, in the April 2000 Financial Statement Review Meeting, a decision was made to correct the \$799 million error over eight months instead of three. A \$267 million entry was made to reverse the earlier entry for the April close. Thereafter, reversing entries of approximately \$100 million were booked for each month from April through November 2000.

The decision to correct the \$799 million error in this fashion was made in Corporate Accounting in consultation with employees from Shareholder Relations. The motivation was not to avoid the effect on the GAAP financial statements of a correction in the current period, but to avoid changes to the MVS that would have drawn the attention of the industry. There is no evidence that the issue was discussed with senior management, and it is unclear whether the issue was raised even as high as the Controller.

³⁴ The Monthly Volume Summaries are publicly released financial ratios and reports of interest to analysts and the mortgage finance industry.

³⁵ As of December 31, 1999, the size of the Total Mortgage Portfolio was \$862 billion.

The employees involved in making the decision defend it as the best available solution to prevent a distortion in the growth trend of the Company's Total Mortgage Portfolio.³⁶ A one-time adjustment to correct the full amount of the error, the employees assert, would have been easily misconstrued as reflecting some different and more fundamental business reality. At the same time, however, the employees do not have a good answer to the question of why these concerns could not have been addressed through a complete and candid disclosure of the error (and the steps taken promptly to correct it). This was clearly a misjudgment and a misapplication of the GAAP principles outlined above. Our investigation finds no evidence, however, that this was an intentional violation of accounting rules. Instead, as with other, similar events discussed below, the error appears to have been the result of a serious lack of accounting skill and discipline.

In any event, the effect of smoothing out the error over time, rather than correcting it immediately, was that for a period of eight months the Company released MVS financial figures that were known to be inaccurate. This misstatement also increased balance sheet assets and liabilities by non-material offsetting amounts.

2. Misclassification of \$4.1 Billion "T-Deal" Repurchases

In January 1999, the Company began to repurchase participation certificates ("PCs") collateralized by sub-prime Loans ("T-deals"). The T-deal repurchases were incorrectly classified as non-Freddie Mac securities, resulting in overstatements of the Total Mortgage Portfolio in the financial statements, and also affecting the MVS. The error appears to be a one-time, unintended coding or classification error. When the error was discovered in October 2000, the cumulative amounts of T-deal repurchases stood at \$4.1 billion.

³⁶ Total Mortgage Portfolio growth is a non-GAAP metric used by industry analysts to evaluate the growth of the Company's portfolio.

Corporate Accounting apparently considered three possible solutions: (i) restating all prior months; (ii) correcting the entire amount of the error in the month of discovery; or (iii) correcting the amount over time. As noted above, there is no basis under GAAP for the third approach, which was the one chosen. The T-deal amounts were corrected and/or reclassified over a 12-month period, from October 2000 to September 2001, by reversing entries of approximately \$399 million per month. Again, the perpetuation of known errors and the choice of a solution with no basis under GAAP appear to have been a decision of Corporate Accounting.³⁷

3. The Balance Sheet Errors in Context

The foregoing balance sheet errors have significance not in what they imply about the business fundamentals of Freddie Mac, but in what they demonstrate about the matters later investigated and discussed under Part III. First, it does not appear that either the Vice Chairman and Chief Operating Officer, David Glenn, or the Chairman and Chief Executive Officer, Leland Brendsel, were informed of either error or how they would be corrected. Nor does it appear that Arthur Andersen, the independent auditor, was consulted. There is no apparent awareness evidenced by Shareholder Relations or Corporate Accounting to consult in-house or outside counsel as to the necessity or advisability of factual disclosure to the public.³⁸ In addition, there

³⁷ The evidence is muddled, with the Controller, Greg Reynolds, stating that while he has no current recollection, he believes he would have been aware of it and, consistent with his general practice, would have relayed it to Clarke, the Chief Financial Officer. Clarke remembers Shareholder Relations telling him about the issue but says Reynolds would have made the final decision and does not recall being consulted by the Controller. As with the GMS Paydown entry, Shareholder Relations was consulted.

³⁸ There was disclosure of the GMS Paydown balance sheet error to OFHEO. Freddie Mac identified a reconciling difference between the source system and the general ledger in Schedule IV.5, Total Guaranteed Mortgage Securities Reconciliation to the general ledger for ATLAS and Other Accounting Processes. From the first quarter to the third quarter 2000, one of these reconciling items "Timing and reporting differences for which no adjustment is necessary" related to the human error that was corrected over time. Amounts reported in this reconciling item to OFHEO were as follows: first quarter - (\$803,639,126), second quarter - (\$502,631,112), third quarter - (\$62,124,887). No disclosure was made to OFHEO of the T-Deal balance sheet error.

is no internal audit involvement, and no investigation of why the errors occurred in the first place.

The pattern that emerges is of an institution whose culture discouraged the candid disclosure and explanation of errors. Finally, these two episodes, more than any other, lend credence to the "off-the-mark" allegations of the anonymous letters. The balance sheet errors and the facts and circumstances described above are consistent with the facts found and conclusions reached in Part III.

PART III. ACCOUNTING ISSUES RELATED TO THE RESTATEMENTS: PHASE TWO OF THE INVESTIGATION

As a result of certain accounting errors identified to the Audit Committee on January 24, 2003, the scope of our engagement was expanded on January 27, 2003 to include an investigation into the facts and circumstances surrounding eight transactions and accounting policies and the factors contributing to accounting errors made with respect to those transactions and policies. In this process, we considered (i) the purpose and effect of the transactions and policies, (ii) the cause of the errors, including the depth and adequacy of accounting expertise and disclosure process of the Company, (iii) who was involved, and (iv) the “tone from the top” and governance process involved, including internal control issues and communications to senior management and the Board.

A. CERTAIN FACTORS RELATING TO THE TRANSACTIONS

Since 1989, Freddie Mac has faced the challenge of evolving from a quasi-governmental entity to a public company that is a major participant in the international capital markets. By the early 1990s, prominent Freddie Mac shareholders were warning Freddie Mac that it needed to communicate to the markets what could be expected as a growth pattern for Freddie Mac earnings.

As a result, one of Freddie Mac’s principal financial goals over the past decade has been to achieve strong, stable earnings growth. The primary, indeed the dominant, business objective has been to manage risks, including asset and liability duration risk, credit risk and interest rate risk. The transactions discussed below did not compromise the Company’s risk management strategy, nor do they directly affect it. The restatements will impact earnings, and as a result regulatory capital, but will not have an apparent effect on safety and soundness. The

transactions investigated by us, therefore, relate to a common theme, that of “Steady Freddie,” the strategy of achieving stable earnings growth, minimizing volatility, and attempting to assure that the financial statements would better reflect management’s perception of the long-term profitability of the business. In the eyes of management, the goal of steady earnings growth is only a subtext of Freddie Mac’s business, not the driver; and the guiding principle is risk management, not quarterly or annual earnings growth.³⁹

It is important to note that the establishment of the goal of nonvolatile earnings growth does not lead inevitably to inappropriate “earnings management,” or GAAP violations. Instead, it creates the context within which the actions that we have investigated occurred. Within Freddie Mac, Leland Brendsel is attributed with both the credit and the responsibility for the policy of nonvolatile earnings growth. This policy was communicated to – and endorsed by – the Board. Setting such a goal also heightened the risk of missteps and thus required strong management oversight. Such oversight was not present here.

Since 1998 (and possibly earlier), Freddie Mac’s Corporate Accounting area has been relatively anemic for an institution of its size, complexity, and importance, both with respect to skill sets of certain key personnel and staff resources, and reliance on manual, as opposed to automated, processes. An awareness of this problem by senior management was

³⁹ The Company utilized a corporate scorecard to determine the amount of funding of a Company-wide bonus pool. The scorecard contained three elements: profitability (40%), core competencies (such as purchasing loans) (40%), and strategic positioning (20%). Typically, the profitability factor was met by meeting or exceeding a mid-teens growth target in earnings per share. In 2002, for example, the profitability factor was 16-18% growth in earnings per share.

Since the vast majority of the accounting errors we investigated related to the deferral of income, we considered whether ensuring that this profitability factor would be met over a multi-year period had motivated these transactions and policies. We found no evidence that the structure of the Company’s bonus plans had a direct correlation to the results produced by the transactions and policies at issue. However, the process for awarding individual bonuses gave so much discretion to Brendsel that we cannot exclude that possibility. In addition, it is clear that senior management’s grading of certain key employees suggests they were expected to support initiatives that would help achieve the goal of steady, nonvolatile earnings growth consistent with analysts’ expectations.

apparent in our investigation of the anonymous letters. Corporate accounting was at its weakest from late 2000 to late 2001 – a period when neither the Chief Financial Officer nor the Controller was a Certified Public Accountant. Certain employees have indicated that, in closing the books during that period, there was a “check the box” approach to corporate accounting at the Chief Financial Officer level leading to aggressive accounting and in turn to the restatements and reaudits. Senior management was aware of this weakness. The transactions and policies we have investigated were not managed or accounted for properly in part due to this weakness in Corporate Accounting.

The Company’s financial disclosure of these transactions in Management’s Discussion & Analysis (“MD&A”) and in the footnotes to its financial statements was incomplete. The disclosure process appears to have been poorly managed and geared toward expressing to shareholders and the market the conclusions that management thought were representative of Freddie Mac’s business. Freddie Mac employees told us that disclosure of specific transactions or derivative strategies was resisted because of the fear that confidential and proprietary information would be revealed, to the Company’s business disadvantage. Others indicate that the Company benchmarked its disclosure to Wall Street financial institutions, which may or may not have been an appropriate standard. Still others have stated that several key decisions regarding disclosure were made on the basis of incomplete information due to weaknesses in communications among Freddie Mac business units. In any event, substantial strengthening of disclosure policy would have been appropriate.

Burdened by a weak Corporate Accounting department, several business units became reliant on Arthur Andersen, and in particular on Rob Arnall, the engagement partner. Without passing judgment as to the adequacy of Arthur Andersen’s audit and consulting services, it is clear that the Company’s reliance on Arnall and Arthur Andersen did not prevent

numerous errors giving rise to the restatements from occurring. In several instances involving the transactions and matters discussed herein, additional research would have been appropriate, as would less reliance on “non-materiality” considerations. Nevertheless, we believe Arnall acted in good faith in rendering advice to the Company.⁴⁰ We find no evidence that efforts were made to conceal facts from Arthur Andersen. Nor have we found credible evidence of attempts to pressure Arthur Andersen improperly into supporting the desired results.

In sum, what appears to be missing at Freddie Mac was a sufficient boundary, either in Corporate Accounting or at Arthur Andersen, or both, to the corporate goal of nonvolatile earnings growth – a boundary that would help ensure that transactions and other matters were accounted for properly.

B. SFAS 133 AND FREDDIE MAC’S RESPONSE

No sooner had Freddie Mac worked through Y2K preparation than it came up against the next challenge for its financial reporting: This came in the form of a significant change in the accounting rules, Statement of Financial Accounting Standard No. 133 (“SFAS 133”), *Accounting for Derivative Instruments and Hedging Activities*. SFAS 133 required the Company to record derivative instruments on their balance sheet at fair market value (*i.e.*, marked-to-market through income) beginning on January 1, 2001.

In what we saw to be a common theme in many of the transactions investigated, management believed that SFAS 133 should be “transacted around” because it did not reflect the economic fundamentals of the Company’s business.⁴¹ More specifically, the Company believed

⁴⁰ Arnall also cooperated with our investigation, making himself available three times for lengthy interviews.

⁴¹ SFAS 133 is extensive, comprising hundreds of pages of technical guidance. Freddie Mac was not alone in its criticism of the standard as a “one-size-fit-all” approach to a complex subject.

that the transition to SFAS 133 would (i) produce a one-time gain – for which the Company would not receive credit from analysts and investors – by accelerating recognition by pulling earnings forward from future periods; and (ii) create artificial earnings volatility in future periods by requiring the marking of derivatives to market but not permitting the marking to market of the debt economically hedged by such derivatives. As a result, Freddie Mac submitted extensive comments to the Financial Accounting Standards Board raising these issues. Once it became clear SFAS 133 would be implemented, Freddie Mac devoted considerable resources to exploring strategies that would mitigate the effects of the rule change within the limits of GAAP and without significantly changing the Company's Retained Portfolio.

Three of the transactions or policies we investigated were related to the implementation of SFAS 133: the CTUG, the Swaptions Portfolio Valuation, and the J-Deals. They are discussed below.

1. **Coupon Trade-Up Giant ("CTUG")**

a. **Background**

Starting in September 2000, Freddie Mac began tracking the expected one-time gain from the transition to SFAS 133, which was initially forecast at approximately \$300 million as of June 30, 2000. By August 2000, a SFAS 133 working group had been assembled consisting of senior personnel in F&I and other business units (Peter Federico, Vice President Asset/Liability Management; Robert Dean, Senior Vice President Market Risk Oversight ("MRO"); Nazir Dossani, Senior Vice President Investments; Eric Reiser, Director of Financial Engineering; and Horace "Chip" Jordan, Director of Accounting Systems). This group recognized almost immediately that a substantial portion of the one-time transition adjustment gain could be offset under SFAS 133 by taking advantage of a one-time opportunity to reclassify portfolio assets with imbedded losses from the accounting classification held-to-maturity

("HTM") to the classification of trading, producing a loss that would be reported in the transition adjustment line item on the Company's income statement. However, the group also realized that this action only solved half the problem as Retained Portfolio assets reclassified to trading would have to be marked-to-market post-transition in earnings, creating future earnings volatility.

In September through November 2000, initial planning by the SFAS 133 working group led to the realization that the likely solution to Freddie Mac's SFAS 133 problem was a transaction that would allow both a reclassification from HTM to trading and a subsequent reclassification from trading to available-for-sale ("AFS"), an asset classification that does not require marking-to-market through income and thus does not produce earnings volatility.⁴² Freddie Mac then set out to investigate a structured transaction that could be used to achieve this reclassification. After considering a possible REMIC-based transaction, the working group ultimately settled on a transaction structure which would become the CTUG.

As the structure of the CTUG began to take shape, a trend began to emerge that would significantly affect the execution of the CTUG and lead to the Swaptions⁴³ Portfolio Valuation adjustment. The projected SFAS 133 transition gain began to increase, growing to approximately \$700 million by the end of November 2000, primarily as a result of an increase in the value of the Company's swaptions portfolio.

b. Overview of Transaction

The increase in the projected transition gain coincided with the establishment of a more substantial SFAS 133 working group consisting of approximately 20 representatives of F&I, Corporate Accounting, Legal, Tax, MRO, Shareholder Relations, and, perhaps most

⁴² AFS requires assets to be marked-to-market through Other Comprehensive Income ("OCI"), which affects Shareholders' Equity, but not reported earnings.

⁴³ A "swaption" is an option to enter an interest rate swap at some future date or to cancel an existing swap in the future.

importantly, Arthur Andersen. Because the accounting treatment was the essential purpose for the transaction, Chip Jordan, the lead Freddie Mac accountant in the working group, prepared a memorandum dated November 22, 2000 outlining the nine steps that the Company (based on the advice of Arthur Andersen) believed were essential to ensuring that the CTUG achieved the desired accounting result.⁴⁴ The memorandum was disseminated to the entire working group.

The five most important steps were:

- (1) Freddie Mac would enter into a series of forward sale and purchase contracts for its PCs in 2000;
- (2) Freddie Mac would reclassify the PCs from HTM to trading on January 1, 2001;
- (3) Freddie Mac would sell and transfer the PCs to a counterparty pursuant to forward sale and purchase contracts previously executed;
- (4) The counterparty would transfer the PCs to Freddie Mac's securitization group. Freddie Mac's securitization group would take delivery of the PCs and resecure them into a Giant security which would be transferred back to the counterparty; and
- (5) The counterparty would "sell" the Giant received from Freddie Mac's securitization group back to Freddie Mac's Retained Portfolio.

If these steps were properly executed, Freddie Mac believed the following would be achieved: (i) a significant loss would be generated by reclassifying the PCs from HTM to trading and from the forward sale contracts, which operated as a hedge to lock in the amount of loss to be recognized on the transfer of the PC from HTM to trading; (ii) Freddie Mac would retain almost its entire interest in the transferred PCs, with the only difference being that it would hold them in the form of a giant security, *i.e.*, the CTUG; (iii) future earnings volatility would be

⁴⁴ Jordan was no longer employed by Freddie Mac at the time of our investigation, and we were unable to interview him.

avoided because the CTUG would be classified as AFS and thus would not be marked-to-market through earnings; and (iv) future earnings would not be accelerated as the transition adjustment loss would be accreted back into interest income over the next several years.

The CTUG strategy as outlined above was presented to Freddie Mac's senior management in November. Specifically, Leland Brendsel chaired a meeting on November 22, 2000 where the CTUG transaction was discussed. David Glenn, Greg Parseghian, and others also approved a visible, high impact, and unique ("VIU") memorandum authorizing the implementation of the CTUG strategy, including the raising of trading limits so the trades could be effected.

Because the SFAS 133 projected transition adjustment gain continued to increase throughout the end of November and the beginning of December, the CTUG transaction was executed in two separate pieces. The first piece, consisting of forward sale and purchase contracts of approximately \$4 billion in 30-year 6% PCs and \$10 billion in 30-year 6.5% PCs, was executed on November 30.

However, the working group was aware that additional losses had to be generated because increases in the value of Freddie Mac's swaptions portfolio had pushed the projected SFAS 133 transition gain far higher than the \$700 million projected in late November.⁴⁵ Thus, on December 8, 2000, an additional \$6 billion in 30-year 6.5% PCs and \$10 billion in 15-year 6.0% PCs were committed to the CTUG under additional forward sale and purchase contracts.

In total, the CTUG strategy produced \$726 million in losses to offset the SFAS 133 transition gain. The losses had two components: (i) \$425 million relating to the

⁴⁵ The value of the swaptions portfolio continued to increase dramatically throughout December, leading the Company to adopt an alternative valuation method to shrink the transition adjustment gain to an amount that could be offset by the CTUG. See the discussion below for a description of the alternative valuation method.

reclassification of the \$32.1 billion of HTM securities involved in the CTUG from HTM to trading on January 1, 2001; and (ii) \$301 million generated through the forward sales contracts. These losses were booked in the first quarter of 2001.

The structure of the CTUG ensured that Freddie Mac's fundamental investment and risk management position did not change. The Company characterized the CTUG as a new security and classified it in AFS for financial reporting purposes, and the \$726 million loss was treated as a discount and was "accreted" into earnings through interest income as additional yield on the Giants over the life of the Giants. The forward contracts were ultimately settled in February and March 2001.

c. Nature of the Accounting Error

Despite Arthur Andersen's guidance and concurrence, the Company and PwC have determined that the CTUG as executed violated GAAP and departed from the internal guidelines set forth in the November 22, 2000 accounting memorandum. Departure from the internal guidance resulted from operational constraints during the settlement of the transactions in February and March 2001. As noted, the guidelines required that the individual PCs be transferred to the counterparty. However, the Freddie Mac traders executing the transactions faced operational issues caused by the substantial number of PCs involved, and decided instead to transfer the PCs directly to Freddie Mac's securitization group, where they were assembled into the CTUG. The CTUG was then sent to the counterparty, where it remained for a couple of hours before being sent back to Freddie Mac. Although it does not appear that Arthur Andersen was informed of the short cut, Rob Arnall has said in interviews that knowledge of the short cut would not have changed Arthur Andersen's conclusion that the transaction achieved the desired accounting.

These transactional shortcuts exacerbated, but did not cause, the misapplication of GAAP, which the Company and PwC have determined requires the restatement of the CTUG transaction. The Company and its current auditors, PwC, have determined that the transaction fails because the transfer of the CTUG security to the counterparty was not a sale under Statement of Financial Accounting Standard No. 125 (“SFAS 125”), *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. This Statement provides standards for accounting for transfers and servicing of financial assets. Specifically, paragraph 9 stipulates that a “transfer of financial assets in which the transferor surrenders control over these assets is accounted for as a sale, to the extent that consideration other than beneficial interest in the transferred assets is received in exchange.” In other words, the accounting rules required that Freddie Mac surrender control of the assets. This did not happen, as Freddie Mac maintained control over the PCs at the core of the transaction for all but a few hours. In addition, the CTUG transaction did not result in Freddie Mac receiving something other than a beneficial interest in the previously-owned PCs that made up the CTUG security. For these reasons, the Company, with PwC’s concurrence, has determined that the transaction would not qualify as a sale under GAAP.

However, it appears that the errors that have led to the restatement were unintentional, rather than knowing, misapplications of GAAP. Based on the transparency, breadth, and duration of the CTUG planning process, it is obvious that the intent of those involved was to structure a transaction that complied with GAAP. The evidence that Freddie Mac relied on the advice of its auditor – rendered after a full and careful consideration of the transaction – is also uncontroverted. Indeed, Rob Arnall continues to defend the CTUG as GAAP compliant, based on his belief that SFAS 125 does not provide definitive guidance, as the transaction was intended to effect a transfer of the securities, rather than a sale. We also

understand that with certain adjustments to the transaction structure, Freddie Mac could have achieved its accounting objective in a wholly appropriate manner. A lack of accounting expertise within the Company, combined with outside accounting advice, which has come into question, caused the errors which led to the restatement of the CTUG transactions.

d. Governance Failure

It is also apparent that the Company failed to adhere to its own governance requirements in implementing CTUG. The Board was advised on December 1, 2000, that management was exploring potential transactions that would make the SFAS 133 transaction adjustment gain earnings neutral.⁴⁶ However, Freddie Mac's bylaws⁴⁷ require Board Committee approval of any transaction exceeding \$11 billion and reporting of any transaction exceeding \$5 billion. As we have seen, the CTUG was divided into four transactions – \$10 billion, \$4 billion, \$10 billion, and \$6 billion. Only one of the three transactions exceeding \$5 billion was presented to the Board – the \$10 billion transaction executed on November 28, 2001. Gregory Parseghian, Chief Investment Officer and Senior Vice President, briefly reported this transaction to the Board's Securitization Committee. The Chairman of the Securitization Committee related the information received from Parseghian to the full Board at the December meeting. Although the four transactions comprising CTUGs correlate directly to different types of underlying PCs, and thus there was a reasonable business explanation for the division, it is also apparent that this division had the effect of avoiding the need for Board authorization.

⁴⁶ The Board was also told that the one-time transaction adjustment gain was estimated at \$600-\$700 million, and that SFAS 133 was likely to create future earnings volatility up to a maximum of \$.25 per share.

⁴⁷ Bylaw FHLMC 98-13, adopted May 14, 1998, requires Securitization Committee approval of any transaction involving Mortgage-Backed Securities with an aggregate principal amount greater than \$11 billion. Transactions between \$5 billion and \$11 billion do not require approval, but must be reported to the Securitization Committee.

2. The Swaptions Portfolio Valuation

a. Background

As the events of December 2000 unfolded, the SFAS 133 transition strategy was in danger of failing to achieve the corporate objective of substantially offsetting the transition gain. The primary cause was the continuing increase in the value of Freddie Mac's swaptions portfolio. What had been estimated to be a \$700 million gain in early November had become \$1.4 billion by early December. Trying to offset this increase with additional CTUG transactions was not an option, as all PCs with imbedded losses had already been used in the earlier CTUG. In other words, the "cupboard was bare" on the CTUG strategy, and it was clear that the Company needed to look for other means of offsetting the hundreds of millions of dollars in additional, transition adjustment accounting gain.

