

Ann M. Kappler
Executive Vice President
and General Counsel
Legal Department
3900 Wisconsin Avenue, NW
Washington, DC 20016-2892
202 752 4850
202 752 6952 (fax)
ann_kappler@fanniemae.com

April 4, 2005

BY ELECTRONIC MAIL AND COURIER

Mr. Alfred M. Pollard
General Counsel
Attention: Comments/RIN 2550-AA31
Office of Federal Housing Enterprise Oversight
Fourth Floor, 1700 G Street, NW
Washington, DC 20552

RE: Proposed Rule on Mortgage Fraud Reporting (RIN 2550-AA31)

Dear Mr. Pollard:

Fannie Mae appreciates this opportunity to provide comments to the Office of Federal Housing Enterprise Oversight (OFHEO) on its proposal to establish safety and soundness requirements with respect to mortgage fraud reporting (the "Proposed Rule").¹

Fannie Mae takes the issue of mortgage fraud very seriously. Fannie Mae is working with OFHEO, Congress, its lender partners and others in the industry to combat the occurrence of and costs associated with mortgage fraud. The company recently expanded its own anti-fraud efforts to include three key anti-fraud strategies: (1) partnering with the industry to help lenders prevent fraud in the mortgage origination process; (2) detecting more cases of suspected fraud in loans that Fannie Mae has purchased; and (3) improving management of fraud and suspected fraud once detected, for example through improved investigation and notification protocols.

Fannie Mae supports the objective of the Proposed Rule and looks forward to working with OFHEO in its efforts to collect information on mortgage fraud from Fannie Mae and Freddie Mac in a manner that helps decrease the overall incidence of mortgage fraud, while at the same time recognizing the companies' business and legal responsibilities.

We respectfully submit the comments below for OFHEO's consideration.

I. Definitions of Mortgage Fraud and Possible Mortgage Fraud

A) Proposed Rule Definitions

The Proposed Rule, in Section 1731.2(c), provides that the term *mortgage fraud*

means a material misstatement, misrepresentation, or omission, relied upon by an Enterprise to fund or purchase – or not to fund or purchase – a

¹70 Fed. Reg. 9,255 (February 25, 2005) (to be codified at 12 C.F.R. pt. .731).

mortgage, mortgage backed security, or similar financial instrument. Such mortgage fraud includes, but is not limited to, identification and employment documents, mortgagee or mortgagor identity, and appraisals that are fraudulent.²

Referring back to the above definition of *mortgage fraud*, the Proposed Rule provides that *possible mortgage fraud*

means that an Enterprise has cause to believe that mortgage fraud may be occurring or has occurred.³

Fannie Mae fully supports the proposed requirement to report mortgage fraud in order to aid in the effort to detect, prevent, and deter current and future mortgage fraud. Fannie Mae does, however, recommend changes to the proposed definitions in order to prevent over-reporting and to more effectively target mortgage fraud.

Under OFHEO's proposed definitions of mortgage fraud and possible mortgage fraud, a loan with a single apparent data inaccuracy, sometimes referred to as a discrepancy, could trigger a report. There are a broad range of reasons why a loan could contain, or appear to contain, a discrepancy, including unintentional misstatements and errors. Reporting based on indicators of unintentional misstatements, misrepresentations or omissions could result in hundreds of thousands of reports to OFHEO per year.

For example, Fannie Mae uses "red flag" tools as part of its pre- and post-funding quality control process. Red flags screen for issues such as social security number inconsistencies, excessive valuation, inconsistencies in the occupancy type, and undisclosed liabilities. These red flags do not themselves indicate whether the discrepancy is due to a data error, a mistake, negligence, or an intentional effort to mislead; and in fact they produce a large percentage of false positives. However, under the current definitions of mortgage fraud and possible mortgage fraud, and because the Proposed Rule requires reporting before Fannie Mae has time to review loans with indicators to determine if an actual or suspected material misstatement, misrepresentation or omission exists, Fannie Mae would be likely to report all loans with red flags in an abundance of caution.

This volume of reporting would divert resources and attention away from actual fraud because it would result in an overwhelming volume of reports and a potentially cumbersome process. Over-reporting of loans to OFHEO that have not undergone sufficient review could also greatly complicate the reporting process. Because the investigation into cases of potential fraud involves several steps, a case that may appear at first to qualify as possible fraud under OFHEO's proposed definition may later be determined to be an unintentional mistake. Reporting on these types of cases too early in the process would mean that a large share of the reports initially submitted would have to be rescinded after further review. This could result in an operationally

² Id.

³ Id.

Alfred M. Pollard, Esq.

Page 3

April 4, 2005

cumbersome process that obscures actual cases of fraud and does not further the purposes of the Proposed Rule.⁴

B) Fannie Mae Suggested Definition of Mortgage Fraud

To prevent over-reporting and its impacts, Fannie Mae suggests that OFHEO refine the definition of mortgage fraud as follows:

Include the element of intent or knowing in the definition of mortgage fraud.