This conundrum was the subject of a "SFAS 133 Transition Strategy Meeting" on December 8, 2000. The meeting was attended by Vaughn Clarke, the Company's Chief Financial Officer, and senior accounting and F&I personnel, including Gregory Reynolds, Controller; Greg Parseghian; Nazir Dossani; Peter Federico; William Stephens, Vice President Shareholder Relations; and Richard Millerick, Vice President Tax. Five options were considered: (i) changing the method used for valuing the Company's swaptions portfolio; (ii) increasing the SFAS 91 amortization reserve; (iii) an impairment adjustment to the Interest Only ("IO") securities portfolio; (iv) funding the Freddie Mac Foundation with stock; and (v) "not offset[ing] the full amount of the transition adjustment gain in order to strengthen capital."⁴⁸ The swaptions valuation is the only option discussed at the meeting which provides a line item match on the income statement to the transition adjustment gain. While at least one

⁴⁸ While the documentary evidence is silent as to whom came up with the swaption valuation option, at least one participant told us that Arthur Andersen advised a participant to "take a look at how the swaptions are valued."

other option – a contribution to the Freddie Mac Foundation – appears to have been seriously considered, we believe that by December 19 at the latest, it was clear to the key participants that the only strategy capable of meeting the objective was a change in the swaptions portfolio valuation.

Changing the valuation method was not simple. A swaption has no quoted market price per se, so Freddie Mac's practice had been to use implied volatility as quoted from BlackRock, Inc. ("BlackRock") in their swaption valuation models to calculate the fair value of the swaptions portfolio. This practice was disclosed in Freddie Mac's 2000 and 2001 financial reports, which state that the fair value of derivatives is based on market prices and/or current market interest rates and estimates of interest rate volatility.⁴⁹ Similar disclosure was consistently made in the MD&A section of the Company's financial reports.

The approach Freddie Mac developed in December 2000 eschewed the implied volatility as shown by the current market prices on the premise that the spike in implied volatility, which had driven up the value of the swaptions portfolio, was not indicative of the true value of the swaptions because the market was illiquid. In other words, Freddie Mac concluded that the market conditions were abnormal because it would be unable to transact at the prices indicated by the market implied volatility. Instead, Rob Dean and Mustafa Chowdhury developed a valuation technique that looked to historic – instead of current – implied volatility once it was demonstrated that the market conditions were abnormal. The justification was rooted in the assumption that significant day-over-day changes in market volatility are an indication of an "illiquid market." Dean and Chowdhury decided that their method would mark as a "flag" any volatility change of greater than two standard deviations. If there were ten such flags in a

⁴⁹ See, e.g., note 15 to Freddie Mac's Financial Statements for the year ended December 31, 2001.

20-day period, the Dean-Chowdhury method deemed the market illiquid, resulting in the selection of the market volatility existing as of the tenth day prior to the first flag.

Dean and Chowdhury's application of this policy in late December indicated that the proper market implied volatility date was November 20, 2000. The use of the volatility from this date in valuing the swaptions portfolio eliminated \$731 million⁵⁰ from the SFAS 133 transition adjustment gain, reducing it to an amount that could be almost fully offset by the CTUG transaction. The Dean-Chowdhury policy was officially adopted on January 2, 2001 (effective December 2000) through a memorandum by Chowdhury approved by Greg Parseghian, Nazir Dossani and Dean, the true author of the memorandum.

The facts surrounding the valuation policy strongly suggest that it was reverse engineered for the sole purpose of producing a change in valuation sufficient to offset the remaining portion of the transition gain. These facts include the following:

- a. On December 19, Dean stated during an F&I rebalancing meeting that he would be able to develop a model with intellectual merit that would justify an adjustment to market volatility. By December 21, F&I had asked BlackRock, the entity utilized in valuing the Company's derivatives, to model swaption values using the November 20 volatility quote. These actions preceded by 7 to 10 days the occurrence of the tenth "flag" necessary to set the Dean-Chowdhury valuation model in motion.
- b. Although the policy hinged on the premise that the swaptions market had become illiquid, only a cursory effort was made to determine whether other parties were transacting, or whether Freddie Mac would be able to transact at the prices indicated by the current market volatility.
- c. Dean was unable to produce the ten "flags" required by his policy using the BlackRock data that Freddie Mac uses for virtually every aspect of its swaptions business, so he plugged in another data set, Yield Book, in order to produce the requisite number of flags.

⁵⁰ Total impact on transition gain was \$731 million, which represents the difference between the BlackRock Financial Management Model value using December 29, 2000 market volatility of \$2.86 billion and the value as determined by the Freddie Mac Accounting lattice model using November 20, 2000 volatility of \$2.13 billion.

- d. No VIU memorandum was prepared. The Board neither authorized the change nor was informed.
- e. Freddie Mac continued to use current market volatility in all of its other business and risk models, including the model for calculating Portfolio Market Value Sensitivity (“PMVS”), a metric that is reported in Freddie Mac’s financial statements.
- f. The Dean-Chowdhury policy was reversed on February 5, 2001, 39 days after it was adopted. The memorandum reversing the policy, authored by Chowdhury, states that the abnormal market behavior from November 30, 2000 through January 22, 2001 had subsided.⁵¹
- g. The reversal of the policy coincides with a desire by F&I to resume transacting in the swaptions market.
- h. The Company’s public disclosure of its valuation policy was never amended or supplemented to reflect the adoption of the Dean-Chowdhury policy.

Freddie Mac’s Vice-Chairman, David Glenn, and Chief Financial Officer, Vaughn Clarke, were almost certainly aware of the swaptions portfolio valuation change. Arthur Andersen’s engagement partner, Rob Arnall, has stated that the policy change was discussed in a meeting with Glenn and C.E. Andrews, the Arthur Andersen advisory partner. The policy change – and its quantitative significance – was discussed at an April 2001 Asset Liability Management (“ALM”) Forum meeting attended by Glenn. Furthermore, Dean’s performance evaluation for 2000, which was prepared by Clarke and approved by Glenn on or about January 5, 2001, commends Dean for having “reduced size of transition gain from \$1 billion to \$.02 billion by recognizing that swaption valuation was not indicative of where options could be traded due to large imbalance in the market.”

It is equally clear that the Dean-Chowdhury valuation policy was implemented with the advice and concurrence of Arthur Andersen. Interviews indicate that the Dean/Chowdhury approach was presented to Arthur Andersen at a December 20, 2000 SFAS

⁵¹ Greg Parseghian, Nazir Dossani, and Rob Dean approved this memorandum.

133 transition meeting, and that Arthur Andersen indicated that it could “sign-off” on such a model provided it had intellectual merit. Arthur Andersen’s workpapers contain a copy of the January 2, 2001 memorandum, with a statement in Arnall’s handwriting that David Kay, the concurring partner, and John Woods⁵², an Arthur Andersen partner with SFAS 133 expertise, concur in the policy. Arnall stated in his interview that he believed that a deviation from market volatility was permissible under Statement of Financial Accounting Standard No. 107 (“SFAS 107”), *Disclosure About Fair Value of Financial Instruments*, as he believed that quoted market prices were not available for the Company’s swaptions portfolio and a deviation from quoted market volatility within their valuation models was within management’s judgment. Arthur Andersen appears to have placed considerable faith in the expertise of F&I’s senior employees, believing that they were uniquely qualified to determine the most accurate valuation of the swaptions portfolio. However, no written GAAP analysis of the valuation methodology was prepared by Arthur Andersen.⁵³

The swaptions valuation is a telling instance of Freddie Mac substituting reliance on Arthur Andersen for the judgment of Corporate Accounting. The evidence suggests that Corporate Accounting had a limited role in the adoption of the Dean-Chowdhury policy. Jamie Amico, Director of Accounting Policy Advice and Analysis, was briefly consulted regarding the change in the swaptions valuation. In addition, Amico, Greg Reynolds, Brian Green and Chip Jordan are copied on the January 2 and February 5 memoranda. There is no evidence that

⁵² Woods is now an employee of Freddie Mac.

⁵³ It is not clear that all relevant facts were communicated to Arthur Andersen. It appears that Arthur Andersen was not aware of the discussions at the December 8 and 19 meetings regarding strategies for offsetting the unexpected increase in the transition adjustment gain or that the Company had asked BlackRock on December 21 to model the gain using the November 20 volatility. We found no evidence that these facts were intentionally withheld from Arthur Andersen.

Corporate Accounting provided any substantive guidance on the implementation of the policy or prepared any formal analysis of the issues.

b. Nature of the Accounting Error

Arthur Andersen's analysis notwithstanding, the Company has concluded that the Dean-Chowdhury swaptions valuation policy does not comply with GAAP. The valuation requirements for financial instruments with quoted prices are set forth in SFAS 107, which states in relevant part:

. . . quoted prices, if available, are the best evidence of the fair value of financial instruments. If quoted market prices are not available, management's best estimate of fair value may be used on the quoted price of a financial instrument with similar characteristics or on valuation techniques.⁵⁴

Accordingly, only in those circumstances where there are no quoted prices for the financial instruments is management permitted to rely on its best estimate of fair value. As discussed above, Freddie Mac never concluded that market volatility quotes or dealer quotes were unavailable, only that the quotes did not reflect a price at which Freddie Mac believed it would be able to transact. This is not a permitted conclusion under SFAS 107.

This misapplication of GAAP resulted from the results-oriented, reverse-engineered, and opportunistic approach by Freddie Mac in trying to reduce the swaptions valuation to a level which could be offset by the CTUG. However, we do not believe the employees involved knew the policy was inconsistent with GAAP. In this regard, the Company relied on Arthur Andersen, whose audit partner considers himself to have been sufficiently informed of the policy, and who advised that it was consistent with GAAP.⁵⁵

⁵⁴ SFAS 107, Paragraph 11.

⁵⁵ Indeed, Arnall continues to believe that Arthur Andersen's advice was correct.

3. The J-Deals

a. Background

The J-Deals are a set of transactions entered into by Freddie Mac to avoid the effects of earnings volatility resulting from marking-to-market certain derivative swaps and IO securities. This volatility was engendered by accounting standards that, in the opinion of Freddie Mac management, presented a distorted view of the economic performance of its portfolio.

The J-Deals consist of four transactions entered into during the first quarter of 2001. The first two transactions, J006 and J007, were similar in purpose to the CTUG in that they were intended to generate an additional \$20 million (approximately \$.03 per share) in losses to offset the SFAS 133 transition adjustment gain and to achieve a redesignation of the underlying derivatives that would avoid mark-to-market volatility in income going forward. The last two transactions, J008 and J009, were intended to avoid potential downside earnings volatility under Emerging Issues Task Force ("EITF") 99-20, Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interest in Securitized Financial Assets, a new accounting standard which accelerated impairment losses on IO and IO-like assets by subjecting them to Lower of Cost or Market accounting. In practical terms, EITF 99-20 required that all IO impairment losses be recognized immediately, but all increases in fair value would accrete into interest income over the life of the asset. In total, J008 and J009 avoided an anticipated loss of \$226 million (\$.28 per share), which would have been recognized in the second quarter of 2001 if EITF 99-20 had been applied to Freddie Mac's approximately \$10 billion portfolio of IO and IO-like assets. A more detailed description of the transactions is set forth below.

b. Structure of the Transaction

J006. This transaction involved the SFAS 133 reclassification of \$1.9 billion of Freddie Mac fixed-rate collateral from the "held-to-maturity" ("HTM") classification to the

“trading classification” and back to HTM (a non-mark-to-market designation). The effect of the reclassification from HTM to trading was the generation of a \$9 million loss, which was recorded as part of the SFAS 133 transition adjustment.⁵⁶

J007. This transaction involved the SFAS 133 reclassification of \$700 million of GNMA ARM collateral from HTM to trading and \$1.7 billion of AFS to trading and then back to AFS (a non-mark-to-market designation). The effect of this reclassification from HTM to trading was the generation of an \$11 million loss, which was recorded as part of the SFAS 133 transition adjustment.⁵⁷

J008. Freddie Mac’s Retained Portfolio contributed collateral including IOs, POs, and mixed mortgage backed securities from the AFS portfolio to Freddie Mac’s Mortgage Funding (Resecuritization) group. The IOs, POs, and mixed mortgage backed securities consisted of both Freddie Mac and Fannie Mae securities with dissimilar underlying collateral. The resulting resecuritization produced three classes of securities (A, B and C). All classes of the securities were contributed to a Freddie Mac Swap Trust J008. The class C, representing 0.1% of the principal amount of the J008, was sold to an outside investor. The remaining beneficial interest in the securities (classes A and B) were classified as AFS, which allowed Freddie Mac to avoid, in large part, the effects of EITF 99-20.

⁵⁶ The mechanics of the transaction were as follows: Freddie Mac sold fixed-rate collateral, along with interest rate swaps that had amortization schedules tied to the same specific underlying collateral, to a counterparty, who then sent the assets and swaps to Freddie Mac’s Mortgage Funding (Resecuritization) group, who securitized the assets by creating pass-through securities that combined the terms of the two instruments. The securities were held in the J006 trust. Freddie Mac bought 90% of the beneficial interest in the J006 trust from the counterparty and classified the beneficial interest as HTM. J006 consists of various classes, each of which coincides with the final maturity date of each fixed-for-floating swap.

⁵⁷ Freddie Mac sold the GNMA ARM collateral, along with some amortizing basis swaps, which had amortization schedules tied to the same specific underlying collateral, to the counterparty, who then sent the assets and swaps to Freddie Mac’s Mortgage Funding (Resecuritization) group, who securitized the assets creating pass-through securities that combined the terms of the two instruments. The securities were held in the J007 trust. Freddie Mac bought 90% of the beneficial interest in the J007 trust from the counterparty and classified the beneficial interest as AFS.

J009. This transaction involved matching⁵⁸ IO and PO securities which were initially classified as AFS. These securities were then transferred to the Freddie Mac Swap Trust J009 Trust and combined into principal and interest pass-through securities. The security retained its AFS classification following the securitization. J009 was comprised of five classes, each of which contained matched IO/PO combinations. Freddie Mac was the sole investor in the beneficial interest issued by the J009 trust.⁵⁹ As with J008, the intention was to ensure a redesignation that avoided the application of EITF 99-20. Upon the advice of Arthur Andersen, the trust was dissolved in the fourth quarter of 2001.

The J-Deals were well researched and the subject of an extensive planning and approval process. As stated earlier in this report, the overall SFAS 133 transition strategy (of which J006 and J007 were part) was known to the Chairman, Vice-Chairman, and Chief Financial Officer. The Chief Financial Officer was also briefed on the effect EITF 99-20 would have on the IO and IO-like portfolio. These transactions were not presented to the Company's Board in any meaningful fashion.⁶⁰

The consideration of J006 and J007 began during December 2000. By the first week of December, a large working group including key personnel in Corporate Accounting, Legal, Tax, and F&I had been assembled and was working on the structure of the transactions. By December 19, Arnall and Woods of Arthur Andersen had advised that they believed the swap trust structure met accounting requirements. On January 1, 2001, a VIU memorandum was

⁵⁸ "Matching" means IOs and POs with the same issuer, strip series, class, underlying collateral, maturity date and factor.

⁵⁹ The retained beneficial interest was inappropriately classified in trading. The retained beneficial interest should have maintained its original AFS classification.

⁶⁰ At the June 1, 2001 Audit Committee Meeting, management reported briefly on EITF 99-20 and stated that "Freddie Mac executed certain portfolio restructurings to reduce its IO portfolio and thus reduce its exposure to the valuation requirements of EITF 99-20."

prepared and distributed describing business purpose, proposed strategy, proposed trades, and business areas consultation of J006 and J007. The VIU memorandum was approved by two senior F&I executives, Greg Parseghian and Nazir Dossani. The business purpose for the transaction as set forth in the Memorandum was as follows:

Freddie Mac has PCs in the held-to-maturity portfolio with a related economic hedge that will fail to qualify for hedge accounting treatment under the rules of SFAS 133. The hedges are pay fixed swaps, with various expiration dates. The MPM [Mortgage Portfolio Management] desk has outlined a strategy that will result in the retained portfolio maintaining the investment returns associated with this asset without incurring the earnings volatility of having to mark the swap to market.

The VIU Memorandum described the structure of the transactions in the following terms:

Freddie Mac will sell the PCs and swap to a dealer. The dealer would contribute the swap and 90% of the PCs to a trust. The dealer would sell the remaining 10% to qualified investors. The new security will pay the same variable rate received in the swap until the swap expires and thereafter pay the same fixed rate as the PCs.

The memorandum also contained Corporate Accounting's advice as to how the transactions should be executed and set forth the conclusion of the External Financial Reporting group, that "this strategy does not require any special reporting or monitoring provisions." As a result, no specific disclosure of the transactions was included in Freddie Mac's financial reports.

On January 5, 2001, a second VIU memo was approved authorizing the execution of J006 and J007. The transactions were executed that day. In mid-January, a "true sale" opinion was obtained from outside counsel to the effect that the assets covered by J006 and J007 were bankruptcy remote as a result of the transfers underlying the transactions.

Shortly thereafter, essentially the same working group began to develop the structure for J008 and J009. In February 2001, advice was obtained from Arthur Andersen on

the proposed structure, including guidance on the sale requirements of SFAS 125. The process culminated in the preparation of a VIU memorandum dated March 8, 2001, and approved by Parseghian, Dossani and other F&I executives. The memorandum described the business purpose for J008 and J009 by referring to the effects of EITF 99-20, including the “loss of approx. \$226 million will have to be recognized in 2Q 2001 if EITF 99-20 is implemented” on April 1, 2001. The memorandum defined the “Goal” of J008 and J009 as achieving “[m]inimal financial income statement impact on the implementation date of EITF 99-20 [and allowing F&I] to maintain flexibility with ongoing and future optimization of IO business.” J008 and J009 were subsequently executed on March 29 and 30, immediately before EITF 99-20 became effective. Subsequent Arthur Andersen workpapers make clear that all of the relevant facts and the business purpose for the transactions were known to Arthur Andersen during the structuring phase and that Arthur Andersen believed the structures were GAAP compliant. No external disclosure was made with respect to J008 and J009.

c. Nature of the Accounting Error

As with the CTUG, the accounting errors that have led to the restatement of the J-Deals primarily concern the application of paragraph 9 of SFAS 125 and the reclassification provisions of Statement of Financial Accounting Standard No. 115 (“SFAS 115”), *Accounting for Certain Investments in Debt and Equity Securities*. As previously discussed, this paragraph establishes the requirements for treating an asset transfer as a sale, which is the key to achieving the desired accounting treatment for the J-Deals. In short, SFAS 125 requires that the J-Deal trusts have sufficient identity independent from Freddie Mac such that it could be said that Freddie Mac surrendered control of the assets in the trusts. SFAS 125 further requires that the resulting interests received by Freddie Mac be distinct from the assets held by Freddie Mac at the start of the transactions.

The Freddie Mac personnel structuring the J-Deals concluded, with the advice of Arthur Andersen, that the trusts used in structuring the transactions met these requirements. However, a review of the trusts with the benefit of the advice of PwC has led the Company to conclude that while J006 and J007 met sales treatment under SFAS 125, Freddie Mac could not achieve a reclassification from trading to AFS under SFAS 115. Freddie Mac essentially received back a beneficial interest in the same assets that it held at the start of the transactions. As a result, the assets could not be considered as making a transition from trading to HTM and AFS. J008 and J009 fail because the trusts, which are essentially synthetic special purpose entities, were not legally distinct from Freddie Mac. These errors appear to us to have been a good faith misapplication of GAAP on the part of Freddie Mac.

However, it is equally clear that the J-Deals are another set of transactions whereby Freddie Mac attempted to transact around accounting standards that it felt did not fairly reflect the true economics of its business. Corporate Accounting lacked the necessary skill sets to analyze the relevant accounting literature on its own, and apparently could not evaluate properly the advice the Company received from Arthur Andersen.

4. Failure To Disclose Fully The SFAS 133 Transition Strategy

In its disclosure of the SFAS 133 transition, Freddie Mac relied on general statements which failed to convey the size of the gross transition adjustment gain and the substantial transactions that had been required to offset it. This general disclosure was consistent with other instances we observed where Freddie Mac sought to avoid making any disclosure that would require subsequent explanation or lead investors to draw any conclusion other than the one management believed best reflected the economics of the Company's business. With respect to the SFAS 133 transition strategy, this practice emerges from the first disclosure in the 2000 IS, which states in relevant part:

Freddie Mac currently expects that the one-time, net cumulative after-tax adjustments required by SFAS 133 will affect "Net income" by no more than \$25 million, and decrease the AOCI component of "Total stockholders' equity" by approximately \$2.5 billion.

This disclosure was slightly expanded in the IS for the first quarter of 2001, which

states:

The one-time cumulative, net cumulative after-tax adjustments required by SFAS 133 resulted in an increase to "Net income" of \$5 million. The increase to "Net income" primarily resulted from gains recognized in measuring certain derivatives at fair value, partially offset by losses resulting from a portfolio restructuring related to certain securities transferred from held-to-maturity.

It was not until the release of the 2001 IS in March 2002 that Freddie Mac made any specific disclosure of the size of the components that produced the small net transition gain, stating:

On January 1, 2001, Freddie Mac transferred approximately \$36 billion of PCs from the held-to-maturity portfolio to the trading portfolio, generating a \$708 million loss reflected as a component of the SFAS 133's cumulative change in accounting principle. Additionally, as part of the SFAS 133 transition adjustment, Freddie Mac transferred \$59 billion of PCs from the held-to-maturity portfolio to the AFS portfolio, resulting in a \$419 million gain in AOCI (\$272 million net of tax).

At no time did Freddie Mac make any specific disclosure of the gross amount of the transition gain, or the key role of the change in the swaptions portfolio valuation in reducing the gain to an amount that could be offset by the CTUG transaction. To the contrary, Freddie Mac never expressed exceptions to its valuation disclosure, continuing to state generally that it used market estimates of volatility to value its swaptions.

As part of our investigation, we sought to determine how these disclosure decisions were made and what the motivations were of the persons involved. We were only partially successful, primarily due to a lack of recollection of some of the key personnel

involved, including Lisa Roberts, who had overall responsibility for Freddie Mac's External Financial Reporting group. We do, however, know the following. In early February 2001, a meeting was held that was likely attended by Robert Rodgers, Manager of External Financial Reporting, William Stephens, outgoing Director of Shareholder Relations, Josephine Umana, Director Reporting, Jamie Amico, then Director Financial Reporting, and Jeff Harris, Vice President Corporate Accounting. An e-mail prepared by Umana summarizing the meeting was distributed on February 6, 2001. It states:

During a meeting last week on SFAS 133, I believe it was decided that the 2000 MD&A would include some disclosure of "components" of the net SFAS 133 transition gain. We will also provide some information about these components during the 1Q01 Earnings Conference Call.

Pursuant to this e-mail, Tracy Abruzzo, a manager in Corporate Accounting, was tasked with preparing the draft disclosure. Her draft, which we believe was prepared during the second week of February, discusses the transition in far greater detail than was ultimately included in the 2000 IS:

The SFAS 133 net transition gain, which will likely increase "Net Income" by approximately \$10 million to \$20 million, is comprised of several offsetting components. Approximately \$700 million of the transition adjustment results from recognizing the time value gains on all fair value (should we say options based?) derivative hedges outstanding at January 1, 2001. Going forward, time value gains on fair value derivative hedges will be recognized in current income. In addition, approximately another \$100 million in gains arise from recognizing the derivatives treated as off-balance sheet pre-SFAS 133 and forward settling options at fair value. These transition gains will be offset by a fair market valuation loss of approximately \$750 million recognized under the SFAS 133 one-time election to reclassify mortgage assets from the held-to-maturity portfolio to the available-for-sale and trading portfolios. The remainder of the transition adjustment reflects the mark-to-market gain for certain forward sold swaptions.

None of the persons involved in the disclosure process has been able to explain why Abruzzo's draft was edited to remove the discussion of the "components" of the SFAS 133 transition adjustment gain, or when the decision to disclose the components reflected in Umana's e-mail was reversed. We do have very limited documentary evidence. Abruzzo's hard copy of Umana's February 6 e-mail contains the following notations in Abruzzo's handwriting: (i) "Gain on deriv. swaptions – Coupon trade-up – B[alance]/S[heet] restructuring"; (ii) "Make sure it's required + how much"; and (iii) "sensitivity in describing coupon trade-up strategy." Abruzzo has acknowledged that the note is in her handwriting, but does not recall what the "sensitivity" was or who expressed it to her.

We also know that the second decision referenced in Umana's e-mail, providing information on the components of the gain for the first quarter earnings call, was also reversed. Vaughn Clarke's talking points for the call, prepared under the auspices of Shareholder Relations, contain the following notation:

Internal Note: We do not plan to discuss the specific items/amounts that resulted in our small net transition adjustment to earnings as part of the Earnings Release/Conference Call. However, in our 1Q01 Information Statement Supplement (or ISS, which is the equivalent to SEC Form 10-Q) to be released in mid-May, we will be required to provide some detail.

Neither Clarke, nor the Shareholder Relations personnel, could recall how this decision was made or the reasons for it. They also could not recall why no "detail" was provided in the First Quarter ISS, despite the apparent decision to include it.

The accounting literature appears to require detailed disclosure beginning with the first quarter 2001 ISS. A speech by then SEC Chief Accountant, Lynn Turner, on April 3, 2001, suggests that disclosure of information regarding the adoption of SFAS 133 was required in the period of adoption of the standard, including, by implication, disclosure of any reclassifications

of SFAS 115 securities relating to the adoption of SFAS 133. Paragraph 17(f) of SFAS 140, which became effective during the first quarter of 2001, specifically requires that the gain or loss from sale of financial assets in securitizations be disclosed. Material referencing the Lynn Turner speech was in Rodgers' files.

C. EARNINGS-DRIVEN ADJUSTMENTS

Two of the issues we were asked to examine as part of our Phase Two investigation were the Company's practices with respect to a reserve account known as the "SFAS 91 Reserve," and the Company's practices with respect to the "loan loss reserve." Our investigation into these issues then opened up broader issues relating to the Company's reserving practices generally. These issues are discussed below.

1. Two to Three Cents: Adjustments to Reserves in Relation to Analyst Expectations

a. The Practice

According to numerous employees and contemporaneous documentary evidence, there was a long-standing practice at Freddie Mac of making discretionary accounting judgments with a view toward producing financial statements that more closely approximated analysts' estimates. Those involved in the practice report that they believed they were free to do so under GAAP so long as the amounts involved were not quantitatively material. The practice began several years ago at least, and during that time appears to have had the general effect of moving earnings to within a penny or two of analysts' estimates of earnings per share ("EPS").

The practice was directed primarily at a series of reserve accounts – especially the SFAS 91 amortization reserve, the legal or general contingency reserve, and the tax reserve.⁶¹

⁶¹ According to employees, the same philosophy of managing toward estimates informed discretionary management decisions such as periodic decisions to fund the Freddie Mac Foundation. The loan loss reserve

After the results of operations for a given month were prepared through standard processes, they were summarized on a form called a "flash report." Also included on those reports were reserve amounts, typically generated through internal models (in the case of the loan loss reserve and the SFAS 91 amortization reserve) or through judgments emanating from outside Corporate Accounting (in the case of the legal reserve).⁶² Finally, the flash reports included analysts' estimates of EPS for the Company.

The structure of the flash reports allows the reader to determine the EPS impact of so-called "Decision items" (or "Decision Adjustments"), and facilitates a comparison of that figure with the analysts' estimates of EPS. According to at least some employees, the flash reports were in fact used for that purpose.

On the not infrequent occasions when the figures from early flash reports diverged from analysts' estimates by more than a penny or two,⁶³ Greg Reynolds related that he would discuss the estimates with the Chief Financial Officer (either Vaughn Clarke or John Gibbons). The Chief Financial Officer would ask if Corporate Accounting could develop a justification for adjusting the reserve. Reynolds said that if Corporate Accounting had a legitimate justification, the adjustment would be made. Reynolds conceded that the rationale for these adjustments often was not very well documented.

In carrying out the direction to develop a justification for a desired adjustment, lower-level Corporate Accounting employees advise that they did not make numbers up, but

account does not appear to have been actively managed in the same fashion, but can be considered part of the story, as it was maintained at levels exceeding what was permissible under GAAP (SFAS 5).

⁶² In the case of the tax reserve, Corporate Tax would prepare a range for the reserve and provide it to Corporate Accounting. Thereafter, Corporate Accounting would determine the amount to be booked from within the range provided by Corporate Tax.

⁶³ These adjustments involved both increases and decreases to EPS. Exhibit B to this Report contains graphs illustrating the effect over time of this practice.

instead searched for a rationale for the adjustment that was consistent with GAAP. We have found no case where a Freddie Mac employee advised us that they were pressured to concur with an adjustment that was known to be incorrect or baseless.⁶⁴ Final decisions regarding reserves were made at the level of the Controller and the Chief Financial Officer.

Our investigation indicated that these reserve adjustments took place at the margin – involving amounts regarded by Freddie Mac’s employees as immaterial. We found no evidence of an adjustment of this nature that exceeded \$37 million, and no occasion when adjustments to the four principal reserves at issue, in aggregate, had the effect of moving the Company’s earnings by more than five cents per share.

b. Knowledge Within the Company

The reserving practices at issue were centered in the Company’s Corporate Accounting department. However, knowledge of the process (at least in a general sense) extended outward to other business units of the Company, and upward to senior management.

For example, in an e-mail dated June 12, 2001, Peter Zou, Senior Portfolio Director, discusses the Company’s progress toward its earnings target with Lisa Roberts. In this regard, Zou states: “The 2q consensus is \$1.00 per share, and [Chief Financial Officer] Vaughn [Clarke] was thinking about \$1.04 per share I met with Joe Amato of Shareholder Relation last week and he was comfortable with . . . \$1.02-1.03 operating EPS.” Zou concludes: “Assum[ing] \$1.03 per share of operating EPS, CA probably does not need to generate any loss.”⁶⁵

⁶⁴ As discussed below in the section on the loan loss reserve, however, there were occasions when lower-level accountants raised serious questions about the reasonableness of some of the reserve figures – sometimes in strong terms.

⁶⁵ In an interview, Zou confirmed that (to his knowledge) the mechanism by which Corporate Accounting “generated losses” was through the type of reserving practices outlined above.

Similarly, notes from a Senior Staff Meeting on December 16, 1998⁶⁶ discuss the fact that NII for the period is exceeding forecast. In this context, the notes state: "This can be offset by a change in assumption around the accounting amortization of debt concession fees (currently over life of the debt but should be amortized much faster). John Gibbons to make this decision which will offset NII increase by 3 cents/share."

Notes kept by Usha Chaudhary, at the time a Vice president and assistant to Glenn, from a "dry run" held on May 21, 1999, in advance of a presentation to the Audit Committee, state: "We have managed earnings via reserves but that is not frequent or significant/material, *i.e.*, several cents." This statement was made in the context of a discussion of the SEC's concerns regarding reserves and earnings management. The notes reflect that those in attendance at the dry run included Leland Brendsel, General Counsel Maud Mater, John Gibbons, Greg Reynolds, and Mel Kahn, Senior Vice President/General Auditor. The materials presented to the Audit Committee contained no such explicit statement.

Diaries maintained by David Glenn's Chief of Staff, Robert Ryan, likewise contain a number of references throughout 2001 to the Company's activities in "shifting income." These notes also reference a conversation with Greg Parseghian in which Ryan attributes to Parseghian the opinion that he "needs help in earnings management of \$1.3b above current target (5.37 vs. 7.14). He can manage \$1.1b. needs help with \$200m some sort of reserve account."⁶⁷ Another entry from Ryan's notes (dated November 15, 2001) provides:

⁶⁶ Among those in attendance at this meeting were former Chief Operating Officer David Glenn and former Chief Financial Officer John Gibbons.

⁶⁷ Parseghian has acknowledged that he was aware of the use of reserves to meet earnings goals, but understood that these reserves were being managed consistent with GAAP.

“Accounting discipline is being lost. Andersen is concerned. Trying to hit an earnings number.”⁶⁸

Although these reserving practices were widely known throughout the Company, they were never clearly presented to the Board. An indirect reference to the practice was included in a presentation by Nazir Dossani to the Investment Committee on June 1, 2001 entitled “Managing the Time Pattern of Net Interest Income Recognition.”⁶⁹ One of the presentation slides states that management is “actively pursuing strategies to meet our long-term objective of stable and growing NII,” and identifies one of these strategies as “Reserve and G&A-related actions.”⁷⁰ No comparable presentation was made to the Audit Committee.

c. Involvement of Arthur Andersen

Arthur Andersen reviewed the Company’s reserving decisions on an annual basis, and (on at least one occasion) during a mid-year quarter. In an interview, Rob Arnall reported that he knew of such reserve adjustments and that his review consisted of satisfying himself that the reserves appeared to be moving in the proper direction.

d. Conclusions

The Company’s acknowledged practices with regard to reserve accounts reflect a lack of accounting discipline. The adjustments appear to have been driven more by the desire to achieve earnings targets than by a balanced and documented assessment of the underlying

⁶⁸ In interviews with the investigative team, each of Brendsel and Glenn repeatedly stated that (prior to our investigation) he had no knowledge that the Company used reserves as part of an effort to hit earnings forecasts. The weight of the evidence, particularly the statements of employees, is to the contrary.

⁶⁹ There were no accountants on the Investment Committee.

⁷⁰ The other strategies identified were “reducing convexity risk” and “buying back high-coupon debt.”

probable loss considerations on which GAAP requires such reserves to be based.⁷¹ We find the employees to be sincere in their belief that they did not knowingly violate GAAP, but the Company's focus on earnings results had that effect.

2. SFAS 91 Amortization Reserve and Engine

a. Background

One of the reserve accounts that was most prominent in the practice outlined above was the "SFAS 91 Reserve," which Freddie Mac maintained for a number of years prior to 2002. The Company's maintenance of that reserve is problematic in two respects beyond the practice of making periodic adjustments to the reserve with a view toward bringing the Company's reported earnings more closely in line with analysts' estimates. First, the very existence of the reserve was not permitted under SFAS 91, and the Company was so advised by the external auditors (who did not regard the issue as material). Second, there was one occasion in March 2002 when the Company departed from its previous practice and used a different methodology in calculating the reserve, again apparently with an eye to the impact this would have on reported earnings.

b. Overview of the Reserve

In 1988, Freddie Mac implemented Statement of Financial Accounting Standard No. 91 ("SFAS No. 91"), *Accounting for Loan Origination Costs*, which required the Company to recognize loan fees, premiums, and discounts as an adjustment over the life of the loan. Given the nature of the mortgage business, Freddie Mac anticipated that a certain portion of its loans would be prepaid, and therefore incorporated an estimate for prepayments when amortizing fees,

⁷¹ SFAS 5, *Accounting for Contingencies*, requires that an accrual be made when both of the following conditions have been met: (i) information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements; and (ii) the amount of loss can be reasonably estimated.

premiums, and discounts. When estimated prepayments differed from the actual prepayments, Freddie Mac is required under SFAS 91 to make a catch-up adjustment to the income statement.

In order to comply with SFAS 91, Freddie Mac created an Excel-based model to estimate the level of anticipated prepayments and to calculate the amount of the catch-up amortization adjustments. The model proved to be volatile as changes in prepayment speeds often caused large swings in the resulting catch-up adjustment. Faced with this increasing volatility, John Gibbons, the Chief Financial Officer at the time, concluded that the model was weak and outdated, and in 1994, he directed the Financial Research Group to enhance the amortization model. After a six-month process, the Financial Research Group determined that the needs of the Company would be better served by a new model using a range of estimates. As the new model was based on a range of estimates, the Company decided to create a reserve to absorb the differences between the estimated and actual prepayments.⁷² Freddie Mac decided to record the catch-up adjustments to the reserve rather than booking them to the income statement as required under SFAS 91.

From 1994 to June 2002, Freddie Mac's policy was to maintain a reserve that was between 1 and 2 standard deviations from the base case that was generated by the amortization model. If the reserve fell outside 1 and 2 standard deviations from the base case, the Company's policy required the excess amount to be booked to the income statement.⁷³ In comparing the

⁷² The creation of the reserve coincided with an unexpected favorable tax event related to a contingent interest that resulted in approximately \$200 million of income. The Company used the approximately \$200 million to establish a contra-asset on the balance sheet, the SFAS 91 reserve.

⁷³ On a quarterly basis, after the model generated the results, the amount to be recorded to the reserve was discussed at the Chief Financial Officer meetings. Representatives from Corporate Accounting, F&I, Shareholder Relations, Corporate Forecasting and Financial Reporting attended the meetings. Representatives from these business units would provide a recommendation of the reserve amount and an analysis of the effect of the recommendation on the analysts' expectations. Often after the meetings, the Controller would provide the Chief Financial Officer with his recommendation of what amount should be booked to the reserve. The Chief Financial Officer would then make the final decision.

actual reserve balance to the 1 to 2 standard deviations from the base case on a quarterly basis from 1994-2001, the Company maintained a reserve that often fell outside the 1 to 2 standard deviations. In these instances, Freddie Mac never booked the excess amount to the income statement as part of its normal quarterly process.

The reserve was fully assessed as part of Arthur Andersen's audit. Arthur Andersen advised the Company that the reserve was inconsistent with the requirements of SFAS 91. Despite the knowing departure from SFAS 91, Arthur Andersen allowed the Company to maintain the reserve because the audit team viewed the reserve in the context of the net realizable value of the asset on the Company's balance sheet.⁷⁴ Moreover, Arthur Andersen deemed the amount of the reserve to be immaterial.

As the size of the reserve increased, Arthur Andersen became uncomfortable with the process.⁷⁵ In the second quarter of 2001, Rob Arnall expressed his discomfort with the reserve to Lisa Roberts and indicated that Freddie Mac should eliminate the reserve. Ultimately, Freddie Mac and Arthur Andersen negotiated a compromise and agreed to narrow the acceptable amount of the catch-up adjustment recorded each quarter to the balance sheet to +/- \$25 million. This band was utilized from the second quarter of 2001 through the second quarter of 2002. In June 2002, Freddie Mac fully depleted the reserve and recorded the remaining reserve amount to the income statement.

The Audit Committee received Key Financial Reporting Estimates Presentations every quarter, from June 1, 1998 through the second quarter of 2001, in which the SFAS 91

⁷⁴ Arthur Andersen felt that the carrying value of assets associated with the Unpaid Principal Balance, including the net effect of the premiums and discounts, was conservatively stated.

⁷⁵ In the fourth quarter of 1999, the reserve reached its highest level at \$216 million. In the third quarter of 2000, Arthur Andersen recommended that the reserve be reduced by \$11.5 million because the reserve had exceeded the 1 to 2 standard deviations from the base case for several quarters. In the fourth quarter of 2000, the reserve decreased to \$131 million, and by the first quarter of 2001, it had been reduced to \$18 million.

reserve was one of the reserves discussed. The presentation identified the rate of expected prepayments and stated whether the amortization reserve estimates (i) were adequately positioned to absorb the prepayment volatility or (ii) needed to be increased over several quarters.

Neither the Audit Committee nor the Board were told that the reserve was a departure from SFAS 91. Freddie Mac stated in the footnotes to its financial statements that it amortizes premiums, discounts, and deferred fees principally to interest income over the estimated lives of the underlying mortgages using the interest rate method.

Freddie Mac considered its use of this reserve justified because it believed that the modeling was flawed and (as a result) would have produced misleading volatility if the catch-up adjustments had been booked to the income statement (as SFAS 91 contemplates). It appears that another reason why the Company maintained the reserve, however, was that it proved to be a useful tool in pursuit of the Company's objective of steady, nonvolatile earnings growth.

c. Substitution of the Flat-Yield Curve

One of the key assumptions used in the SFAS 91 model to estimate the amount of the catch-up adjustment is the interest rate yield curve, which can vary significantly depending on the date and methodology used. From 1998 through 2002, Freddie Mac changed its interest rate methodology six times, but there is no documentation to support the rationale for such changes. A number of employees in Corporate Accounting stated that the model was flawed and that no one understood how the process really worked. Until 2001, there was no significant pressure for the Company to update the model because even though the reserve was often outside the 1 to 2 standard deviations, the Company never recorded the excess to the income statement. With the implementation of the +/- \$25 million range, Freddie Mac now faced potential income statement volatility since any amount outside the range would be booked to the income

statement. Peter Zou also began to focus on the reserve because the establishment of the +/- \$25 million range had a potential impact on the Company's NIM forecasts.

Given this heightened scrutiny of the SFAS 91 reserve, Corporate Accounting began performing multiple runs of the model to determine the impact of various assumptions on the results. Despite the multiple runs, Corporate Accounting typically used interest rates from the last Tuesday of every month. The Company followed this policy but for one notable exception in March 2002.

In the first quarter of 2002, Freddie Mac became aware that its NII would significantly exceed forecasted results, and therefore, outpace analyst earnings expectations. As part of the multiple run process, Corporate Accounting used a 60-month forward yield curve, which indicated that the Company would have an additional \$141 million of income, thereby exacerbating the NII situation. Corporate Accounting provided the results to Zou, who questioned the reliability of the \$141 million number given the previous month's model result. Zou contacted Bob Davis in Corporate Accounting and asked him to research the numbers. One of the options that Davis and his supervisor, Steve Bledsoe, considered when reviewing the \$141 million number was a flat-yield curve. Bledsoe raised the issue of a flat yield curve with PwC, who had recently signed on as Freddie Mac's new auditors. PwC told Bledsoe that some of their clients had used flat-yield curves but cautioned that those clients' businesses were distinct from that of Freddie Mac.

PwC did not approve the use of the flat yield curve. Nevertheless, shortly thereafter, Corporate Accounting, at the direction of Davis, inserted the flat-yield curve into the model. The flat-yield curve decreased income for the first quarter of 2002 by \$141 million and increased income by a comparable amount in the second quarter of 2002. A flat yield curve had

never been used with the model prior to March 2002. In April 2002, Corporate Accounting inserted a spot rate into the model.

Freddie Mac was willing to use the one-time flat-yield curve to (i) minimize the impact of the SFAS 91 amortization model and (ii) eliminate the anomaly of the \$141 million of income. The knowing substitution of the flat yield curve violated GAAP's principle of consistency. Bledsoe and Davis never discussed the flat-yield curve with Edmond J. Sannini, the Company's Controller. The use of the flat yield curve was also not disclosed to the Board.

d. Conclusions

The individuals involved in the substitution of the flat yield curve assert that they had sincere concerns about the accuracy of the results originally produced by the Company's SFAS 91 model. We find those assertions credible. At the same time, however, these individuals acknowledge that they were also influenced by the fact that the results originally generated by the model had such a significant impact on the Company's financial statements. As with the establishment of the reserve and the quarterly adjustments made to it, the substitution of the flat yield curve appears to have been undertaken (at least in part) with the objective of bringing the Company's reported earnings more closely into line with analysts' estimates.

3. Loan Loss Reserve

a. Background

Our investigation also focused on Freddie Mac's maintenance of the "loan loss reserve," a reserve designed to cover potential losses in the Company's mortgage portfolio. In the late 1990s, actual loan losses decreased, but the Company did not reduce its loan loss reserve. The Company viewed its rapidly growing Total Mortgage Portfolio as a proper justification for a high loan loss reserve level, despite the existence of substantial internal debate over whether

such a high level was justified. In 2002, the Company reduced the loan loss reserve by approximately \$250 million after PwC advised that the level was not in accordance with GAAP. Our investigation indicates that while the Company maintained its loan loss reserve at levels in excess of those authorized by GAAP, this does not appear to have been driven by concerns of earnings management. Rather, it appears to have been the product of excessive conservatism grounded largely in the Company's historic loss experiences in the early and mid-1990s.

b. Relevant Facts

In 1990, the Multi-Family Division incurred large unexpected loan losses that exceeded its reserve by approximately \$100 million. This event concerned the Audit Committee and senior management, and they wished to avoid having to explain such an unreserved loss again.

As a result of this experience, Corporate Accounting was directed to improve the model used to predict the level of loan losses. Greg Reynolds was principally responsible for this initiative. Throughout the 1990s, the model was refined. Jesse Abraham and his staff in the Single-Family Division were responsible for operating the model.

From 1994 to 1997, actual loan losses increased dramatically, which resulted in Freddie Mac recording increases in the loan loss reserve. Beginning in 1997, however, the improved national economy led to fewer defaults and lower loan losses. The Company nevertheless chose to maintain the loan loss reserve at a high level.

In 1998 and 1999, actual loan losses continued to decline despite the rapid growth of the Total Mortgage Portfolio. Despite its improving loss experience, the Company feared that a reduction of the loan loss reserve would expose the Company to unexpected losses similar to those incurred in 1990.

The loan loss reserve level was set through a three-part process. First, Corporate Accounting presented estimates to the Chief Financial Officer. The loan loss reserve estimates were based on the analysis performed by the Single Family and Multi-Family Divisions. Second, as part of the quarterly “dry runs” for the Audit Committee meetings, Brendsel and Glenn would receive estimates from Corporate Accounting for the loan loss reserve through the “Key Financial Reporting Estimates” presentation. Finally, this presentation would be made to the Audit Committee.

The “Key Financial Reporting Estimates” presentation developed by Corporate Accounting included three possible reserve levels: “Minimum GAAP,” “EM Standard,” and “Adverse Case.”⁷⁶ For each quarter, the loan loss reserve level approached or exceeded the Adverse Case. To account properly for contingencies, SFAS 5 requires that the loss be both “probable” and “reasonably” estimable. The relevant Freddie Mac employees appear to have departed from these standards.

There was substantial internal debate between Jesse Abraham’s group and Corporate Accounting over the appropriate level of the loan loss reserve. In his interview, Abraham reported that officials in Corporate Accounting, including Reynolds, frequently asked him to “shock” the model, resulting in more pessimistic results and a justification for a higher reserve level. In July 1999, a memorandum from Abraham’s staff states that Reynolds asked the staff to run a “fourth EXTREME pessimistic scenario [sic]” which included the “lowest historic fair value we’ve seen in the U.S.” In response to this request, Carol Griffith of Abraham’s staff sent an e-mail to Lynn Oliver in Corporate Accounting stating that “[w]e (Jesse Abraham and Staff) consider the probability of the extreme pessimistic scenario, while not zero, to be

⁷⁶ Beginning June 7, 2002, these levels for all reserve accounts were renamed “base low,” “best estimate” and “base high.”

extremely low.” Others in Corporate Accounting, including Jeff Harris, Lynn Oliver, and Lisa Roberts, reported that they felt pressure to avoid a repeat of the 1990 experience even though they felt that the reserve level was too high.

In reports to the Audit Committee, the Company’s loan loss reserves were stated to be quite conservative. For example, the Audit Committee was informed on a number of occasions that actual loan losses were in decline in the late 1990s.⁷⁷ In March 2001, the Audit Committee was informed that “the current reserve balance is well in excess of the most probable case.” In September 2001, the Audit Committee was informed that “the adverse case [of the loan loss reserve scenarios] reflects an immediate economic recession across all regions We consider this highly unlikely.”⁷⁸ There is no indication, however, that the Audit Committee was ever advised that the loan loss reserve was in danger of violating GAAP. To the contrary, on June 4, 1999 Reynolds informed the Committee that “Freddie Mac’s methodologies and standards for measuring reserve requirements are consistent with GAAP and SEC guidance.”⁷⁹

In its 1999 workpapers, Arthur Andersen concluded that “reserve calculations are within the parameters set forth by senior management, based on reasonable assumptions and that the existing reserve balance is adequate but not excessive.”⁸⁰ When interviewed, Rob Arnall

⁷⁷ A September 11, 1998 presentation to the Audit Committee states that “[p]rincipal losses continue to decline, largely due to the strength of the economy and loss mitigation initiatives.” This language was substantially repeated in at least ten later presentations to the Audit Committee.

⁷⁸ A similar statement was included in the June 2001 presentation to the Audit Committee – “[g]iven that the current reserve balance continues to be well in excess of the most probable case, we are adequately reserved even if a more significant economic downturn were to occur. The Adverse Case reflects an immediate economic recession across all regions of a magnitude worse than California in the mid-1990s....We consider this highly unlikely due to strong house price appreciation in all regions of the country and loss mitigation policies.”

⁷⁹ The former chair of the Audit Committee, Russell Palmer, indicated in one Board meeting that the Company might at some point be challenged by the SEC to defend the reserve level.