To be consistent with other statutory or regulatory frameworks, the Proposed Rule's definition of mortgage fraud should include the element of intent to deceive.⁵ If all loans affected by material misstatements, misrepresentations or omissions are reported without regard to whether they were knowingly made, it may result in reporting of non-fraudulent transactions including for example, those involving inadvertent mistakes on loan applications, missing loan documentation, and underwriting errors.

For this reason, Fannie Mae strongly believes that the definition of mortgage fraud should include the concept that the "material misstatement, misrepresentation, or omission" be "knowingly made" or "intentionally made." The addition of the concept of "knowingly" or "intentionally" would firmly connect the material misstatement, misrepresentation or omission to an intentional and deliberate act that causes Fannie Mae to rely on the misstatement, misrepresentation or omission when it funds or purchases, or declines to fund or purchase, a mortgage. With this change, the reports OFHEO will receive are more likely to contain information that will assist in combating mortgage fraud.⁶

When Fannie Mae acquires a mortgage loan, the lender represents and warrants to Fannie Mae that the loan satisfies the loan eligibility requirements (such as limits on the loan amount, loan-to-value ratio, and conformity to permitted property types) and underwriting requirements (dealing, for example, with analysis of the borrower's credit history and verification of the borrower's income and assets) governing the transaction, and that the loan information provided upon delivery is true and correct. If the representations and warranties are breached, the lender can be asked to repurchase the loan or take other corrective action. The contractual repurchase obligation provides an incentive for lenders to implement procedures for quality underwriting and is one of the ways Fannie Mae manages the safety and soundness of its investments and discourages inappropriate loan underwriting of all types.

⁴ The problems resulting from over-reporting have precedent in other fraud reporting regimes. The Director of the Treasury Department's Financial Crimes Enforcement Network (FinCEN) has warned against an "overreaction on the part of industry" that results in over-reporting of Suspicious Activity Reports due to fears of criticism from their financial regulators. He noted that such over-reporting of suspicious activity is "of little value to law enforcement officials." Blackwell, Rob, "OC, Fed, Citi Take Hits in Levin Report," *American Banker*, March 16, 2005.

⁵ "Fraud" is defined to mean "a knowing representation of the truth or concealment of a material fact to induce another to act to his or her detriment!" Black's Law Dictionary 685 (8th ed. 1979).

⁶ In developing guidance under this regulation, Fannie Mae recommends that OFHEO also consider the impact of reporting all cases of knowing material misrepresentation rather than just the subset of these loans that are determined to be part of a pattern of mortgage fraud or related to suspected institutional fraud.

Alfred M. Pollard, Esq.

Page 4

April 4, 2005

Many loans that lenders are asked to repurchase do not, in fact, involve any intentional misstatement, misrepresentation or omission by the lender or any other party to the transaction. Rather, they involve mistakes or errors, such as when a lender miscalculates a borrower's income. Fannie Mae is concerned that unless OFHEO's proposed definition of mortgage fraud is modified to include the concept that a party to the transaction must have knowingly or intentionally made a material misstatement, misrepresentation, or omission Fannie Mae will be compelled to report on a large number of loans that contain merely unintended business mistakes. This would cause Fannie Mae to label numerous loans with innocent errors as "mortgage fraud," and to name the lenders who submitted the loans as parties connected to mortgage fraud, even when the information they transmitted was not intentionally incorrect.

The concept of requiring a "knowing" or "intentional" act to support a suspicion of wrongdoing such as fraud is common in regulatory and statutory regimes, including HUD regulations. For example, the formulation in the Program Fraud Civil Remedies Act,⁷ implemented by HUD through regulations published at 24 CFR Part 28 for liability, uses the term "material" in the context of a knowing act. Hence liability under the Program Fraud Civil Remedies Act is for:

"Any person who makes, presents, or submits, or causes to be made, presented, or submitted, a claim that the person knows or has reason to know -- (A) is false, fictitious, or fraudulent; (B) includes or is supported by any written statement which asserts a material fact which is false, fictitious, or fraudulent; (C) includes or is supported by any written statement that -- (i) omits a material fact; (ii) is false, fictitious, or fraudulent as a result of such omission; and (iii) is a statement in which the person making, presenting, or submitting such statement has a duty to include such material fact."⁸

Another example is found in HUD's rules for public housing agencies regarding the discovery of certain types of fraud through litigation under the Section 8 Program. There, fraud and abuse are defined to mean "a single act or pattern of actions...that constitutes false statement, omission, or concealment of a substantive fact, made with intent to deceive or mislead..."⁹ Similarly, the criminal fraud statutes generally used to prosecute fraudulent activities include the concept of knowingly or intentionally as an element of the crime.¹⁰

⁷ 31 U.S.C., Chapter 38. Emphasis added.

⁸ 31 U.S.C. § 3802.

⁹ 24 CFR, § 792.103 (*emphasis added*).