⁸⁰ In December 2000, the Arthur Andersen workpapers state that “AA LLP has concluded that the Company has applied consistent and supportable judgment in determining its reserve needs, and that those loan loss reserves recorded are adequate and reasonable.”

stated that Arthur Andersen gained comfort with the reserve by measuring the reserve level as a percentage of the Total Mortgage Portfolio.

The Company externally disclosed the amount of the loan loss reserve on the balance sheet each quarter as well as offering an explanation in its financial reports. The disclosure remained substantially the same over the years. For example, in 1999, the disclosure states that "Management maintains the corporation's . . . Reserve for Mortgage Losses at levels it deems adequate to absorb estimated losses incurred on the total mortgage portfolio." The loan loss reserve level was also disclosed to OFHEO.⁸¹

c. Conclusions

For a number of years, the Company's loan loss reserves were consistently maintained at levels higher than those permitted by GAAP. This appears to have been the result of what can (in hindsight) be described as excessive conservatism, but we can not exclude the possibility that it was motivated by earnings objectives.⁸² The basic facts showing a divergence between the Company's loan loss reserves and its actual probable losses were widely known within the Company. As with many of the other subjects of our investigation, however, it appears that the Company, senior management, and the Board received inaccurate advice from internal and external accountants as to whether the Company's practices in this regard were in compliance with GAAP.

⁸¹ For example, in December 1999, the Company informed OFHEO that "[l]oan loss reserves are maintained at a level that in management's judgment are adequate to absorb probable losses embedded in the retained and sold portfolios."

⁸² Although the reserve levels may have been determined with a view toward their impact on reported earnings, the evidence on this point is not clear. For example, the high level of the reserve may have been attractive because it provided flexibility in the event the Company had to adjust its other reserves. On the other hand, former Chief Financial Officer John Gibbons believes it was understood that the loan loss reserve would not have been available to cushion an earnings shortfall.

D. “THE LINKED SWAPS” AND THE MANAGEMENT OF “OPERATING EARNINGS”

1. Background

In the second half of 2001, Freddie Mac entered into a series of transactions known as the “Linked Swaps,” which had the effect of transferring approximately \$420 million in operating earnings from 2001 into later years.⁸³ The transactions had minimal business justification other than the shifting of operating earnings. These facts raise concerns because at the time the Company had identified “operating earnings” as the key financial metric to which the market should refer as reflecting the true economics of the Company, on a basis comparable with its competitor, Fannie Mae. The Company also elected to continue with the transactions in the face of concerns, expressed by in-house accountants as well as the external auditors, that the transactions could be construed as improper earnings management.

2. Overview of Transaction

In the summer of 2001, as a result of an unanticipated steepening of the interest rate yield curve, Freddie Mac realized net interest income (“NII”) on earnings assets⁸⁴ far in excess of what had been projected. This topic was addressed in an Asset Liability/Management Forum (“ALCO”) meeting on August 7, 2001.⁸⁵ The minutes of the meeting reflect that, as of that time, NII “was \$5.87 per share, which is \$0.89 per share higher than plan.” The minutes summarize a report by Greg Parseghian that “a continuing challenge for Freddie Mac is managing the tradeoffs between achieving current period earnings, managing risk and meeting

⁸³ This investigation uncovered the Linked Swaps through interviews, and brought them to the attention of the Audit Committee and PwC.

⁸⁴ NII on earning assets is the difference between the Company’s interest income on all of its earning assets and interest expense on all its interest-bearing liabilities.

⁸⁵ According to the minutes of the meeting, attendees included David Glenn, Greg Parseghian, Paul Peterson, Nazir Dossani, Vaughn Clarke, Rob Dean, Bob Ryan, Byron Boston, Gary Kain, Jim Hendricks and Dan Dugan.

future period earnings expectations. We have enjoyed enormous success this year and in past years, which has raised the bar for future years as far as meeting earnings expectations.” The minutes reflect that those in attendance “decided to take up this discussion outside this meeting.”

Based on the recollection of those in attendance, it appears that a follow-up discussion took place immediately after the conclusion of the scheduled business of the ALCO meeting. There are no minutes or notes to document who attended or what transpired at this follow-up meeting, but based on witness recollection and subsequent events, it appears that either at this meeting, or at some time closely proximate, Vaughn Clarke approached two F&I managers – Nazir Dossani and Peter Federico – and directed them to develop a strategy for addressing the unanticipated surplus of NII.⁸⁶

Thereafter, Federico, working with Dossani and others at F&I, developed the idea of the “Linked Swaps” – also known as the “Key Rate Duration” or “KRD swaps” (and, in some cases, “the leveraged swaps”). Over a period of approximately three weeks, beginning on August 14, 2001, Freddie Mac entered into eight sets of paired trades. These eight “swaps” each consisted of a pay-fixed interest rate trade offset by a receive-fixed interest rate trade. While the pay-fixed trades accrued interest payment obligations immediately, payments to the Company on the receive-fixed trades did not begin until a minimum of one month later. Taken together, the two sides of a given swap would thus have the effect of decreasing NII in the immediate reporting period, with an equivalent increase in NII in subsequent periods.

Each of the pay-fixed and receive-fixed legs of the first eight Linked Swaps had a notional amount of \$5 billion. On September 7, 2001, Freddie Mac entered into a ninth linked

⁸⁶ This reflects the recollections of Dossani and Federico. In interviews with the investigative team, Clarke stated that he did not know about the Linked Swaps until after the fact, and that he had no idea why F&I came up with the strategy. The weight of the available evidence is to the contrary.

swap, in the same essential structure as the first eight, but this time each leg had a notional amount of \$10 billion. Moreover, unlike the first eight Linked Swaps, the ninth was leveraged, by an interest rate factor of 5.0, resulting in a total leveraged amount of each of the pay-fixed and receive-fixed legs of \$50 billion.⁸⁷

As a result of the gap between the pay and receive legs of the transactions, prior to their termination in December 2001, the nine Linked Swaps together resulted in a decrease in the non-GAAP calculation of operating earnings⁸⁸ for the third and fourth quarters of 2001 of approximately \$420 million, with an increase in operating earnings in later periods (2002 and beyond) of the same amount.

The relevant witnesses at F&I acknowledge that the purpose of the Linked Swaps was to transfer operating earnings from 2001 into later periods. According to these witnesses, the swaps were consistent with the Company's risk management strategy at the time. The Company believes the trades had a positive impact on the Company's exposure to key-rate duration risk.⁸⁹ According to employees, the transactions would not have been entered into if that were not the case. But the employees acknowledge that the effect on key rate duration risk was "minimal" and was far outweighed by the operating earnings-shifting effects. Were it not for their effect in transferring operating earnings from 2001 into later periods, the Linked Swaps either would not have been entered into, or they would have taken a very different form.

⁸⁷ In an interview, Greg Parseghian stated that he believes the leveraged feature of the ninth linked swap may have been his idea.

⁸⁸ Beginning with its first quarter 2001 reporting, Freddie Mac began providing a supplemental performance measure known as "operating earnings." Management stated that it believed that results presented on an operating basis, while not a defined term with GAAP, nor comparable in many cases to supplemental performance measures used by other companies, were beneficial in understanding and analyzing Freddie Mac's financial performance because they better reflect the economic effect of Freddie Mac's risk management activities. Freddie Mac's operating earnings, along with corresponding ratios, reflect adjustments for certain income statement effects of SFAS 133. These adjustments relate primarily to the timing of derivatives income and expense recognition.

⁸⁹ Key rate duration is a measure of the sensitivity of the portfolio to changes in interest rates.

Contemporaneous evidence of the Company's purpose in entering into the linked swap transactions exists in the form of audio tapes of the telephone calls through which F&I traders executed the transactions.⁹⁰ In the tapes, the traders (who dealt with five different counterparties in these trades) concede that the dominant purpose was to achieve the desired operating earnings effects. Thus, in executing the first linked swap on August 14, 2001, F&I trader Ray Powers describes the trade to a counterparty trader as "a way to move positive carry forward . . . into future years," adding that "we don't necessarily want to come out and say that, right? (laughs)." In a telephone call later that day, Powers states that "we have an accounting reason for doing it," and in a conversation the following day, he suggests that the transaction has some "duration" impact, but is "really" about "cash flows."⁹¹

Similarly, in connection with another linked swap, on August 17, 2001, another F&I trader, Sean Flanagan, rejects an alternative trade proposed by a counterparty trader on the grounds that "it wouldn't have the desired effect . . . It's carry related." Flanagan explains in a later conversation that the idea is to "book expense now and get it back in six months." He advises the other trader to "keep that under your hat."⁹² In a subsequent conversation – which took place on August 22, 2001, in connection with another linked swap – Flanagan explains that the Company has so "much good carry around here that we don't need it all. . . . [B]ut it's like, you just have to manage expectations . . . [N]ext year we all know it's not going to be so easy."

3. Internal Controls

⁹⁰ During all relevant times, Freddie Mac recorded the phone conversations of traders for F&I and SS&TG, twenty-four hours a day, seven days a week. These recordings of these calls are held in perpetuity.

⁹¹ These explanations are partly in response to questions about the transactions by counterparty employees, one of whom states, before receiving these explanations, "I don't want to be taken off in handcuffs here for doing something that's not kosher."

⁹² Flanagan also stated: "I don't want to see any [expletive deleted] Bloombergers about this trade either (laughs)."

Prior to executing the Linked Swaps, the relevant managers at F&I conferred with an F&I accountant – Eric Reiser, Director of Financial Engineering – about the propriety of the transactions. Reiser concluded that the transactions complied with GAAP and raised no other concerns that would prevent the transactions from going forward. Reiser communicated these conclusions orally to his supervisor, Peter Federico, who in turn reported them to Nazir Dossani and Greg Parseghian.

Reiser and others at F&I reported in interviews that, prior to executing the first linked swap, they also sought and obtained the approval of Freddie Mac’s Corporate Accounting department. According to the witnesses from F&I, these communications likely took place orally, either in person or over the telephone. There appears to be no documentary evidence reflecting any such communications between F&I accountants and Corporate Accounting at that time, and the relevant witnesses from Corporate Accounting all report that, to the best of their recollection, no such communications took place.

There is, however, documentary evidence that F&I disclosed both the purpose and the essential structure of the Linked Swaps transaction to Corporate Accounting just after the execution of the last (leveraged) linked swap on September 7, 2001. In an e-mail transmitted on that date, Reiser informed Jamie Amico and Lisa Roberts in Corporate Accounting as follows (emphasis added): “*As part of its earnings transfer activities, F&I intends to enter into offsetting pay-fixed and receive-fixed interest rate swaps. The pay-fixed swaps will begin accruing interest immediately and the receive-fixed swap will be three-month forward starting.*”⁹³ The e-mail

⁹³ The e-mail refers to the Linked Swaps in the future tense only, without referencing any of the earlier Linked Swaps, and without referencing any communications between F&I and Corporate Accounting about any of those earlier Linked Swaps. While this may raise some inference that the e-mail itself was the first communication with Corporate Accounting about any of the Linked Swaps, the totality of the evidence is ultimately inconclusive on this point. By itself, however, the inability to resolve the question definitively from a clear documentary record raises some of the same internal control and management issues that characterize the linked swap transactions as a whole.

proceeds to outline the leverage feature unique to the ninth linked swap, and solicits the guidance of Corporate Accounting on the specific question of how, in terms of the Company's regulatory reporting obligations, the transaction would be disclosed – *i.e.*, whether the transaction would be disclosed in terms of the notional amount of \$10 billion or the leveraged amount of \$50 billion.⁹⁴

In a reply e-mail transmitted later that afternoon, Lynn Abell, Accounting Manager in Corporate Accounting Policy, provided Reiser with the requested guidance regarding the disclosure of notional amounts. However, despite being clearly advised of the essential structure of the transaction – and the fact that it was part of the Company's "earnings transfer activities" – neither Abell nor anyone else at Corporate Accounting raised any further concerns at this time about the propriety of the transaction, which continued on schedule.⁹⁵

In addition to these interactions with accountants at F&I and Corporate Accounting, F&I representatives also conferred with the Company's Legal department about the linked swap transactions. Thus, on September 7, 2001 – the day the final, leveraged linked swap was executed – Federico approached Kevin MacKenzie, an attorney in Legal, again on the question of notional amounts. Thereafter, other attorneys in Legal undertook a broader inquiry into the linked swap transactions that extended over a period of at least several weeks. During that time, the attorneys were briefed at length on the transactions by Rob Dean, Senior Vice President of MRO. During the course of this inquiry, Steve Dinces, Vice President and Deputy General Counsel, concluded that the transactions would be permissible (as far as Legal was

In addition, it is a clear example of communication and control weaknesses in F&I, a problem identified by numerous employees in other Freddie Mac business units during interviews.

⁹⁴ Various witnesses explained that, at the time, the Company's total derivatives positions were approaching \$1 trillion, and that this was a threshold that many in the Company preferred to avoid.

⁹⁵ Shortly after the September 7 e-mail exchange, Jamie Amico, Assistant Controller Director, did develop concerns that the Linked Swaps could be viewed as "earnings management." He raised those concerns with the Chief Financial Officer, the Company's external auditors, and others at the Company.

concerned) provided that they satisfied two tests: (i) that they had a legitimate business or risk management effect; and (ii) that they met the requirements of GAAP.

In order to address this test, Legal requested that Dean determine the impact of the Linked Swaps on risk management. On or about September 11, 2001, Dean prepared a matrix in which he concluded that the Linked Swaps did in fact have an impact on the Company's risk management strategies, that this impact was positive, but that it was "minimal." He provided this to the Legal Department. After receiving Dean's matrix, Legal concluded its inquiry into the business purpose of the transactions.

4. Involvement of Arthur Andersen

The Company's external auditors, Arthur Andersen, were not consulted prior to the execution of any of the Linked Swaps. Rob Arnall learned of the transactions during a discussion with Jamie Amico shortly after the last, leveraged linked swap was executed on September 7, 2001.

Upon learning of the transactions, Arnall had serious concerns, and over the ensuing weeks, he discussed his concerns with a number of Freddie Mac employees. The nature of Arnall's concerns was that the transactions had the effect of transferring significant amounts of operating earnings with only slight risk management benefits. Arnall later concluded that the transactions were "barely" consistent with GAAP, but he acknowledged that the primary effect of the swaps was on operating earnings, which is a non-GAAP measure.⁹⁶

In order to learn more about the Linked Swaps, Arnall met with a number of employees, including Dossani and Federico. During the meetings with Dossani and Federico,

⁹⁶ From a GAAP perspective, we understand that the Linked Swaps essentially offset between line items on the income statement – NII and Fair Value Gains (Losses).

Arnall suggested that the swaps should be terminated.⁹⁷ Arnall undertook to raise the issue with more senior management.

Sometime in late September or early October, Arnall had a telephone conversation with Vaughn Clarke in which he related his concerns about the Linked Swaps, and in late October, he had an additional meeting with Clarke on the subject. In interviews with the investigation team, Arnall reported that he advised Clarke at this meeting that the Linked Swaps should be unwound as soon as possible, and that the Company should not engage in any further transactions of this type. Arnall recalled that Clarke's response was that if the transactions satisfied GAAP, there was no reason they should not be permitted.⁹⁸

Clarke reported that he recalled Arnall raising concerns about the size of the Linked Swaps, the fact that they had one counterparty, and the fact that they lacked a strong business purpose. Clarke says that he was aware that the transactions had the effect of shifting operating earnings, but he thought they were permissible because he was told that the transactions also had a risk-management purpose.

In addition to meeting with the Chief Financial Officer, Arnall also requested and was granted a meeting with David Glenn.⁹⁹ The meeting took place on September 27, 2001. Present at the meeting were Glenn, Arnall, and Arnall's advisory partner, C.E. Andrews.

⁹⁷ F&I was prepared to follow that advice, but according to a recorded telephone conversation on October 12, 2001, Jamie Amico advised Federico not to unwind the swaps.

⁹⁸ Clarke gave the same essential response to Amico and Lou Betancourt, an accountant who reported to Amico, when they raised their own concerns with him about the Linked Swaps, and after they had provided him with a presentation on earnings management.

⁹⁹ During his interviews, Glenn advised the investigative team that he first learned about the Linked Swaps during this meeting with Arthur Andersen. There is some evidence to suggest, however, that Glenn may in fact have known about the Linked Swaps much earlier. For example, Glenn was present at the August 7, 2001 ALCO meeting, where the surplus in NII was identified, and where (according to some witnesses) the idea originated of devising a set of trades to address that surplus. Moreover, Glenn was present in a meeting of the Investment Committee of the Board on September 7, 2001, where it was reported that the surplus in operating earnings had been substantially eliminated – a change that would have been difficult to account for without an understanding that a

Reported recollections from this meeting differ.¹⁰⁰ According to all credible accounts, however, at the very least, Arnall repeated his concerns about the Linked Swaps during this meeting, and the possibility was raised that the swaps should be terminated or unwound.¹⁰¹

Shortly after his meeting with Arthur Andersen, Glenn met with Brendsel. Glenn reported Arnall's concerns about the Linked Swaps, and he and Brendsel discussed the possibility of terminating or unwinding them. Their reported recollections of precisely what was said on that subject differ. Glenn advised the investigation team that, because he was scheduled to go out of town for a week-long business meeting, he simply framed the issue for Brendsel and left it for him and others at the Company to resolve. Brendsel indicated that he left the meeting with the understanding that Glenn would take appropriate action (although it is not clear he expected Glenn to terminate the swaps).

Notwithstanding these interactions, the Linked Swaps were allowed to continue for more than two additional months. They were not in fact terminated until December 2001, shortly before they were scheduled to terminate, and after \$420 million in operating earnings had already been shifted into later reporting periods.

major transaction like the Linked Swaps had been effected. While this evidence may be suggestive, taken together the totality of the evidence is ultimately inconclusive on the question of precisely what Glenn's role may have been with regard to the Linked Swaps prior to his meeting with Arthur Andersen.

¹⁰⁰ According to his statements to the investigation team set forth in Exhibit A, the pages missing from Glenn's diaries relate to this meeting with Arthur Andersen.

¹⁰¹ In interviews, Arnall reported that he advised Glenn during this meeting that the Linked Swaps were permissible, but that they were "close to the edge" of permissibility, and that the Company should not engage in further transactions of this type. Arnall's recollections in this regard are consistent with those reported by his former concurring partner, C.E. Andrews. Glenn reported in one interview that he was told by Arnall that Arnall was investigating the Linked Swaps, and that Glenn should not take action with respect to the Linked Swaps at that time. In a subsequent interview, Glenn stated that Arnall expressed concerns about the Linked Swaps during the September meeting, that Glenn, himself, offered to unwind them, but that Arnall told him to wait while he (Arnall) investigated them. Glenn stated that in the one additional meeting he had with Arnall on the subject, Arnall stated that he had become comfortable with the transactions and with the fact that the Company would not engage in similar transactions in the future.

5. Internal Disclosure

On several occasions, Freddie Mac's senior management made internal disclosures to the Board or Committees of the Board that touched on the subject of the Linked Swaps. On none of these occasions, however, does it appear that the Board was apprised of the full impact of the transactions or the potential concerns they raised, and in some cases there is evidence that efforts were undertaken to assure that the Board would receive a carefully managed description of the transactions.

One example of these efforts can be found in an August 23, 2001 "Dry Run," in which senior management conducted a review of information to be presented to the Investment Committee. In the actual presentation to the Investment Committee (on September 7, 2001) the Committee was advised that:

The favorable impact of lower short-term debt costs, which are significantly less than Plan, are more than offset by the following activities:

1. Reducing convexity risk;
2. Buying back high-coupon debt;
3. Using swaps to transfer NII to 2002 and beyond.

This comment was made with reference to the spread on the average balance of the mortgage portfolio, with these techniques contributing a \$0.23 per share reduction of reported NII. The presentation also stated: "F&I NII per share of \$5.23 is in line with expected analysts' estimates of \$4.17 for 2001 operating EPS. Without action to stabilize the time pattern of NII, F&I NII per share could be as high as \$5.80."

The Investment Committee presentation obscures the fact which the "dry run," edited down by senior management, makes dramatically clear: Without the Linked Swaps, and the shift of \$420 million in operating earnings, the anticipated NII was \$0.57 per share over analysts' expectations. There can be little if any doubt that the Chief Executive Officer, Chief

Operating Officer and Chief Financial Officer of the Company were aware of these facts and their implications.

The September 7, 2001 report to the Investment Committee likewise contains no information about the magnitude of the swaps or their relatively minimal justification in terms of the Company's standard risk-management objectives.¹⁰²

Oblique references to the Linked Swaps were made in a conference call with Audit Committee Chairman Tom Jones on October 16, 2001. In preparation for that conference call, Lisa Roberts drafted a detailed description of the transactions, including the fact that they "are considered unusual in nature given their relatively minor [e]ffect on interest rate risk position and yet a disproportionately high impact on Net Interest Margin." Roberts' draft also quantified the expected effect of the transactions, in terms of shifting operating earnings forward from 2001, as "approximately \$400 million."¹⁰³

Between the completion of that draft on October 11, 2001 and the conference call package prepared and sent to Jones the following day, the draft was edited to remove the key details regarding the nature, size, and effect of the transaction. The final disclosure to Jones, which only referred to "several pay-fixed and receive-fixed swaps with substantially offsetting terms," described those swaps as "strategies for managing the volatility of interest rate risk and net interest margin," and represented them as meeting SFAS 133 requirements. The disclosure

¹⁰² Although the strategies for addressing the surplus in NII were discussed at some greater length during the Investment Committee meeting itself, there is no credible basis for concluding that any of the foregoing topics were covered during this discussion.

¹⁰³ The October 11 Lisa Roberts draft stated: "During 3Q01, Freddie Mac entered into several pay-fixed and receive-fixed swaps with a total notional balance of approximately \$180 billion and substantially offsetting terms. These swaps are considered unusual in nature given their relatively minor [e]ffect on interest rate risk position and yet a disproportionately high impact on Net Interest Margin. More specifically, these swaps reduced Net Interest Margin by approximately \$120 million in 3Q01 and are expected to reduce Net Interest Margin by \$250 million in 4Q01 and increase Net Interest Margin by approximately \$400 million over the next five years. The derivatives are accounted for as hedges under SFAS 133."

omitted any reference to the magnitude of the operating earnings effects, and contained no discussion of the fact that the effect on interest rate risk was in fact “relatively minor” or “minimal.”¹⁰⁴

There is conflicting evidence as to who was responsible for editing the Roberts’ draft. Those potentially involved in the process include, in addition to Roberts, Brian Green, the Interim Controller, and Rob Arnall. Roberts indicated that Green was responsible, which Green denies. During an interview, Arnall acknowledged that it was possible that he was responsible for the edits.

Finally, as part of the process of the Audit Committee’s quarterly review of significant matters impacting financial reporting for the fourth quarter of 2001, management provided a report, which quantified the impact of the Linked Swaps at \$135 million. The report is misleading because the \$135 million figure represents the impact of only the ninth swap (the leveraged swap) on fourth quarter operating earnings. The Audit Committee was never informed that the impact of all nine Linked Swaps was approximately \$420 million.

6. Public Disclosure

On or about October 9, 2001, Jamie Amico prepared a draft public disclosure about the Linked Swaps. Amico does not currently recall the precise context in which he drafted the disclosure, or to whom the draft was circulated, but the October 9 date suggests that it may have been intended for the Company’s ISS for the third quarter of 2001. Amico’s draft makes

¹⁰⁴ The October 12 disclosure provided to Jones stated: “There was a significant increase in the derivative balance this quarter. The increase resulted from strategies for managing the volatility of interest rate risk and net interest margin. During this quarter, Freddie Mac entered into several pay-fixed and receive-fixed swaps with substantially offsetting terms. These transactions met the SFAS 133 requirements and were accounted for in accordance with the Company’s policy; however, the policy is being evaluated to consider other alternatives.”

clear that the Linked Swaps have had and are expected to have the effect of transferring earnings from 2001 to subsequent reporting periods.¹⁰⁵

Neither Amico's draft nor any other general or specific description of the Linked Swaps was included in the Company's third quarter disclosures. Instead, according to the knowledgeable witnesses, two more general references to the Linked Swaps were included in the Company's subsequent public disclosures.

In the Company's fourth quarter earnings release, a new footnote was inserted in Table 4, Net Operating Interest Yield, at the request of the external auditors. That footnote provided: "Increased derivative costs in 4Q 2001 are partially offset by increases in fair value gains, which will be reflected in operating earnings over time." According to Arnall and other witnesses, this footnote was meant to be a reference to the Linked Swaps.¹⁰⁶

These general references to the Linked Swaps appear to be the result of defects in the Company's disclosure processes at the time. Responsibility for public disclosure was exercised by the Chief Financial Officer. Vaughn Clarke, the Chief Financial Officer at the time of the Linked Swaps disclosures, recalled participating in meetings on the subject of linked-swaps disclosures, but his interviews make clear that he was relying on Arthur Andersen to assure that the disclosures were appropriate.

¹⁰⁵ The Amico draft stated: "As part of the corporation's risk management strategies, it regularly executes swap, option, futures and other derivative contracts. While carried on the balance sheet at fair value as required under SFAS 133, the earnings effect in aggregate as well as with respect to specific income statement line items may span multiple reporting periods over the derivative life and/or hedged item life. In the case of interest rate swaps, for example, the interest income and expense effects generally are reflected in the financial statements according to the contractual terms of the swaps.

"In the third quarter of 2001, the corporation executed a significant volume of interest rate swaps and other derivative contracts in response to a steepening yield curve and declining short-term interest rates in particular, which declines have accelerated further after the terrorist events of September 11. Many of the derivatives executed in the third quarter have and are expected to have the effects of reducing reported and operating net interest margin in the third and fourth quarters while increasing margins in the out periods."

¹⁰⁶ A substantially equivalent footnote was contained in the Company's MD&A in the 2001 IS.

Arnall indicated to us that Arthur Andersen viewed its role as being focused on GAAP measures. Once satisfied that the transactions were consistent with GAAP, Arthur Andersen did not see its professional obligations as extending to Freddie Mac's general disclosure policy. Since the overwhelming effect of the Linked Swaps was on operating earnings, a non-GAAP measure, we have inferred that Arthur Andersen may not have scrutinized the disclosures as carefully as it would have had the Linked Swaps affected GAAP net income.

Members of the Company's Corporate Accounting department were also involved in the discussions regarding disclosures for the Linked Swaps. But in addition to the general problems with Corporate Accounting discussed elsewhere, the department was going through a transition period, with a new Corporate Controller, Ed Sannini, starting on October 31, 2001 – in the midst of the relevant period for decision making on linked-swaps disclosure – but after the transactional commitments were made.

In a meeting with Freddie Mac's senior internal disclosure lawyers and Rob Dean on February 19, 2002, shortly before the release of the Company's 2001 IS, Sannini raised the issue of linked swap disclosures. He described the issue as raising a "red flag."¹⁰⁷ He explained that the income management aspects of the transaction far exceeded the interest rate risk management effects. He suggested that a policy needed to be developed about the Company's involvement in transactions of this nature in the future, and he questioned how the transactions should be addressed in the Company's upcoming press release.

Following Sannini's comments, Maud Mater advised that, in the future, the Company's derivatives transactions should be limited to those which have as their

¹⁰⁷ John Kincaid, an attorney in Freddie Mac's Legal department, made detailed notes of the February 19 meeting, and the quoted statements in the paragraph are from his notes. Those notes are consistent with the recollections of virtually all of the witnesses in attendance at the meeting.

“predominant” objective the management of interest rate risk. With respect to the issue of disclosure, Mater advised that the Company should “[f]ind something to say that all derivatives have effect[s] on financial results.” Mater advised that the Company would “[t]ake [the] risk on past transactions.”¹⁰⁸ As noted, the disclosure ultimately made in the 2001 IS was that: “Derivatives entered into for risk management purposes also may significantly affect Freddie Mac’s net income due to expenses incurred to enter into such transactions, changes in their fair value and their potential impact on the timing of interest income and expense.”

7. Conclusions

The Linked Swaps were executed at the direction of senior management in order to spread over time the positive effect of a steep yield curve on increases in operating earnings. The witnesses all acknowledge that this was the purpose of the transactions, and that the risk management effects were insignificant.

Linked Swaps are also problematic in that they were designed to shift the non-GAAP metric that senior management had developed for presentation to the markets as a better reflection of the Company’s performance. The transactions were the product of a management philosophy that set a tone from the top of achieving specific accounting results but that responded to warning flags of accounting controversy with inaction.¹⁰⁹ The Linked Swaps also raise issues relating to the failure of Company employees to identify the accounting and

¹⁰⁸ The quotes are taken from Kincaid’s notes. Mater does not remember the discussion of linked-swaps disclosure, but, in interviews, she made the following points: (i) she did not have a full understanding of the Linked Swaps at the time in question; (ii) the disclosure issues regarding the Linked Swaps were considered under extreme pressures of time in attempting to get the 2001 IS ready to print; (iii) the discussion of the Linked Swaps disclosure constituted one of approximately a dozen issues in the meeting, with most of the other issues being viewed at the time as representing more significant issues of disclosure policy. In sum, Mater believes the disclosure of Linked Swaps in the 2001 IS was less of a studied decision than the Kincaid notes might suggest.

¹⁰⁹ Neither Leland Brendsel nor David Glenn chose personally to see to it that the transactions that troubled Arnall were addressed to his satisfaction.

disclosure concerns in a more timely fashion.¹¹⁰ But notwithstanding that failure, by late September, Freddie Mac senior management, at the highest levels, was aware that there were serious concerns about the propriety of the Linked Swaps. Management could have terminated the trades at that time, stopping their ongoing effects in shifting operating earnings, but management failed to do so until virtually the entire desired accounting effect was achieved. Brendsel, Glenn and Clarke all assumed a posture of “deniability.”

The failure to provide the Board or its Committees with more complete and timely information about the transactions, through a VIU Memorandum or otherwise, raises serious internal control and governance issues, and there is evidence from which it can be inferred that there was an effort by senior management to “manage the message” presented to the Board.

The Company’s public disclosures about the Linked Swaps fall short of the standards expected of publicly reporting companies. The public disclosures do not meaningfully inform the public about the essential nature and purpose of the Linked Swaps or their effect on operating earnings. There were clear weaknesses in the Company’s disclosure processes and clear misjudgments by those involved.

E. THE “BLAYLOCK TRADES” AND THE CIRCUMVENTION OF INTERNAL CONTROLS

1. Background

The Blaylock trades are a series of 13 trades between SS&TG and F&I that were executed in 2000 and 2001. Although SS&TG and F&I are permitted to trade directly with each other, Freddie Mac executed these 13 trades through Blaylock Partners (“Blaylock”), a regional

¹¹⁰ F&I asked Corporate Accounting specifically about the impact of these swaps on the notional disclosure and minimum capital. The Accounting Policy Interpretation memorandum related to the leveraged swap addresses both of these issues using SFAS 133 Derivatives Implementation Issue Nos. A9, F6 and K1 as guidance. There is no

broker-dealer, in order to enhance the quality of the Retained Portfolio.¹¹¹ PwC and the Company have raised two concerns: (i) the Company's use of Blaylock may have circumvented tax and accounting rules and (ii) the trades were motivated by a desire to reduce taxable income or improperly acquire securities for the Retained Portfolio.

Our investigation has concluded that Freddie Mac's motivation for the 13 trades was to improve the quality of the Retained Portfolio either through (i) the purchase of certain specified assets from SS&TG or (ii) by exchanging less valuable securities held in the Retained Portfolio for more valuable securities held by SS&TG. All or a portion of five of the trades violated Freddie Mac's internal tax policy because the securities traded had been held longer than 30 days and were prearranged with Blaylock. The remaining eight trades, structured as like-kind swaps, violated the requirements under SFAS 125 and SFAS 140 that F&I and SS&TG transfer control (*i.e.*, risk) over the securities to Blaylock.

2. Overview of Transaction

SS&TG operates autonomously from the other business units of the Company as an independent broker-dealer. SS&TG's primary activity is to identify valuable assets for its customers, including F&I. The Blaylock trades potentially violated two limitations on the trading relationship between SS&TG and F&I.

First, F&I is restricted from purchasing securities from SS&TG directly if the assets have been held by SS&TG for more than 30 days. SS&TG's internal controls prevent these sales by generating an error report that indicates which securities are outside the 30-day

suggestion in the memorandum that the leveraged swap is in violation of GAAP. Based on witness interviews, discussions about the propriety of the transactions were oral.

¹¹¹ F&I chose to execute the trades through Blaylock based on the personal and professional relationship of Byron Boston, a Vice President in F&I, with Blaylock trader Al Siegel. Boston worked with Siegel for several years at First Boston Securities. Boston stated that he used Blaylock as an intermediary since he trusted Siegel and believed that using a regional broker would reduce the risk that the market would learn of his investment purchasing strategy.

window. If F&I purchases assets directly from SS&TG outside the 30-day window, federal tax regulations require the Company to mark to market the securities, which would create volatility in taxable income for the Company.¹¹²

Second, F&I is prohibited from selling assets classified as Held-to-Maturity (“HTM”) in its Retained Portfolio. If F&I sells HTM assets, the entire Retained Portfolio risks being “tainted.” If the portfolio is tainted, the Company would need to reclassify the entire portfolio to Available for Sale (“AFS”) and the portfolio would need to be marked to market in stockholders’ equity. To avoid tainting the Retained Portfolio, it is permissible for F&I to engage in like-kind swaps, which do not constitute a sale. However, F&I and SS&TG cannot engage in intracompany like-kind swaps or “dollar-rolls.”

Faced with these limitations on its trading relationship with SS&TG, F&I and SS&TG entered into 13 transactions with Blaylock between May 8, 2000 and November 30, 2001 to acquire or swap assets to enhance the Retained Portfolio. The trades totaled approximately \$3 billion, and, in return for the transactions, Blaylock received market-rate broker commissions totaling approximately \$250,000.

The 13 trades can be divided into two categories: (i) the purchase of securities by F&I that SS&TG held for more than 30 days and (ii) the execution of like-kind swaps between F&I and SS&TG to exchange assets.

¹¹² Section 475 of the Internal Revenue Code requires a security that is held in inventory by a broker-dealer must be held at its fair market value. SS&TG’s inventory is designated either Held for Investment or Held for Sale. Inventories designated as Held for Investment are recorded at purchase price. All securities designated as Held for Sale are marked to market and the corresponding gain/loss is included in the taxable earnings for that year. Internal Revenue Service Ruling 97-39 requires a dealer in mortgage loans to designate the indebtedness as either Held for Investment or Held for Sale within 30 days of acquisition or origination.

a. **Trades Outside the 30-day Window**

Of the 13 Blaylock trades, some of the assets underlying five of the trades had been held by SS&TG for longer than 30 days. The issue surfaced in early 2000, when F&I and Blaylock discussed the sale of \$100 million in securities to F&I. F&I later discovered that a portion of the \$100 million pool that Blaylock proposed to sell had been previously held by SS&TG for longer than 30 days. F&I contacted Corporate Tax to determine whether F&I could acquire these securities from Blaylock if Blaylock had purchased a portion of them from SS&TG. Richard Power from Corporate Tax provided Jane Gagen, a trader from F&I, and Mike Lynch, the Controller in SS&TG, with written guidance that in order to obtain assets from Blaylock that had previously been held by SS&TG for more than 30 days, F&I could have “no actual or implied knowledge that pools obtained from [Blaylock] contained collateral previously held by SS&TG.”

Power’s approval was contingent upon (i) no agreement between the three parties to transfer specifically pre-identified pools of assets and (ii) Blaylock assuming no obligation to make the F&I and SS&TG trades contingent upon one another. In interviews, Power and Richard Millerick, Vice President Corporate Tax, stated that their guidance to Jane Gagen was not intended to develop a systemic strategy for acquiring securities past the 30-day window through Blaylock.¹¹³ Nonetheless, it appears that in the period ahead the traders took the guidance from Corporate Tax as a more general authorization to move assets outside the 30-day window from SS&TG to F&I. Moreover, in doing so, the traders ignored the express limitations on the practice as outlined by the tax attorneys.

¹¹³ In fact, the written guidance cautioned Gagen of the potential abuses of circumventing the 30-day rule by using a third party.

The trader transcripts make clear that the Blaylock trades outside the 30-day window were in fact pre-arranged. For example, on February 14, 2000, F&I, SS&TG and Blaylock executed a trade for \$7 million in collateral that was held by SS&TG for longer than 30 days. In a conversation between Buck Buchanan, a trader in SS&TG, and Smriti Popenoe, a trader in F&I, Popenoe explained that “I am just going to sell you the TBAs through Blaylock and I’m just going to buy these bonds from you directly.” Popenoe then informed Buchanan that she would call Blaylock so that Joe Langhorn, a trader in SS&TG, and Blaylock “can talk to each other and get the trade done.” On November 30, 2001, the three parties engaged in a trade for \$34 million in collateral that was held for longer than 30 days. In a conversation between Bill Sanders, a trader in SS&TG, and Chris Kuehl, a trader in F&I, Sanders stated that he could enter into the trade “[b]ut I’ve owned this thing for more than 30 days.” Sanders offered to call Blaylock to arrange the trade, and Kuehl agreed.

Thus, with respect to five of the Blaylock trades, F&I and SS&TG were able to transfer desirable securities to the Retained Portfolio that F&I could not otherwise directly purchase from SS&TG without risking a higher tax burden. F&I and SS&TG circumvented the internal 30-day tax rule and violated Corporate Tax guidance that the transactions not be pre-arranged. By structuring the trades through Blaylock, Freddie Mac avoided the higher tax burden associated with federal tax regulations. As of now, we understand, the Company has not yet quantified the adjustment.

b. Like-Kind Swaps

The remaining Blaylock trades fell within the 30-day window. With these trades, F&I sought to exchange a pool of TBAs it held in its HTM portfolio with more valuable specified securities held by SS&TG. On May 2, 2000, Gagen contacted Chip Jordan in

Corporate Accounting and Rob Mailloux¹¹⁴ of Arthur Andersen to discuss the execution of a dollar-roll between F&I and SS&TG. Jordan and Mailloux advised Gagen that a dollar-roll with SS&TG was impermissible because of their intracompany relationship; however, Mailloux informed Gagen that the transaction could be structured as a dollar-roll “[i]f you were doing this [transaction] with another dealer.”

On May 3, 2000, Gagen proposed to Jordan that the trades be executed through Blaylock. Jordan approved the transaction as long as (i) F&I placed the assets it received from SS&TG in HTM and (ii) the trade satisfied the dollar-roll requirements.¹¹⁵ Gagen explained to Jordan that “it’s the same product, same coupon.....it’s same WAM....the only difference is low loan balance...and that’s a two tick difference...which is not enough to create a problem in yield.”

On May 4, 2000, Gagen participated in a series of telephone conversations with Corporate Accounting and SS&TG. First, she asked Jordan for written confirmation that F&I could “run the quality improvement trade through Blaylock I’ll sell the TBA to Blaylock in return for low loan balance [securities held by SS&TG]...and SS&TG will sell that to Blaylock and Blaylock will sell to SS&TG the TBAs that I’m selling [to Blaylock].”¹¹⁶ Gagen later contacted Buchanan and told him that because of the intracompany relationship, the trades would be run through a third-party dealer. She also explained that “we’re going to call the dealer and

¹¹⁴ Mailloux is now an employee of Freddie Mac.

¹¹⁵ Under SFAS 125 and SFAS 140, to qualify as a like-kind swap, the assets being transferred and the assets being repurchased must satisfy the following six criteria: (i) similar assets as collateral, (ii) same issuer, (iii) identical form and type so as to provide same risks and rewards, (iv) same security coupon (interest rates), (v) “good delivery” requirements and (vi) similar yields.

¹¹⁶ On May 4, 2000, Jordan left a message for Gagen informing her that he was “assuming that you’re going to do a dollar-roll with this third party in order to get...the low loan balance securities on your books, so I am assuming you meet the six criteria for identical securities, including the fact that the mortgage-back[ed] security must be from the same agency.”

we are going to say, 'okay. You have to do this trade on both sides and take out an 1/8. Here's who you are doing one side with and here's who you're doing the other side with and the prices have to match up.'...and then the dealer just does it." Gagen also informed Langhorn that she received approval from Corporate Accounting, Legal and Tax to structure the trades through Blaylock.

After two like-kind swaps with Blaylock, Lynch contacted Rob Mailloux on June 9, 2000 to follow up on Arthur Andersen's advice regarding the transactions. Mailloux explained to Lynch that F&I and SS&TG could not do the transaction directly because that would constitute an intracompany dollar-roll. Mailloux reiterated that in order to execute the trades through a third party to effect the like-kind swap, the assets needed to be substantially the same under the dollar-roll requirements.

Through our review of the trader tapes and witness interviews, it appears that Corporate Accounting and Arthur Andersen received different information from the Company. Chip Jordan was clearly advised that F&I and SS&TG structured the transaction and controlled the securities. Under SFAS 125 and SFAS 140, however, in order for the trades to qualify as a transfer of assets, F&I and SS&TG would need to surrender control over the securities. Because Blaylock was unable to exercise any discretion over the assets (*i.e.*, to establish the price or determine the assets to be exchanged), F&I and SS&TG failed to relinquish any control over the securities.

In contrast, the information provided to Arthur Andersen was not as explicit. Mailloux reported that he was unaware that Blaylock had no discretion over the assets. There is no evidence that F&I and SS&TG intentionally withheld information from Mailloux; rather, F&I and SS&TG failed to describe the trades clearly to Mailloux in a single conversation.

3. Disclosure

Knowledge of the 13 Blaylock trades did not go any higher than Chuck Foster, Vice president of SS&TG, and Byron Boston, Vice president of Investments in F&I. There is no evidence that Legal, senior management or the Board were informed of the Blaylock trades. Freddie Mac did not disclose the trades in its external disclosures. The trades were executed directly between the three parties and were not visible to the market.

4. Conclusions

Based on our investigation, we have concluded that Freddie Mac's motivation for the 13 Blaylock trades was to improve the quality of the Retained Portfolio. For the five trades outside the 30-day window, F&I and SS&TG ignored Corporate Tax's direction that the trades through Blaylock could not be prearranged. The five trades were an intentional violation of Corporate Tax's advice.

As to the remaining eight trades, F&I appropriately contacted Corporate Accounting and Arthur Andersen for accounting advice. Both Corporate Accounting and Arthur Andersen approved of executing the trades through a third party. It is not clear that Arthur Andersen was fully informed of the prearranged nature of the trades, but Corporate Accounting clearly was. The advice Corporate Accounting gave did not comply with GAAP, but there is no evidence that the Company intended to violate SFAS 125 and SFAS 140.

F. GOOD FAITH ERRORS

Finally, our investigation identified three sets of practices or transactions where the Company has acknowledged an accounting error, but with respect to which our investigation has turned up no evidence that the error was the result of anything other than an honest mistake about the requirements of GAAP.

1. Government Securities Clearing Corporation (“GSCC”)

Our understanding is that this issue will be one of the larger single items in the restatement. Our investigation indicates that this issue involves a good faith accounting error resulting from a well intentioned effort to restructure the Company’s spreadlock contracts to avoid unnecessary risk and simplify the recordkeeping process. Spreadlock contracts – and their corresponding short sales contracts – simulate the purchase, and simultaneous repurchase, of U.S. Treasury securities. The operation of these contracts results in locking in the spread (hence “spread-lock”) between the cost of debt issued in anticipation of the acquisition of income-producing assets (mortgages or PCs) against changes in interest rates until such time as the income-producing assets are actually purchased.

Prior to 2000, these transactions were entered into typically with a single counterparty and received hedge accounting treatment. In 1999, the Legal Department expressed concern that these transactions lacked consistent documentation and exposed the Company to unnecessary counterparty credit risk. Freddie Mac sought to address these concerns by implementing these transactions with multiple counterparties but all through the GSCC. Utilizing the GSCC allowed the Company to reduce counterparty credit risk because all counterparties utilizing the GSCC post collateral based on a GSCC assigned risk factor.¹¹⁷

The primary accounting issue was whether Freddie Mac could continue to achieve hedge accounting treatment on the spreadlocks if they were conducted through the GSCC. Arthur Andersen concurred with Freddie Mac’s internal judgment that hedge accounting was appropriate. In reaching this conclusion, the Arthur Andersen accountants working on this issue

¹¹⁷ The Credit Committee of the Board received a presentation in April 1999, to the effect that Corporate Finance Operations had begun the process of preparing to use the GSCC for treasury and agency securities settlement, and recommended use of GSCC to settle debt sales.

forwarded their research to the Professional Services Group in Chicago (the national office), which agreed with the audit team's conclusion. Armed with this advice, Freddie Mac began the execution of short sale and spreadlock transactions through the GSCC in October 2000.¹¹⁸

After consultation with PwC, the Company has determined that classification of these transactions as derivatives under SFAS 133 is based on incorrect application of current rules. The following table enumerates the legs of the transactions and the difference in the interpretation of the applicable accounting treatment.

Transaction	Leg 1	Leg 2	Per FM and Andersen prior to 2003	Per FM and PwC for restatement
Spread-lock	Purchase of U.S. Treasury Security (in normal Settlement)	Repurchase (sale and purchase)	Synthetic forward treasury position qualifying for hedge accounting (SFAS 133).	Leg 1 – cash instrument accounting. Leg 2 – Financing (SFAS 140).
Short Sale	Sale of U.S. Treasury Security (in normal settlement)	Reverse repurchase (purchase and sale)		

The Company now believes that the use of the GSCC – while helpful in mitigating counterparty credit risk – does not permit the spreadlocks to qualify for hedge accounting treatment under SFAS 133.¹¹⁹ The effect of this change in accounting treatment is

¹¹⁸ Freddie Mac disclosed the use of these spreadlocks to OFHEO in the third and fourth quarters of 2000 and the net loss on outstanding open positions.

¹¹⁹ At issue is whether the transactions as structured through the GSCC can properly be viewed as a single unit. The guidance thought to be applicable prior to 2003 was SFAS 133 Derivatives Implementation Group Issue No. K1, which states that the following factors will result in the transaction being viewed as a unit: (i) transactions entered into contemporaneously and in contemplation of one another; (ii) transactions were executed with the same counterparty (or structured through an intermediary); (iii) transactions relate to the same risk; and (iv) no apparent economic need nor substantive business purpose for structuring the transactions separately that could not also have been accomplished in a single transaction.

that (i) the underlying assets will be carried on the balance sheet and (ii) a gain will be recognized upon sale rather than deferred and recognized over the life of the hedged item.

Our investigation did not uncover any evidence suggesting that the Company had any reason to question the advice it received from Arthur Andersen, or otherwise should have known that its accounting for the spreadlock transactions was not in accordance with GAAP.

2. **MODERNs**

a. **Background**

Freddie Mac entered into a transaction called the MODERNs to transfer \$243 million in credit risk to a group of investors in exchange for a series of premium payments. The transaction was effected through a Special Purpose Entity (“SPE”) incorporated in the Channel Islands, which Freddie Mac did not include on its balance sheet. Concerns have been raised by PwC and the Company regarding the Company’s failure to consolidate the SPE’s operations on Freddie Mac’s balance sheet and whether this was motivated by a desire to shift risk off balance sheet. While the failure to consolidate the SPE was inconsistent with GAAP, our investigation finds no evidence that the violation was intentional or improperly motivated.

b. **Overview of Transaction**

Every year, Freddie Mac spends millions of dollars purchasing mortgage insurance to mitigate the credit risks as part of the Guarantee Program, which guarantees principal payments to investors.¹²⁰ In 1997, Morgan Stanley approached Freddie Mac with an alternative method to transfer a portion of its credit risk to qualified institutional investors. The method is known as Mortgage Default Recourse Notes (MODERNs).

¹²⁰ 97% of the mortgage reference pool had been securitized and were therefore not reported in Freddie Mac’s Retained Portfolio.

John Gibbons, the Chief Financial Officer at the time, instructed Frank Vetrano, an investment manager in F&I, to oversee the development of the MODERNs. From late 1997 through early 1998, Vetrano, with a large working group, developed a strategy to execute the details of the MODERNs. On March 24, 1998, the Company created G3 Mortgage Reinsurance Limited, a SPE incorporated in Jersey, Channel Islands.¹²¹ Freddie Mac did not include the restricted cash and debt related to the MODERNs transaction on its balance sheet.

Freddie Mac and G3 entered into a Reinsurance Agreement, under which Freddie Mac paid monthly premiums for reinsurance on a pool of mortgages¹²² held by Freddie Mac. This "Mortgage Reference Pool" was valued at \$20 billion.¹²³ In return for the premiums, Freddie Mac received on a monthly basis a fixed percentage of the unpaid principal balance of any mortgages in the pool that defaulted during that month. In total, Freddie Mac transferred \$243.3 million of credit risk to G3.

In order to transfer the credit risk to the capital markets, G3 in turn issued \$243.3 million in credit risk to institutional investors in the form of MODERNs. G3 issued five classes (A through E) of MODERNs to third-party investors. The performance of the MODERNs was directly tied to the credit performance of the underlying \$20 billion reference pool. If the MODERNs did not perform well, the investors in the MODERNs were at risk of losing their entire investment.

¹²¹ G3 issued ten shares of stock with a par value of \$1, which were held by an unrelated non-profit Jersey entity. The evidence indicates that G3 is independent of, and not related to, Freddie Mac.

¹²² The mortgage reference pool consists of 197,457 conventional, single-family, 30-year, fixed-rate mortgage loans (the Mortgage Loans) aggregating approximately \$20,000,316,884 as of the closing date of the transaction (the Mortgage Reference Pool), all of which Freddie Mac guarantees. All of the Mortgage Loans were originated during 1996 and represent approximately 23.2% of the single-family, 30-year, fixed-rate mortgage loans (by principal balance) purchased by the Retained Portfolio for that year. No loans were delinquent at the inception of the MODERNs transaction.

¹²³ The proceeds from the sale of the MODERNs are deposited in a collateral account administered by Chase Manhattan Bank (Ireland) PLC, the Trustee, and Chase Manhattan Bank invested the proceeds in commercial paper.

G3 incurred approximately \$7 million in costs to execute the transaction, which were paid by Freddie Mac. The costs included all structuring fees, as well as legal, accounting and administrative costs associated with the transaction.

After two years, Freddie Mac had the option to cancel, in reverse alphabetical order, one or more classes, except the E class. Because actual credit losses were substantially lower than initially expected, Freddie Mac, in May 2000, exercised its option and canceled classes A through D.

The transaction was highly visible throughout the Company. The working group included Corporate Finance, Marketing, Legal (including outside tax counsel), Corporate Accounting and Corporate Tax, which analyzed and approved of the MODERNS transaction. Corporate Tax evaluated the tax implications of creating G3 as an off-shore entity and supported off-shore incorporation based on domestic regulatory and tax concerns.

c. **Nature of Accounting Error**

Corporate Accounting and Arthur Andersen determined the appropriate accounting treatment for the MODERNS.¹²⁴ Corporate Accounting concluded, and Arthur Andersen agreed, that G3 did not have to be consolidated with Freddie Mac under GAAP consolidation requirements. EITF D-14 is the relevant accounting guideline that established the criteria for consolidation of SPEs by sponsors. The Company originally concluded not to consolidate G3 based on the following:

- In substance, the MODERNS investors held both the equity and debt of the SPE. The MODERNS securities (specifically the E class) were considered by Freddie Mac to be equity in the SPE, and, therefore, there was substantial equity at risk;

¹²⁴ Manju Malkani and Lynn Abell, in Corporate Accounting, drafted a memorandum documenting the accounting policy guidance for the MODERNS, dated May 21, 2002.

- The activities of G3 were not all on behalf of Freddie Mac; and
- The risks and rewards of the assets and the debt of G3 did not rest with Freddie Mac; they rested squarely with the holders of the MODERNs.

As part of the restatement, the Company has concluded that off balance sheet treatment of G3 was incorrect. The Company has concluded that G3 should be consolidated based on the following:

- The majority owner has made a nominal capital investment (\$10), and the MODERNs Classes are in the form of debt, not equity;
- The activities of G3 are virtually all on behalf of Freddie Mac; and
- Certain risk and rewards of G3 may rest indirectly with Freddie Mac. This means, though not legally bound, Freddie Mac may choose to make sure investors in MODERNs receive their payment in the event of a shortfall with the swap transaction G3 entered into with Morgan Stanley.

In 2000, following the issuance of SFAS 140, Arthur Andersen revisited its advice on the MODERNs and concluded that G3 should be consolidated with Freddie Mac. Arthur Andersen, however, did not require consolidation of G3 because it concluded that the transaction was immaterial from a balance sheet perspective.

Leland Brendsel and David Glenn were informed of the MODERNs transaction prior to its execution. The Company informed the Board's Credit Committee of the MODERNs in several presentations; and during an Annual Credit Update on May 14, 1998, the Board received materials with information on the MODERNs transaction. Freddie Mac included information regarding the MODERNs transaction in its second quarter 1998 OFHEO submission, as well as during a December 1998 meeting with OFHEO. The Company also

provided a general disclosure of the MODERNS in its second quarter 1998 ISS. The external disclosure does not indicate that G3 was an offshore SPE.

In summary, while the Company has determined that its failure to consolidate G3 on its balance sheet was a misapplication of GAAP, our investigation has turned up no credible evidence that this error was motivated by a desire to move risk off balance sheet. It appears that the Company was motivated by legitimate credit risk concerns and that the failure to consolidate G3 was the result of a good-faith error. There is nothing about the identity or ownership of G3, or its incorporation off-shore, that upon investigation appears problematic.

3. PC Smoothing

a. Background

In 1995, Freddie Mac instituted a policy, known as “PC Smoothing,” to enable the Company to match interest expense with interest income, both of which result from the prepayment of mortgages underlying PCs. This policy was implemented with widespread support within the Company and with the approval of Arthur Andersen. It was intended to reduce volatility in earnings due to changes in the rate of prepayments. This policy was terminated in 2002, after the Company concluded, with PwC’s concurrence, that its interpretation of GAAP was incorrect. We have investigated the Company’s rationale for adopting this policy as well as whether the policy was used to affect earnings, and have concluded that the practice of “PC Smoothing” raises no issue beyond good-faith error.

b. Overview of Methodology

Freddie Mac securitizes mortgage pools and issues PCs to investors. The Company receives principal and interest (“P&I”) payments from seller/servicers, and these payments are passed through to PC holders. In the event of a mortgage prepayment, Freddie Mac becomes responsible for the interest payment to the PC investor for up to 60 days after the

prepayment is remitted. However, Freddie Mac has possession of the underlying principal amount from the prepayment, which generates additional interest income until the principal payment is due to the PC investor.¹²⁵

The PC smoothing policy permitted Freddie Mac to recognize the interest expense owed to the PC holder over the entire period from the date of prepayment by the mortgage holder to the date of payment of interest to the PC holder.¹²⁶ The level of prepayments over time was volatile. Therefore, the stated purpose of this policy was to reduce the earnings volatility caused by fluctuating prepayment levels.¹²⁷ A second purpose was to permit the Company to match the interest expense over the time during which interest was being earned. Both of these purposes were widely known in the Company, and there was no internal debate over the policy.

In 1995, an accounting memorandum setting forth the policy was prepared by Steve Bledsoe and Bill Buckner in Corporate Accounting. Former Controller Greg Reynolds and Paul Scarpetto in Shareholder Relations also assisted in the development of the policy. According to Buckner, Arthur Andersen signed off on the implementation of the PC smoothing policy with Reynolds. Furthermore, there is an Arthur Andersen workpaper from December

¹²⁵ The expense incurred to the PC investors is a liability referred to as "Principal and Interest (P&I) Due to PC Investors."

¹²⁶ The policy is reported in Accounting Policy 450 which states that "it is Freddie Mac's policy to recognize the PC Variance expense over the entire period that Freddie Mac is liable for the prepayment proceeds (the period from the date of prepayment to the date the proceeds are remitted to the PC investor)." This policy was adopted as "Accounting for Mortgage/Security Variances" in a memorandum dated October 31, 2001, which states that "prepayments are interest-bearing at the PC coupon rate from the date of prepayment until the date the PC security balance is reduced. However, the related interest expense is recognized from the date of the prepayment to the date of payment to better match interest costs to the entire period the P&I due is outstanding."

¹²⁷ An internal Freddie Mac document dated September 1996 states that "[t]he PC variance smoothing methodology was developed to reduce earnings volatility created by changing prepayments." It also reports that "[t]his methodology defers the recognition of PC interest expense so that it coincides with recognition of related float income."

1999 entitled “FM, PC Variance Smoothing” which concludes that the interest expense was properly spread over the applicable period.¹²⁸

The “PC Smoothing” policy was initially disclosed in the 1995 Annual Report. The disclosure stated that the new policy did not have a material impact on the financial statements. This disclosure was repeated from 1996 to 2001. There is no indication, however, that this practice was ever discussed with the Board.

c. Nature of Accounting Error

In 2002, the Company, with PwC’s concurrence, concluded that the PC smoothing policy was an incorrect interpretation of GAAP. Instead, the interest expense owed to the PC holder should have been recognized in the month during which the prepayment occurred and not spread over the time period between prepayment and pass through to the PC investor. The alteration of this policy¹²⁹ caused a one-time income increase of \$51.7 million. As part of the reaudit, the Company will restate the affected balances for the periods covered by the reaudit.

As a result of our investigation, we concluded that there was no evidence that anyone in the Company was concerned, or concluded, that this policy was inconsistent with GAAP. Furthermore, quantitative analysis demonstrates that the use of this policy did not

¹²⁸ This workpaper is dated December 31, 1999, and states “AA LLP concludes that the PC Variance Expense is being properly smoothed over the applicable float period as no exceptions were noted.” A second workpaper dated December 31, 2000 states that “the Company adopted the policy of amortizing the expense associated with its PC Variance balance in order to ‘match’ the expense with the associated early mortgage paydowns to the interest earned on cash balances maintained from the early paydowns.” It goes on to report that “[t]he expense has been deferred during 2000 also falls well below the listing scope for the Company’s income statement. Therefore AA LLP passes on further review of this process, as it is deemed immaterial.”

¹²⁹ The revision of the policy was included in Accounting Policy 430, updated on September 30, 2002, and stated that “[w]hile the period benefited to Freddie Mac may be interpreted to encompass prepayment up through PC payment pass through, we decided to change our accounting to record all of this interest expense in the month it is incurred, and not deferring a portion of it into future months.” The Company also wrote a guidance memorandum dated December 31, 2002 which offered further detail of the revision of Accounting Policy 430. It states that “a decision was made by Corporate Accounting Management to record what would have been this month’s allocation of interest expense to ‘Other Income, Net’ to avoid impacts to [Net Interest Margin] that would affect the comparability to other periods.” This guidance memorandum also calculated the one-time income increase of \$51.7 million.

consistently move earnings closer to analysts' expectations. In some quarters, PC smoothing increased income and in other quarters it reduced income. In sum, PC smoothing does not appear to have been used as an earnings management tool, but rather to reduce volatility through the matching principle, which had been approved by the Company's external auditor.

4. **Round Robin Settlements**

a. **Background**

During the course of its audit work, PwC became aware of a practice within SS&TG called Round Robin Settlements and requested us to investigate whether the practice raises any accounting or legal issues. We found that the practice,¹³⁰ which essentially consists of net settling multiple-counterparty trades where Freddie Mac is both a buyer and seller of offsetting quantities of the same security within the same settlement period, does not present any such issues. To the contrary, the practice is settlement convenience which is specifically referenced in the Bond Market Association's Uniform Practices Manual.

b. **Overview of Practice**

SS&TG typically engages in Round Robin Settlements on occasion when Round Robin situations are identified by its clearing agent, Bear Stearns. Round Robin Settlements are most likely to be identified when trades are being settled on the so-called "48-Hour Day." If a trade cannot be settled because Freddie Mac or its counterparty is unable to deliver the subject security or securities, the trade is said to be a "failed" trade. When Bear Stearns identifies a particular trade that is in danger of failing, it attempts to trace the various trades involving the security or securities in question so as to identify where the fail occurred, *i.e.*, which party is

¹³⁰ The Bond Market Association's Uniform Practices Manual describes a Round Robin Settlement as a situation involving "the settlement of mortgage securities among three or more firms that have booked a transaction to receive and deliver the same security or securities . . . [in a] closed loop among the firms in which no single entity is capable of making delivery." *Id.* at Chapter 8, 22(a)(2/21/2002. In such a situation, "[p]articipants in a Round Robin do not move the subject securities from participant to participant . . . [I]nstead, they exchange settlement proceeds." *Id.*

incapable of making delivery. If Bear Stearns is successful, and it appears as though the trades are circular in that Freddie is both a buyer and seller of offsetting quantities of the subject security during the period covered by the settlement date, Bears Stearns will arrange for a Round Robin Settlement in the manner set forth in the example above. Round Robin Settlements are regarded as desirable by SS&TG because they cure trades that may otherwise fail and mitigate settlement risk by minimizing the movement of securities and cash. While SS&TG does not appear to keep a formal tally of the number of Round Robin Settlements, we have been told that they are relatively infrequent, numbering in the hundreds over the last few years. F&I may also engage in Round Robin Settlements, but on a less frequent basis. We have found no evidence that Round Robin Settlements are ever done on a pre-arranged basis wherein the parties agree to the Round Robin Settlements prior to, or contemporaneous with, the execution of the trades.

c. Nature of Accounting Error

Round Robin Settlements do not typically have accounting implications. The exception is a class of Round Robin Settlements for over-subscribed TBA pools. An example would be a pool in which \$50 million in securities are traded but in which only \$10 million in securities are ultimately issued. It is possible that the \$40 million in surplus trades could net settle on a Round Robin basis. For certain periods, the amount of the oversubscription was recorded as a purchase or sale of securities in the Company's books and records. Because no securities were actually issued for the oversubscribed portions of the TBA pools, the Company has determined that this was erroneous and, accordingly, corrected its books and records.

In sum, Round Robin Settlements seem to be undertaken at the initiative of Bear Stearns, which provides SS&TG's back office support, and only reported to SS&TG on the Round Robbins on an ad hoc basis. Round Robin Settlements appear to be more rare in F&I and arise most frequently in situations where there has been a "failed" trade. There is no evidence

that Round Robin Settlements are executed on a pre-arranged basis or are the product of anything other than legitimate market activity.¹³¹

¹³¹ During the course of our inquiry into Round Robin Settlements, we learned of three unrelated issues, two Gold PC support initiatives and a 2002 repurchase transaction, that we believe require further investigation. We are in the process of gathering evidence on these issues.

PART IV. CONCLUSION

This Report sets forth the material factual findings relating to the issues Baker Botts was directed to consider. However, the Report may be supplemented or revised to the extent that the remaining investigation steps result in the discovery of additional evidence.

EXHIBIT A

THE EVENTS OF JUNE 4, 2003

EXHIBIT A

THE EVENTS OF JUNE 4, 2003

The morning of June 4, 2003, David Glenn's legal counsel requested a meeting at 3:30 p.m. on that day in Baker Botts' offices. Counsel began the meeting by saying that Glenn had been under a lot of stress over the past few months in light of the reaudit and the determination of PwC not to accept Glenn's representations. He said that Glenn always intended to cooperate with our internal investigation and that he would be producing his handwritten notebooks for our review. He also said that Glenn would make himself available for any questions we might have about the notebooks after reviewing them. However, he and Glenn had requested this meeting because Glenn wanted to discuss certain aspects of this production with us in person. He added that what Glenn would be telling us was very difficult for him to do, and was the result of the stress under which he had been working. He also said that Glenn cared very much for Freddie Mac and wanted to do the right thing.

Glenn began by saying that what he was going to tell us was the result of the enormous stress he had been under, and that he was not proud of it. He said that when he was notified several weeks ago that he must produce his handwritten notes for our investigation, he took them home to review. While reviewing them, he made certain alterations to the notes. What follows are the alterations as explained by Glenn.

The first document was a two-page document marked "DG 0116" at the bottom of the first page. He directed our attention to the second page and told us that one of his management techniques is to have a dinner in his office with representatives of a business unit. The page marked DG 0117 was his notes from a dinner on October 2, 2000 with representatives of F&I. At these dinners, he would typically go around the table and ask everyone about the most significant thing he or she was working on. Peter Federico told him about the expected (at

that time) transition adjustment from SFAS 133 of \$350 million, and that “we need to decide how to spread that over several years.” Glenn said that he changed “we need” or it might have said “we must” to “we’re trying.”

The second document was a page marked “DG 0164.” Glenn did not identify specifically who attended the meeting. The subject of the meeting was surging EPS. Glenn said that the note he altered relates to possible on-top adjustments to match the estimated faster prepayments of mortgages. When reviewing this note, Glenn said that he scratched out the words “in Dec” because he thought they would be taken out of context by PwC and interpreted as indicating that he knew about the swaptions portfolio policy change in December 2000 through February 2001. Glenn said that in retrospect he concluded that the altered language had nothing to do with the swaptions portfolio policy change and therefore that it did not serve its purpose.

The third, multi-page document was marked “DG 0147” through “DG 0152.” Glenn said that he would need to give us some background information for our understanding. He began describing a meeting with Greg Parseghian and Nazir Dossani on February 1, 2001, in which they told him that without changes to Freddie Mac’s business, Freddie Mac would not be able to sustain double digit earnings growth in a few years. He said that this meeting made a big impression on him. The angled comment to the right of the first page was a note Glenn made to himself as to how their statement “jives” with long-term earnings forecasts that had been presented to Freddie Mac’s Board. He said that the next line reflects a statement of Dossani and Parseghian that earnings are front loaded because of accounting requirements, such as SFAS 133. Parseghian and Dossani then made three recommendations that would help Freddie Mac maintain earnings growth. First, the “VAR” limit (a measure of risk) should be increased from

7.5% to 10%. Second, the Company should reduce the threshold return on equity (ROE) requirement for investments from 15% to about 12% or 13% as long as the Retained Portfolio had an average ROE of 15%. Glenn did not describe the third recommendation of Parseghian and Dossani. He said that Parseghian indicated that a new investment “paradigm” was needed, and he asked himself the question at the bottom of the page “what does ‘change in paradigm’ mean?” He discussed the comment to the left side of the page that “[o]verall risk has actually declined over time” even if the VAR limit were increased. The explanation was that since the Retained Portfolio had grown very significantly in size, the VAR risk had increased as a result, but the mortgages and mortgage participation certificates (PCs) in the portfolio were actually less risky on average than they used to be. Then, he turned to his notes of Parseghian’s comments at the bottom of page DG 0147 that the changes were not inconsistent with shareholder expectations. He said that he had had doubts about Parseghian’s argument. The next page (DG 0148) were notes to himself about follow-up questions for Parseghian and Dossani. Glenn then skipped quickly over the next three pages. On page DG 0152, Glenn focused our attention on the notes from February 7, 2001. He said this was a senior staff meeting to discuss the “new investment paradigm” issue that he had begun to discuss with Parseghian and Dossani on February 1. He said that the word “smoothing” had been written toward the right margin and appeared by itself, and he had erased it. In the middle of the page, he added the word “controls”, toward the lower left, he added the words “forecasts assumption,” and still further down, he erased the words “allows smoothing.” He explained that this last note related to his request to Parseghian and Dossani that he wanted a model that showed consistent earnings, without relying on purchases that would increase the size of the Retained Portfolio and thereby increase earnings.

Glenn then distributed a single page marked DG 0211. He said that at the bottom of this page there was a note attached to the page by a paper clip, that said something to the effect of "next page lost" or "next pages lost." He told us that when PwC had started to ask him questions about the Linked Swaps in December 2002, he ripped the pages out of the spiral bound book relating to his late September 2001 meeting with Rob Arnall and took them home to review. He subsequently lost those pages and cannot now find them. Then, he attached a small piece of paper to the notebook indicating that the page(s) were lost. When he was reviewing the notebooks, he removed the clipped note indicating that the pages were lost. We asked him if he was sure that the pages were lost, and Glenn responded that he was.

Based on our review of the photocopied diaries, we have no reason to believe that there were alterations other than those identified to us. The alterations themselves have no bearing on our understanding of, or findings related to, the matters we have been investigating. The alterations do not affect our conclusions regarding what happened, who was involved, the character of the accounting error, or the purpose of the transaction or policy. In our opinion, the most likely explanation of Glenn's actions is that he was trying to make his notes consistent with previous statements he made to PwC and us about his awareness and involvement in several of the transactions.

Attached to this Exhibit A are those pages identified to us as altered by Glenn. A

* indicates altered text, as identified by Glenn.

FRI 30th, Sept 29, 2000

Monday, Oct 2, 2000

o SF market

- capital stress is less, ^{from which} prices are not perfectly correlated
- AIF liquidity at less than 15%
- bank on charter

→ TWO PROBLEMS THAT ARE LINKED TO COMMUNICATION

o Lehman mtg

- STEVE ... spreads & stock price
- EDWIN ... subprime / predatory lending / optimum i. window
- MARK ... WARRIL ... advisory business
- JO MARRAS ... bond distribution's, trading
 → also heading risk neutral
 → also risk aversion
- DOROTHY ... Govt, sovereign issues globally, ... also risk aversion
- STEVE ... exec committee
- MARI ... run mortgage business

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1. ECONOMIC VALUE
 PLEASE IS GOING TO RECONSTRUCT
 NO PARTIALITY BY AT LEAST
 "BRIAN" MARK BURTON

Dependent status means
 they change or price
 relative than a spread
 against another product

Lehman Bros
 Assets: "provides bank in"
 products to restructure etc."

→ BRUCE ... oversees market in potential legal debt & equity
 ... need more help on equity side

DATE: MYRIAM SPREAD, LP, GOVERNMENTS

THE BUY CASE FOR OUR STOCK & RECENT LEHMAN REPORT

- primarily a class action
 under the securities act
 courts are finding assets
 use optimum to determine
 to other institutions. are like
 confidence, Lehman has
 non confidence

Oct 2

3,9

o Funding & Investments

Mazin → a lot of skills, models, etc. 1/3 of time on FAS 133 - Corporate Strategy

swaps & options need to be marketed to market

→ FAS provides some flexibility, should be ok

→ here, we've had to make a lot of progress

hedging requires embedded options in FAS portfolio

100 B of swap and option trading

Alan → Remittance project

→ could lead to implications about SF interferences L1 Pool

→ some model gets different assumptions from F&L & SF

Peter → FAS 133 in change of implementing the swap aspect of FAS 133

→ need to decide how to handle one time designation of which available for sale.

→ transition FAS 133 to FAS 133 is 350 million... *{ we need to make things }* *

to decide how to spread that over several years

Usha → FAS 133 - responsible for Business Process Review standpoint

→ integration of FAS 133 into closing issues

→ accounting and reporting processes not well integrated

(150-200 hrs)

Alvardo → FAS 133 → Sharp drop in rates would significantly increase

complexity coverage of portfolio. We think the market itself

has this exposure

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Greg → personally likely needed more securities. Not enough time working on Tech's 3, strategy

Tuesday Oct 3, 2000

◦ Overall market share on 801 48.5%

◦ Looking for opp'ty

→ imp't optimum portfolio

→ We are considering investment in size of 1 to 2 million

- Does it meet Threshold return

- Does it improve overall capx

⇒ Need conditional approval to move forward

◦ Consider sub debt structure

⇒ sub debt @ 5% rdv to marketplace

◦ Peter Hancock declined ...

Ryan has been contacted ...

if Miller is others ...

Move forward next week ... bootid ...

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• Single Family Forum

• Mt. Airy Overlap

* ++ Bond Format

++ Rate of 0.8 is still appropriate

- Empirical beta = 0.8

- Other Colling vdr ... the empirical risk diff / 0.8 = 0.8 to 0.8

Wednesday, March 14, 2001

Thursday, March 15, 2001

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9

Emergency EPS

* 1 - Modest use of key adjustment to models to lifted factor

Preparation of models ... 150 million - double

* 2 - Regular reporting as rates all by producing models

into affecting the funding 300 million - Not double

~~... 300 million is double~~

0-3 FAS 133 ... suspension book expense expected be 180 million } front loading
... current outlook is around of 50 million

1. Higher growth 60 million - double

6. Greater currency 150 million front loading

solutions: create an operating company structure that is similar to FAS 133

and not just taking out hedge ineffectiveness ... this would cost an expense amount of 300 million instead of 50 million income

buy back legal company debt

- o Background of Offshoring
- o Everybody on Wall St knows Latin
- o Karmarkar

Monday, Feb 1, 2001

- o Greg Najar
 - Wb changes, cannot claim double digit growth in few years
 - Front loading revenue because of early exits
 - Karmarkar
 - Increase VTE to 7.5% & 10%
 - Reduce threshold but still commit to average of 15% AOC
 - The long run volatility assumptions to to stabilize produce AOC

How does this fit with
A.I. company's financial
performance to date

Questions

Opport risk his industry
declined over time

- What does "change in paradigm" mean?
- What impact will it have on delegation
- Is Vajda aware of this
- Does this spot light weakness in reports?
- Greg says this is not inconsistent w/ shareholder expectations

PRUDENCE

'CONFIDENTIAL'

- Do forward looking statements depend on you
- Still not double digit if change paradigm
- investment bus "remains a terrific business"
- Can still have reasonable change of hitting early plan

- Difference today & past:
Caution about path of setting track; not out of new products

2.

Some question on gas/margin

- (2) ... we don't seem to have a recurrent process in place - in forecasting margins not enough detail & ups
- (3) ... Who is/should be responsible for understanding or improving with better data/analysis or budget
- (4) ... Why do we think this content is not different than implicit expectation was in mkt ... How can we see hand-out today from existing reports ... only
- (1) ... report we have a decomposition of profit HFI

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Why don't we have better info on expected returns?

- Too much focus on S&P income? ←

FRIDAY AM

What are lessons learned ←

FRIDAY, Feb 2, 2001

o Vaughan vs. Holmes

- regarding rebranding/integrals

• K retention grant also shows

-- already received --- will impact meet'n

-- rebrand has add'l funds --- troubled ahead process

• Gaus report presented by Bob, Nazim

-- Vaughn is aware of it

No need for 2 o'clock mtg

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o Gaus/Nazim

More conversation on NTE and remediation

Sunday, Feb 4, 2001

* Lebed / GE / GI / DG - Review

re AEB - SF not represented at high enough level, no lets, Pat,

Don S, Margaret Paul

Bob/Gaus to follow up with regards: An individual discussion needs

Monday, Feb 5, 2001

Investment Day Room - Gary, Alex, Al Deen, Maud, Dennis, DG, BR, GL, LCB

- Is this a change in market-risk input principle - Leland
- I have the option not to change anything - Leland
- Is this consistent w/ statement to shareholders - DG
- What is impact on capital & commitments - Maud
- Doesn't feel his ticks to me - Leland

Tuesday, Feb 6, 2001

Steve Dennis: Confirmed the window period will stay open until Feb 13.

New Capitalistic Forum:

Upcoming decision items:

Bot A Fees

Lending Fees

Treasury & papers

SIS/ Lab manager

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Lending Fees: completing non-binding Term sheet, expected
for today...

How do you satisfy yourself as to the sufficiency of triggers

Basket America / Focus - direction is occurring today.

- create world class fulfillment & tech company

[Fulfill Co] ← [Tech Co]

OWN

BAC

BAC

F

F&S

(Processing
Association)

(Processing
Technology)

Franklin Rainbow

-- We commit to deliver 4/3 of customer service - reflected when we begin to perform.

-- If one player becomes dominant, others will share & reduce

ALCO Forum:

2.

Controller's Dinner: Wilson, Dick B, Emily, Uske, Jeff Harris, Louise

→ What is the role of the Caprock Controller

Jeff Harris - Full Controls → all the controls are at the back end.

Challenge is transfer knowledge from consultant to employee

(All the support
from business
leadership)
Job

Uske - Full Controls → full financial & reporting controls; control around

HRM and HRM management processes

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- Emily is down & not stable in your division \Rightarrow Emily to take over central scenario
- Nick \rightarrow determining SF probability
- Brian \rightarrow HC acc prep
- Louisa \rightarrow man of negotiation for HR... increased availability

Wednesday, February 7, 2001

SMOOTHING

① Investment Performance & Forecasts

++ 5 year NII forecast (F&I)

CFD is making

++ smooth version of PVA into NII (F&I)

② How does transition/smoothing occur *

++ who does it - Controls

E added

NOT ELIGIBLE INTO

INCOME

++ How tight should be man be?

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③ LCD/DWG/GP/PT/AC/Various are sufficiently suggesting in w/s
 incidents between value creation & reporting of income... Role Abnity,
 lack of alignment, inconsistency

NO DECISION

\rightarrow EIS mediation, TRADE, PREMIERS

\rightarrow ACCES SMOOTHING FORECASTS ASSUMPTION

E added

+ invest 2, 3 or 4 good people

+ Action Anderson

+ Mel Kinn

+ Guy/Vaughan

NOT GOOD LINKAGE BETWEEN
 VALUE PROPOSED & GOOD SERVICE

Not allowed smoothing *

We need a long-term earnings forecast w/o new purchase

Local level... Nazim

Put it all up... Vaughan

WOULD THIS BE THE
 BASIS FOR VAUGHAN?

Recommence NII

Do over the 1998 & 1999 EIS granules to smooth the path

September 19, 2001

◊ Indochina and integration team

◊ Funding Forum

◊ Credit Risk

September 19, 2001

- Health Care Changes... I approved increased employee cost
per Sept 19, 2001 document

Sept 20, 2001; Thursday

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◊ Lehigh Univ:

→ ~~summary~~ Breakfast: David, Mary, Greg, Paul, Rick

→ Mg Comm: Roundtable format: TIME

→ Bus Develop:

Sept 21, 2001; Friday

◊ WFF deal - Review at Finance Comm

- General new construction - 1st million first mortgage - 10 year interest adj

- Petroleum Risk Assn - 30-day

- DCF @ 3.8% assuming 5% varying rate

- LTV = 71%

- ROE = 24 1/2%

- 1.5% debt per unit

I signed

LM/AM

clip -
next page
lost

DG 0211

Exhibit B

This exhibit indicates how "management adjustments" to the Amortization reserve (SFAS 91), General Contingency Reserve (Legal), and Tax reserve affected EPS during the relevant periods. Management adjustments are made "on-top" of the normal quarterly reserving process (except for the General Contingency Reserve for which the only adjustments are management adjustments). For purposes of this analysis, the entire amount of each management adjustment has been excluded.

Additional information is provided for each of these reserves as well as the loan loss reserve to show how the balances changed over time. To the extent that Freddie Mac had an internal policy to establish an acceptable reserve range, that range has been depicted compared to the actual reserve balance.

It is important to note that this analysis does not consider the possible effect on EPS of any other transactions or adjustments undertaken outside of the management adjustments made to these reserves.

The following legend applies to Pages 2, 4, 6 and 8.

Recording of management adjustments moved actual EPS:

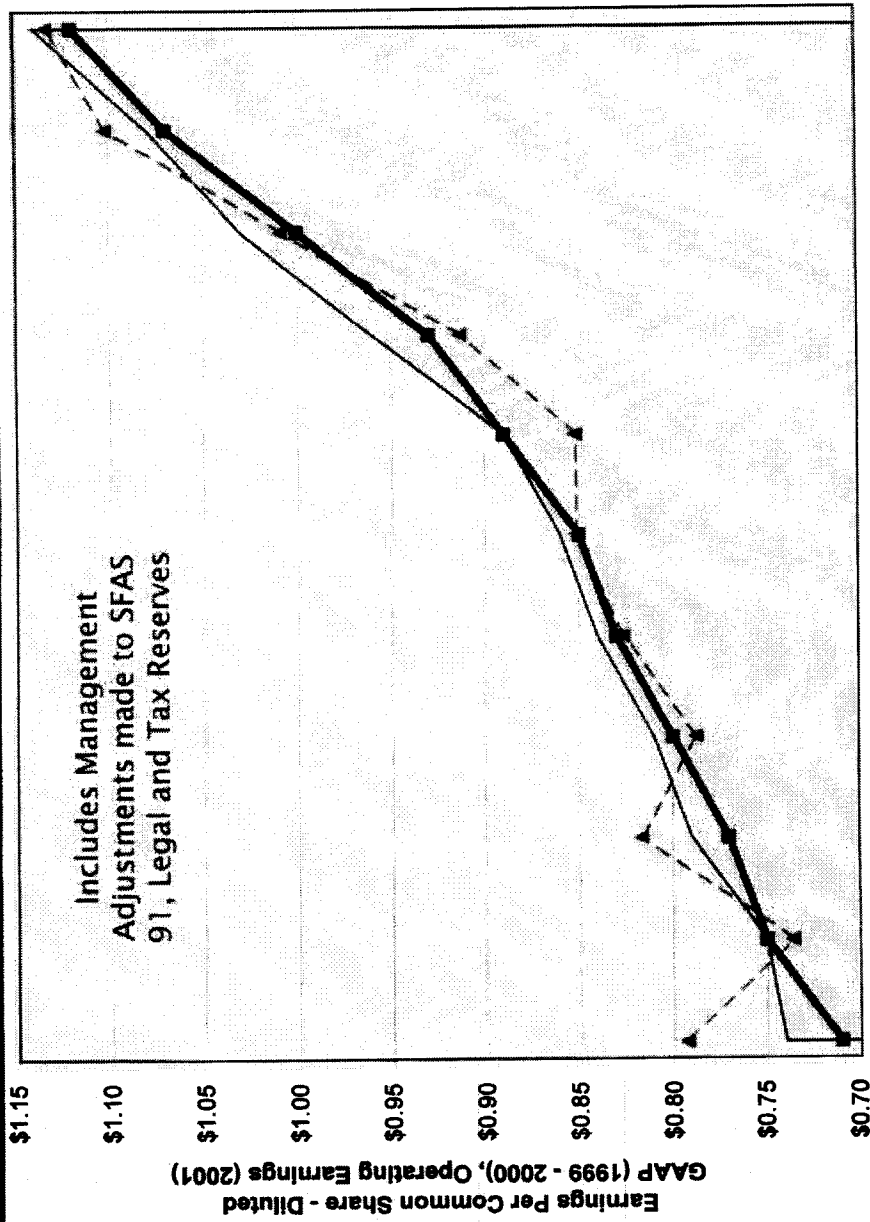
✓ = Closer to analysts' estimates.

✗ = Farther from analysts' estimates. In every case where this occurs, EPS is always farther above estimates.

● = From one penny below, or on expectation, to one penny above.

NA = No management adjustments were made to this account in this period.

Impact of Management Adjustments



	Jun-99	Sep-99	Dec-99	Mar-00	Jun-00	Sep-00	Dec-00	Mar-01	Jun-01	Sep-01	Dec-01
EPS, As Reported	\$0.74	\$0.75	\$0.79	\$0.81	\$0.84	\$0.86	\$0.89	\$0.96	\$1.03	\$1.08	\$1.14
Analysts' Estimates	\$0.71	\$0.75	\$0.77	\$0.80	\$0.83	\$0.85	\$0.89	\$0.93	\$1.00	\$1.07	\$1.12
As Reported excluding Mgmt Adj	\$0.79	\$0.74	\$0.82	\$0.79	\$0.83	\$0.85	\$0.85	\$0.91	\$1.01	\$1.10	\$1.13

Did adjustments bring EPS closer to analysts' estimates?

Jun-99
 Sep-99
 Dec-99
 Mar-00
 Jun-00
 Sep-00
 Dec-00
 Mar-01
 Jun-01
 Sep-01
 Dec-01

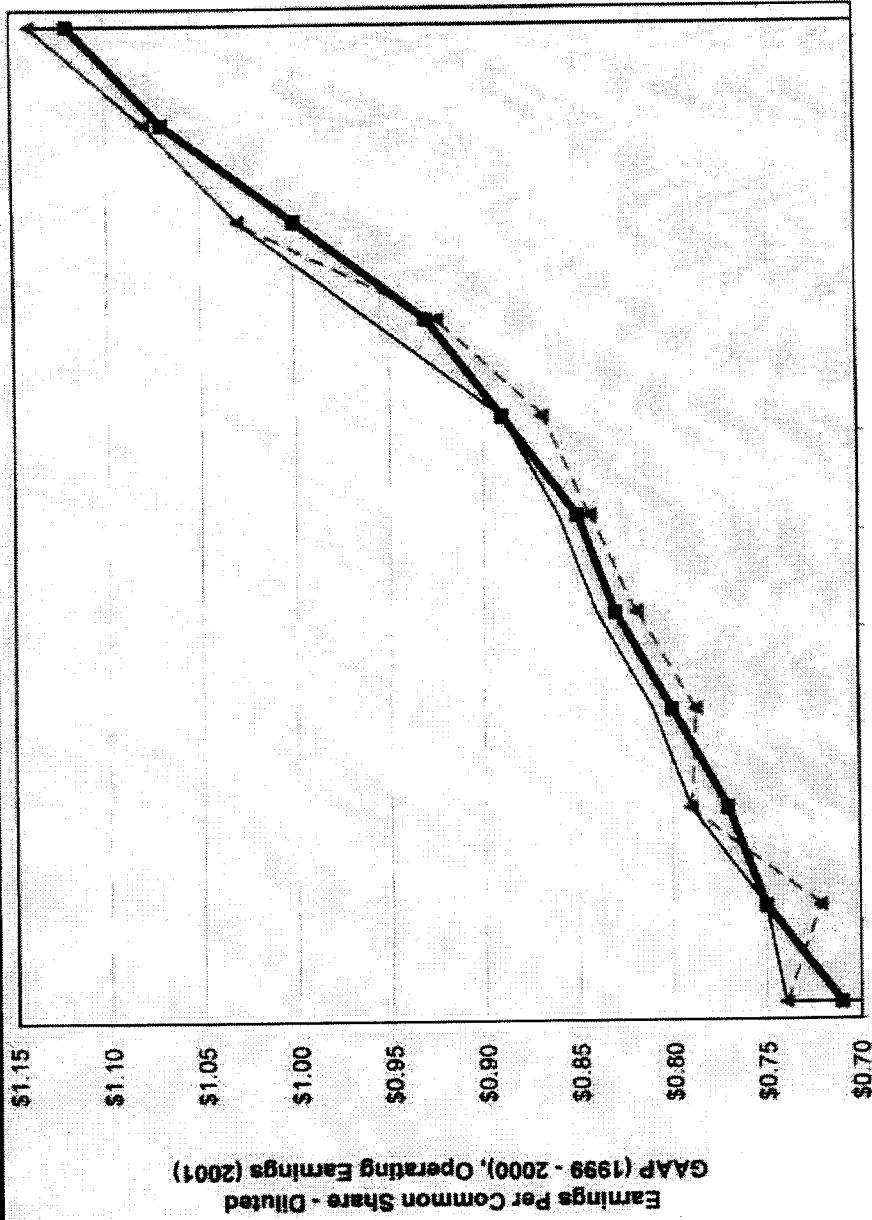
Did Management Adjustments move EPS Closer to Analysts' Estimates?

	1999				2000				2001			
	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	
SFAS 91	NA	✓	NA	●	●	●	✓	✗	NA	NA	NA	
Legal	✓	✓	NA	NA	✓	✓	✓	✗	✗	NA	✗	
Tax	✓	NA	✓	NA	NA	NA	NA	NA	NA	✓	✓	
All	✓	✓	✓	●	●	●	✓	✗	✗	✓	✗	

Recording of management adjustments moved actual EPS:

- ✓ = Closer to analysts' estimates.
- ✗ = Farther from analysts' estimates. In every case where this occurs, EPS is always farther above estimates.
- = From one penny below, or at the estimate, to one penny above
- NA = No management adjustments were made to this account in this period

Impact of Mgmt Adj - SFAS 91 Reserve



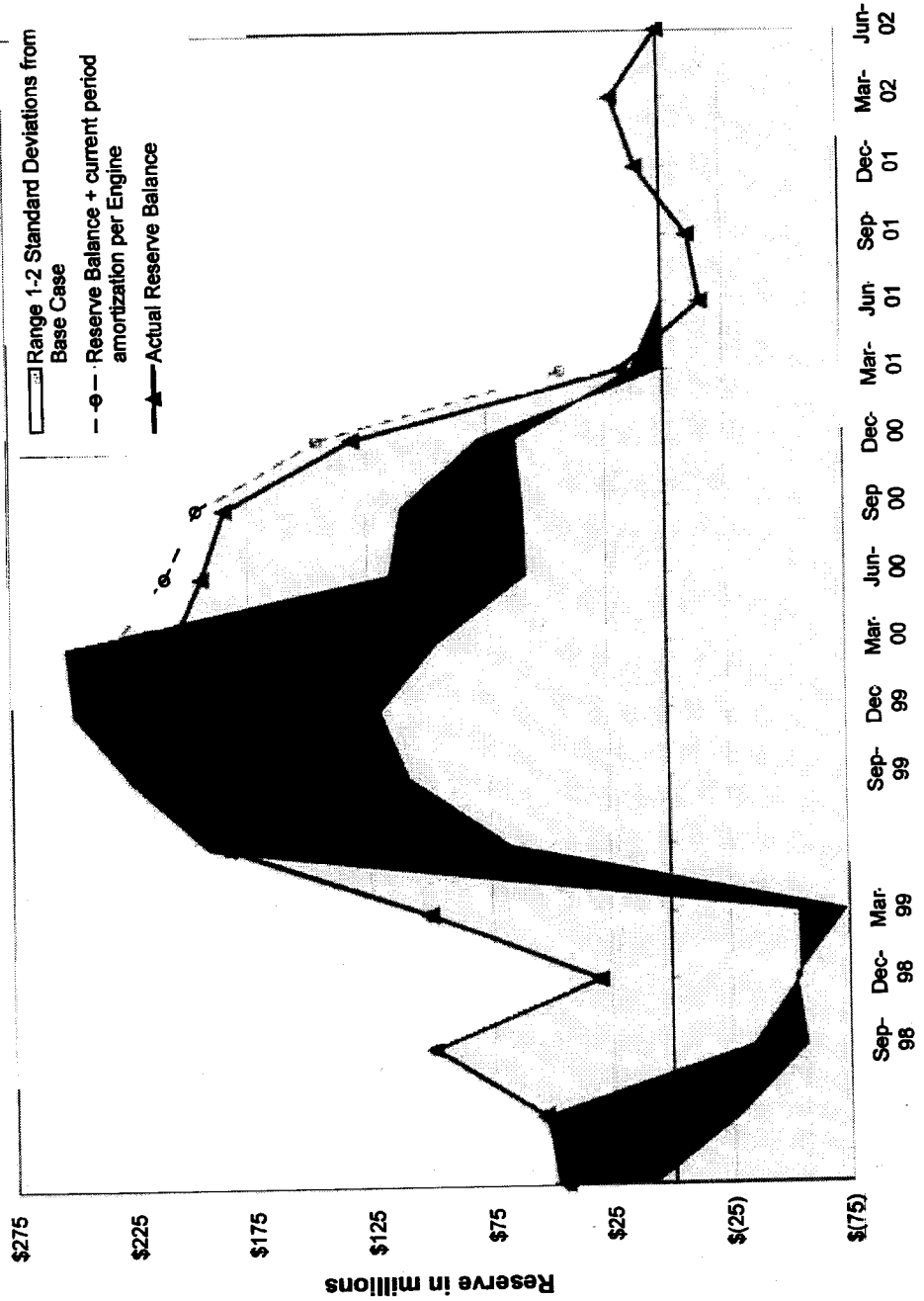
Legend	Jun-99	Sep-99	Dec-99	Mar-00	Jun-00	Sep-00	Dec-00	Mar-01	Jun-01	Sep-01	Dec-01
□ EPS, As Reported	\$0.74	\$0.75	\$0.79	\$0.81	\$0.84	\$0.86	\$0.89	\$0.96	\$1.03	\$1.08	\$1.14
■ Analysts' Estimates	\$0.71	\$0.75	\$0.77	\$0.80	\$0.83	\$0.85	\$0.89	\$0.93	\$1.00	\$1.07	\$1.12
▲ As Reported excluding SFAS 91 Adj	\$0.74	\$0.72	\$0.79	\$0.79	\$0.82	\$0.84	\$0.87	\$0.92	\$1.03	\$1.08	\$1.14

Do adjustments bring EPS closer to analysts' estimates?

NA NA NA NA NA NA NA NA NA NA NA

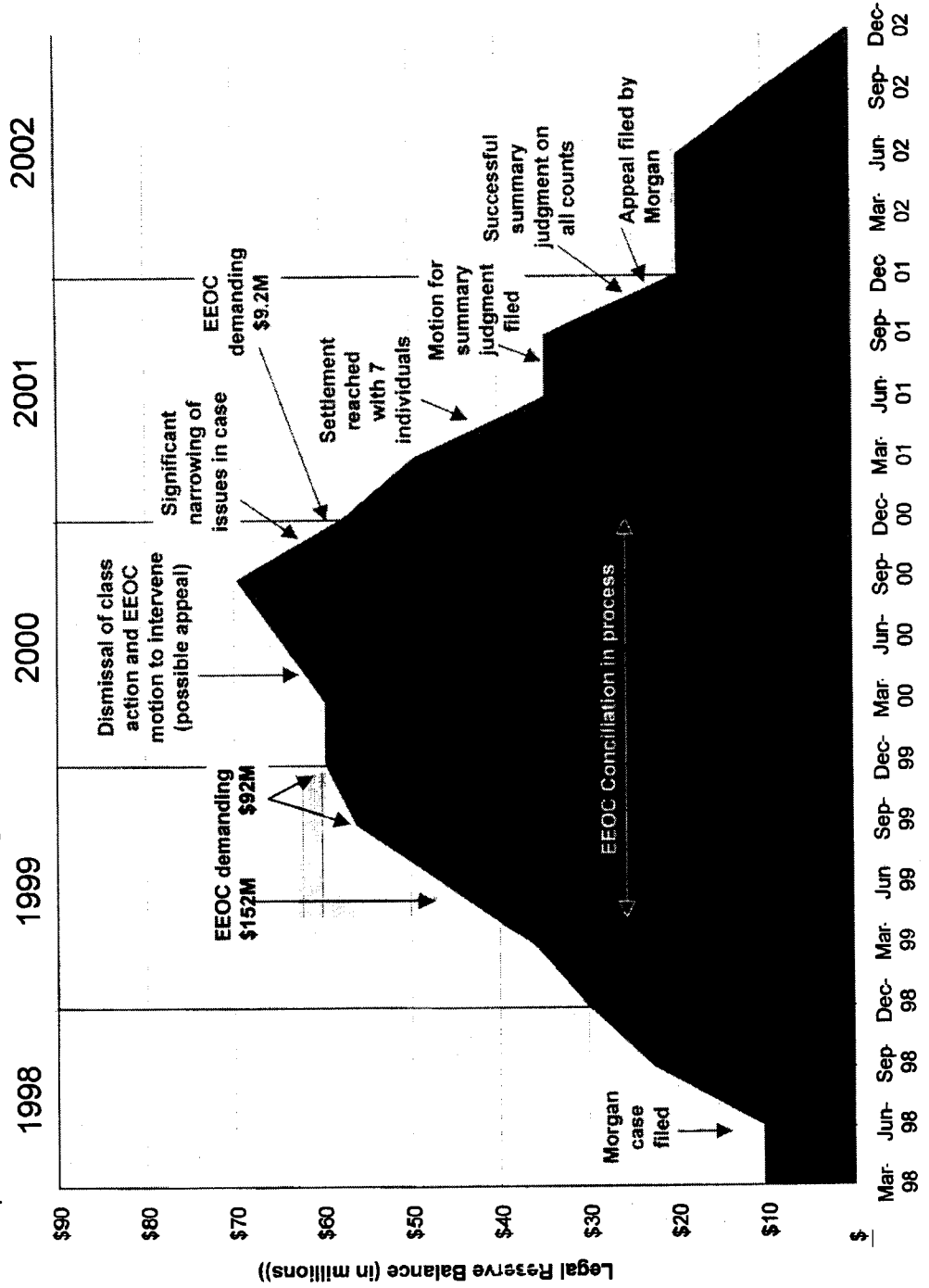
Amortization Reserve (SFAS 91)

Freddie Mac's policy established an acceptable range for the amortization reserve at 1 to 2 standard deviations from the base case interest rate path. The graph below shows the actual reserve balance compared with Freddie Mac's internal policy. The "reserve balance + current period amortization per engine" shows the reserve balance that was generated from the normal quarterly process. The difference between that line and the "Actual Reserve Balance" is the impact of management adjustments that were made to this account.

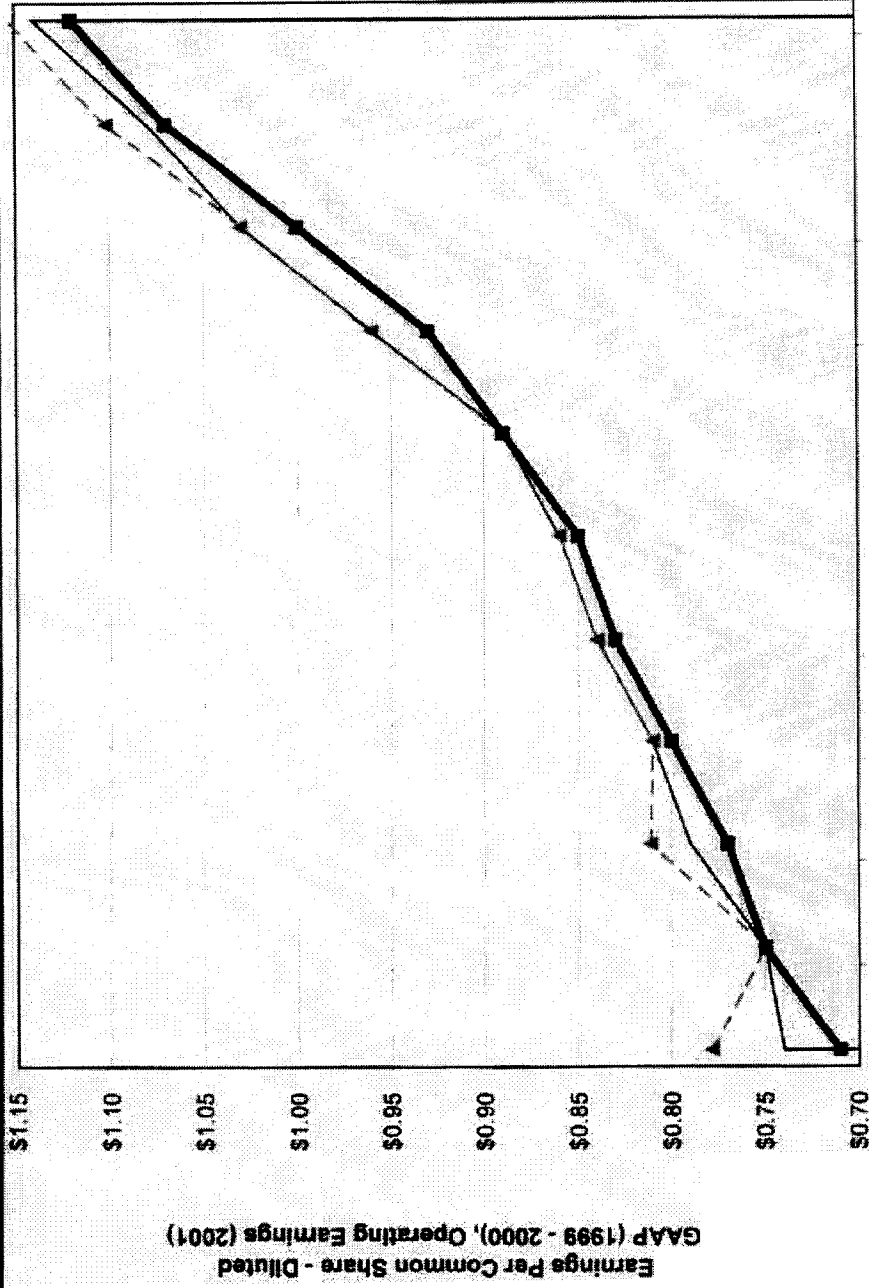


Legal Reserve

The following graph depicts the actual balance in the Legal Reserve as well as the key events related to a discrimination lawsuit and the attempt of the EEOC to intervene. This has been prepared based on contemporaneous documents detailing the significant events in the case.



Impact of Mgmt Adj - Tax Reserve

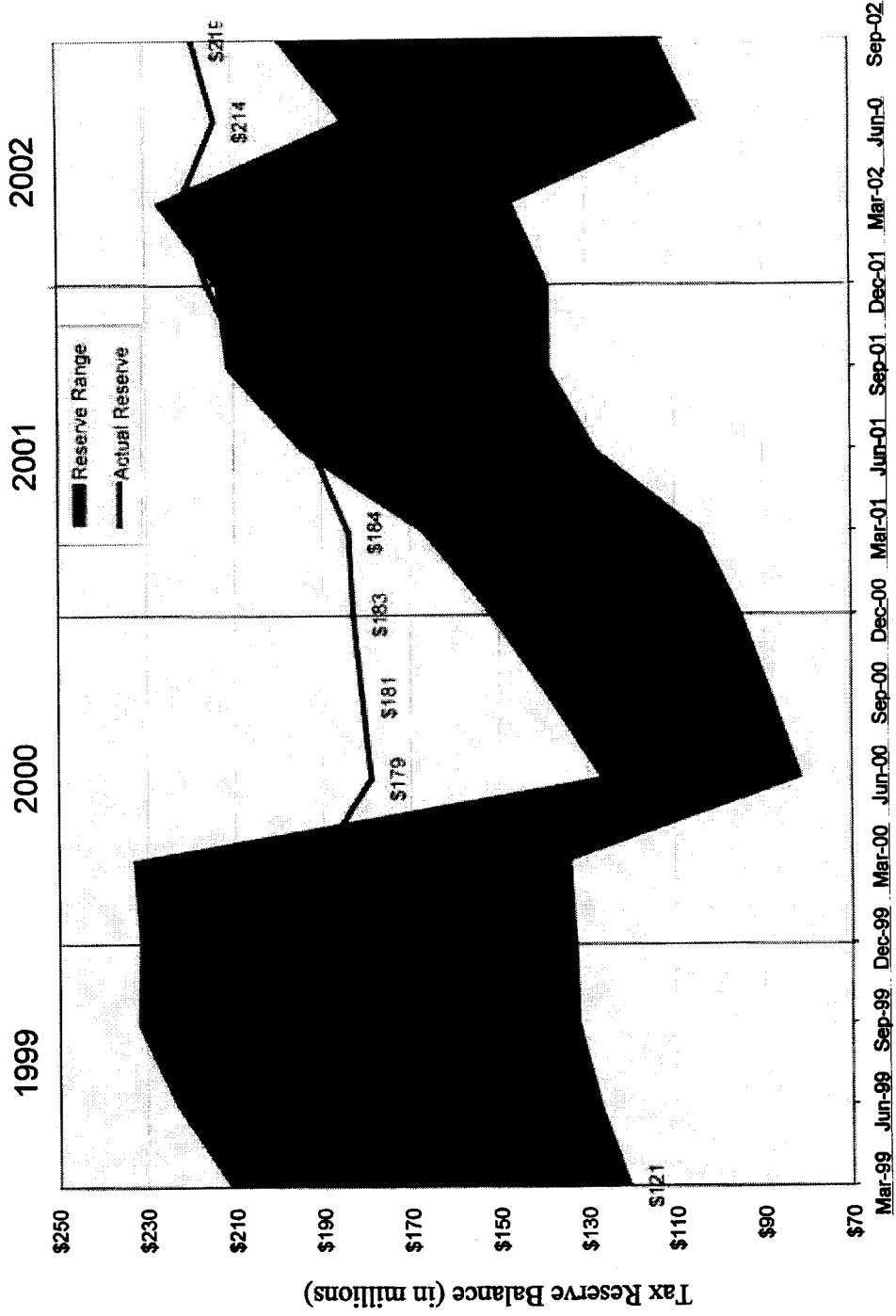


	Jun-99	Sep-99	Dec-99	Mar-00	Jun-00	Sep-00	Dec-00	Mar-01	Jun-01	Sep-01	Dec-01
EPS, As Reported	\$0.74	\$0.75	\$0.79	\$0.81	\$0.84	\$0.86	\$0.89	\$0.96	\$1.03	\$1.08	\$1.14
Analysts' Estimates	\$0.71	\$0.75	\$0.77	\$0.80	\$0.83	\$0.85	\$0.89	\$0.93	\$1.00	\$1.07	\$1.12
As Reported excluding Tax Adj	\$0.78	\$0.75	\$0.81	\$0.81	\$0.84	\$0.86	\$0.89	\$0.96	\$1.03	\$1.10	\$1.15

Do adjustments bring EPS closer to analysts' estimates? NA NA NA NA NA NA NA NA NA NA NA

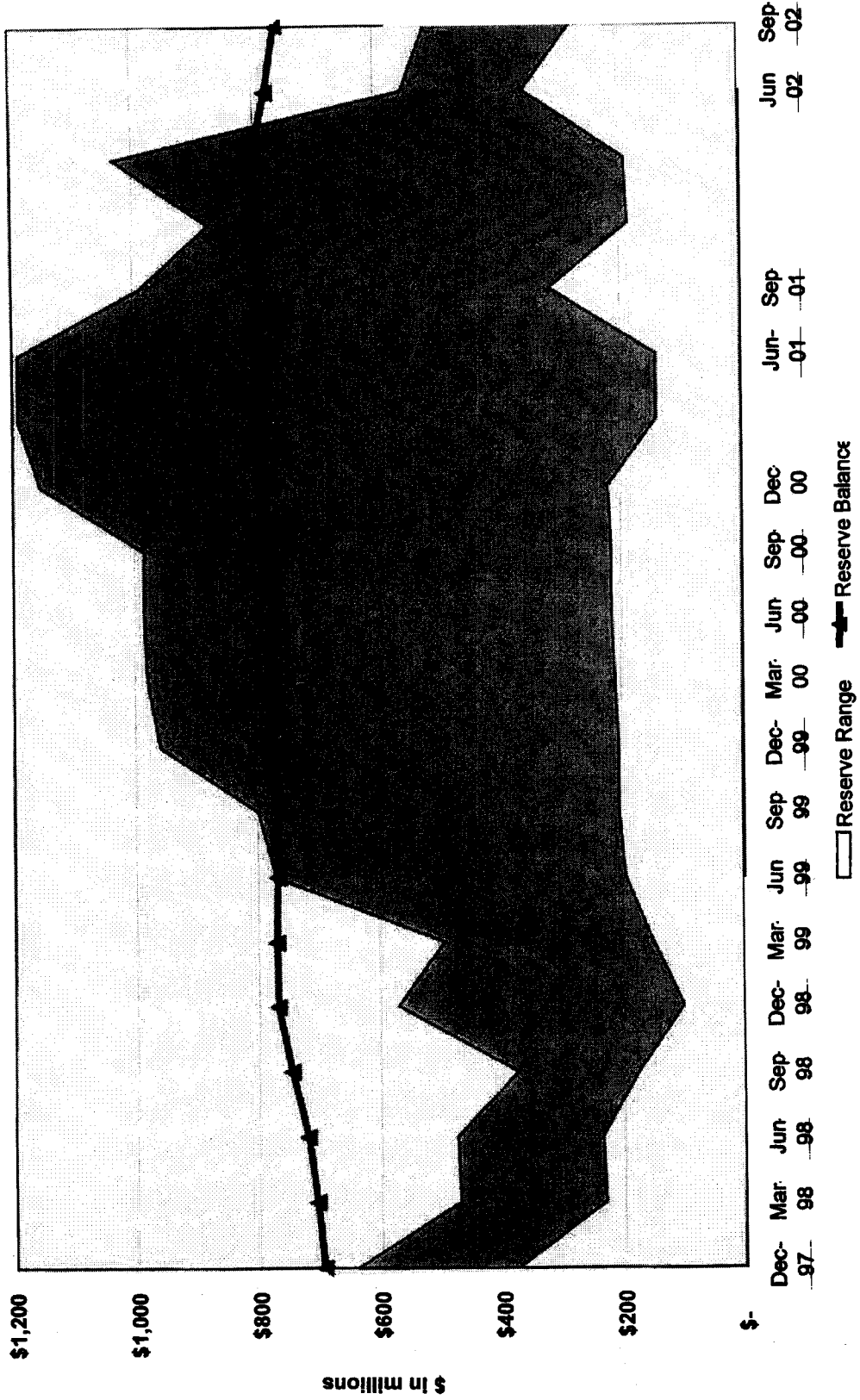
Tax Reserves

Freddie Mac's policy established an acceptable range for the tax reserve which was twenty to forty percent of the difference between the "Most Probable Case" and the "Realistic Worst Case". The graph below reflects the actual reserve balance compared with Freddie Mac's internal policy.



Loan Loss Reserve

The Single-Family and Multi-Family Divisions of Freddie Mac determine their estimates of the most probable losses and develop acceptable reserve ranges based upon those estimates. The following graph summarizes the sum of the ranges for both of these Divisions as well as the actual loan loss reserve balance.



EXHIBIT

B



2 pages by FAX

June 7, 2003

Members of the Board of Directors
Freddie Mac
8200 Jones Branch Road
McLean, Virginia 22101

Members of the Board:

OFHEO's review of the restatement process for Freddie Mac's financial statements is ongoing. During this review, I have become increasingly concerned about evidence that has come to light of weakness in controls and personnel expertise in accounting areas and the disclosure of misconduct on the part of Freddie Mac employees. The removal of members of the management team only goes a part of the way toward correcting serious problems--concerns surrounding management practices and controls remain. I believe additional actions must be taken by the Board to address these matters.

While Freddie Mac's asset quality, capital positions and other safety and soundness measures remain strong, conduct has occurred that is inconsistent with OFHEO's expectation of prudent management practices.

In light of these developments, I am directing the following immediate actions:

1. The Board will provide OFHEO with plans to address reform of Board oversight of management's supervision of accounting practices; personnel and systems changes; for implementing accounting services quality controls; and, a program for routine communications by the Board with OFHEO on the progress of its remediation plan. The Board should provide its plan of remediation to OFHEO for review and approval expeditiously.
2. OFHEO is deploying a special team to investigate all aspects of the issues surrounding the review of the re-audit that revealed deficiencies in accounting practices and controls and the matter of employee misconduct discovered on June 4, 2003. I expect the Board and management's full cooperation with this initiative.
3. Freddie Mac will make available to OFHEO all communications to the Board and management regarding deficiencies in accounting practices and an investigation of employee misconduct that was discovered on June 4, 2003.

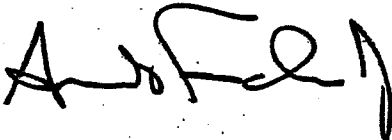
4. The Board will provide an explanation to OFHEO of its rationale for the termination packages for three individuals in light of the circumstances surrounding their departure from Freddie Mac-- Leland Brendsel, Vaughn A. Clarke and David W. Glenn. The Board and management will make clear to these individuals that their termination packages are subject to OFHEO approval.

In the case of personnel terminated for misconduct, OFHEO would object to any re-employment of such individuals. Also, in the case of personnel terminated for misconduct, they should be made aware that OFHEO may hold them liable for indemnification to Freddie Mac for losses that may have resulted from their conduct.

The Board shall designate members to oversee the actions directed in this letter. Freddie Mac management and Board members shall be available to meet with OFHEO as necessary and OFHEO may meet with the board at its discretion. Until the remediation plan is fully implemented, OFHEO's special team will expect regular reports on actions taken by the Board and management.

OFHEO will undertake such further actions as it deems appropriate.

Sincerely,

A handwritten signature in black ink, appearing to read 'Armando Falcon, Jr.', written in a cursive style.

Armando Falcon, Jr.

EXHIBIT

C



OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT
1700 G STREET NW WASHINGTON DC 20552 (202) 414-3800
Office of the Director

June 17, 2003

Mr. Allan Ratner
Vice President and Deputy General Counsel
Freddie Mac
8200 Jones Branch Drive
McLean, Virginia 22102-3107

Dear Mr. Ratner:

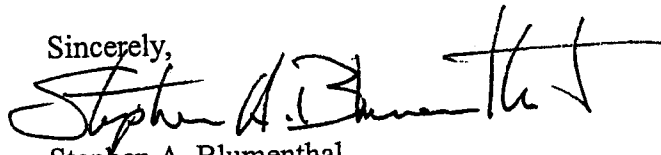
At our meeting on June 11, 2003 concerning the retirement benefits Mssrs. Brendsel, Clarke and Glenn, it was agreed that Freddie Mac would provide OFHEO with additional information. The requested information is listed below:

1. Minutes and any available notes of Board of Directors or Compensation Committee discussions concerning "resignation," or however otherwise referred to, termination of Vaughn Clarke or any other available documentation or explanatory materials generated by Freddie Mac personnel or its agents or received by Freddie Mac personnel or its agents.
2. A brief explanation of operation of SERP, including description of how and when the plan has changed.
3. Accounting of accrued retirement benefits to David Glenn reflecting modifications approved by OFHEO in February 1998.
4. One paragraph description of each "Accrued Benefit" item in Exhibit 4.
5. An explanation and amount of David Glenn restricted stock vesting on June 5.
6. A copy of Leland Brendsel's letter of resignation and Board resolutions relating to resignation.
7. A description of Leland Brendsel's past and future roles with Freddie Mac Foundation; brief description of the Foundation's Board and employees (or use of Freddie Mac employees), and the funding of the Foundation, in particular any payments made to its Chairman, by Freddie Mac; and information as to when Brendsel will serve on the board of the Foundation.

8. An explanation of when Leland Brendsel's retirement benefits commence (i.e., in thirty days from the date of notice or following his contractual 24 months of salary continuation).
9. Information on the history of long-term incentive grants as program functions for senior management: basic intentions of programs; application to which officers; description of how program has grown over time.
10. A valuation of Leland Brendsel's stock options as of June 6, using a Black-Scholes methodology, with specified assumptions as to volatility, etc.
11. An accounting of SERP benefits for Leland Brendsel, reflecting changes over time.
12. The current total actuarial valuations of accrued pension benefits for Brendsel, Glenn and Clarke, based on current ages; present value of same calculations, specifying discount rate and method for selecting discount rate.

Please provide this information expeditiously. Thank you.

Sincerely,

A handwritten signature in black ink, appearing to read "Stephen A. Blumenthal". The signature is fluid and cursive, with a long horizontal stroke extending to the right.

Stephen A. Blumenthal
Counsel to the Director

EXHIBIT

D



OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT
1700 G STREET NW WASHINGTON DC 20552 (202) 414-3800
Office of the Director

June 18, 2003

Mr. Allan Ratner
Vice President and
Deputy General Counsel
Freddie Mac
8200 Jones Branch Drive
McLean, Virginia 22102-3107

Re: Document Request

Dear Mr. Ratner:




In connection with the Office of Federal Housing Enterprise Oversight's ongoing Special Examination of Freddie Mac, I am making the following additional request for documents. Please provide the requested documents to OFHEO within five business days.

Freddie Mac is to produce:

1. Copies of any and all electronic communications, including but not limited to e-mails, and Blackberry (or similar device) communications, to or from Freddie Mac employees and/or Freddie Mac Board members concerning:
 - a.) The reports and supporting documentation provided by FIT, Mercer Oliver Wyman and any other consultants engaged by the Audit Committee and/or the Board of Directors related to matters raised in connection with the ongoing re-audit
 - b.) Reports, presentations, summaries, minutes, transcripts related to the ongoing re-audit
 - c.) Complete, unedited Board and Board Committee packages from January 1999 through the response date;
 - d.) Notes, transcripts and/or summaries of Board and Board Committee meetings (from January 1999 through response date) taken or compiled by Freddie Mac employees
 - e.) Complete, unedited Management Forum packages from January 1999 through June 2003
 - f.) Complete, unedited MARC reports from January 1999 through March 2003
 - g.) Complete, unedited Enterprise Business Risk Exposure Reports from January 1999 through second quarter 2002 or the latest date they were created
 - h.) Complete, unedited Risk Management Review packages and reports from January 1999 through March 2003
2. Copies of any and all communications from January 1, 1999 through this date, including electronic communications, between Freddie Mac, its Board members, agents or representatives and the Securities and Exchange Commission ("SEC").

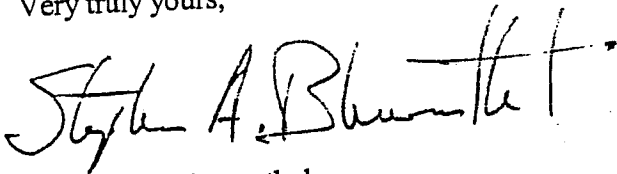
3. Copies of any and all communications from January 1, 1999 through this date, including electronic communications to or from Freddie Mac employees, Board members, agents or representatives concerning communications with the SEC.

In addition, OFHEO instructs Freddie Mac that it has a continuing obligation to provide copies of documents and/or communications, whether in hard copy or electronic format, that are responsive to this request or the requests directed to Freddie Mac on June 7, 2003 and June 11, 2003. Under this continuing obligation, Freddie Mac is required, for example, to provide OFHEO with "complete, unedited Board and Board Committee packages" for all Board and Board Committee meetings subsequent to June 6, 2003. The continuing obligation will remain in force until further notice.

- Finally, the following individuals are to be added to the list of people OFHEO will interview:
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- 
- 

OFHEO appreciates your continued cooperation in this matter and I look forward to your prompt response.

Very truly yours,



Stephen A. Blumenthal
Counsel to the Director

EXHIBIT

E

June 11, 2003

**Termination Provisions
Relating to Leland Brendsel**

- Mr. Brendsel began employment at Freddie Mac in 1982. He became CEO in 1987 and Chairman of the Board in 1989.
- He entered into an Employment Agreement with Freddie Mac, executed as of September 7, 1990, that set forth the terms and conditions of his employment as Chairman of the Board and Chief Executive Officer of Freddie Mac. The Employment Agreement includes provisions relating to compensation, termination of employment and compensation upon termination.
- At Freddie Mac's request, Mr. Brendsel resigned, effective June 6, 2003, as Chairman and Chief Executive Officer and as a member of the Board of Directors. He submitted a notice under his Employment Agreement resigning from employment for good reason effective 30 days from June 6, 2003.
- Pursuant to his Employment Agreement, Mr. Brendsel's post-employment compensation upon his resignation in response to the Board decision to elect a new Chief Executive Officer is:
 - Payment of base salary for a period of 24 months at the rate of base salary (\$1,180,000 per year) at time of employment termination;
 - Payment of pro-rata bonus for 2003, *i.e.*, a bonus at the most recently determined target (which is the 2002 target of 125%) of salary at time of termination, pro-rated for the portion of the year through the end of the month of employment termination (*i.e.*, January 2003 through July 2003) (\$860,417), to be paid within 60 days after employment termination;
 - No bonus payment for 2002, pursuant to the Board's determination in accordance with the Employment Agreement;
 - Vesting of long-term incentives pursuant to the terms of the Employment Agreement, *i.e.*, lapsing of restrictions on restricted stock/units and vesting of stock options on the date of employment termination, with stock options to be exercised by the earlier of their exercise date or 24 months after employment termination (see Exhibit 1 for details);
 - Health care and life insurance benefits for a period of sixty (60) months following employment termination as provided for in the Employment Agreement; and
 - Under his Employment Agreement, Mr. Brendsel is subject to a non-disclosure requirement, a two-year non-compete requirement and a one-year non-solicit requirement.
- The Office of Federal Housing Enterprise Oversight ("OFHEO") has informed the Board that this termination package is subject to OFHEO approval.