¹⁰ See 18 U.S.C. § 1001 ("whoever, in any matter within the jurisdiction of the executive, legislative, or judicial branch of the Government of the United States, knowingly and willfully--(1) falsifies, conceals, or covers up by any trick, scheme, or device a material fact; (2) makes any materially false, fictitious, or fraudulent statement or representation; or (3) makes or uses any false writing or document knowing the same to contain any materially false, fictitious, or fraudulent statement or entry . . ."); §1341 ("Whoever, having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises . . ."); §1343 ("Whoever, having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises . . ."); §1344 ("Whoever knowingly executes, or attempts to execute, a scheme or artifice-- (1) to defraud a financial institution; or (2) to obtain any of the moneys, funds, credits, assets, securities, or other property owned by, or under the custody or control of, a financial institution, by means of false or fraudulent pretenses, representations, or

Likewise, the Suspicious Activity Report (SAR) financial institutions are required to file pursuant to the Bank Secrecy Act¹¹ refers to suspected violations of numerous Federal criminal statutes that include the element of knowledge or intent. Even the catchall reporting requirement of the SAR, that financial institutions report where "the transaction has no business or apparent lawful purpose or is not the sort in which the particular customer would normally be expected to engage . . ." (SAR Instructions 1.d.iii) refers to an unlawful purpose which would require a knowing or intentional element.

C) Fannie Mae Suggested Definition of Possible Mortgage Fraud

Similarly, in order to prevent over-reporting in the category of *possible mortgage fraud*, Fannie Mae recommends that OFHEO refine the definition of *possible mortgage fraud* as follows:

Define possible mortgage fraud as a case in which an Enterprise has reasonable or justifiable cause to believe, based on a review of the available evidence, that mortgage fraud may be occurring or has occurred.

Fraud detection and investigation procedures at Fannie Mae and elsewhere in the mortgage industry follow a process that initially casts a wide net to look for discrepancies that might indicate inaccuracies or inappropriate activity, and then systematically narrows the focus of further review to a smaller set of suspicious loans and incidents. At each stage the universe of suspected cases narrows and the investigation continues until a determination as to the presence or possibility of an intentional material misstatement, misrepresentation or omission can be made. In some cases, the review necessarily stops at a very broad level without additional investigation, because, for example, the loan did not meet the criteria established for further review, or because documentation is not available to make a determination. Requiring reports of loans with possible discrepancies too early in the review process would result in reporting large volumes of information on loans that have only marginal indicia of possible fraud and no documentation of fraud. Changing the definition of possible mortgage fraud to condition the "cause to believe" as "reasonable or justifiable" and "based on a review of the available evidence" prior to reporting would prevent the over-reporting described in this section, while still capturing those cases where Fannie Mae has information that could support the suspicion that mortgage fraud is occurring or has occurred.

As described above, Fannie Mae utilizes automated tools and manual processes that identify loans that contain a red flag indicating a discrepancy or possible inaccuracy in specific areas of the loan file. In some cases, further review of the loan file will determine that the red flag was an indicator that a material misstatement, misrepresentation or omission has occurred, whether intentional or unintentional. Because of this connection, loans that trigger red flags may be considered possible mortgage fraud under OFHEO's proposed definition since the red flags

promises . . ."); *U.S. v. Chandler*, 98 F.3d 711, 716 (2d Cir. 1996); *United States v. Guadagna*, 183 F.3d 122, 129 (2d Cir.1999); *U.S. v. Henningsen*, 387 F.3d 585, 590-91 (7th Cir. 2004); *U.S. v. Moede*, 48 F.3d 238, 241 (7th Cir. 1995).

¹¹ 31 U.S.C Section 5318.



could be “cause to believe” that a material misstatement, misrepresentation or omission may have occurred. However, the red flag itself does not provide sufficient information to enable this determination. While the Proposed Rule’s definition of mortgage fraud would consider such red flags as indicators of mortgage fraud or possible mortgage fraud, Fannie Mae does not view loans that trigger red flags as suspected cases of mortgage fraud unless and until they have undergone further review and unless there is an indication of a possible intentional material misstatement, misrepresentation or omission.¹²

In addition to the use of red flags, Fannie Mae also conducts more detailed post-purchase quality control reviews of a systematic sample of loan files. A variety of factors and a representative sampling of loan types are taken into account with other methods when determining which loans are reviewed.¹³ During the process of conducting these reviews, Fannie Mae may identify a discrepancy in the loan file that indicates the need for further investigation. As described above, the presence of a discrepancy could have several causes, including a data entry error or an inadvertent mistake in applying the underwriting standards. Under the Proposed Rule’s definition of possible mortgage fraud, loans with these discrepancies could qualify for reporting to OFHEO because the discrepancies could also indicate that a fraud had occurred. Fannie Mae believes reporting in these cases is only useful at the point at which Fannie Mae can make a determination that the discrepancies are not errors, but give rise to a reasonable belief that intentional material misstatements, misrepresentations or omissions occurred.¹⁴

Fannie Mae’s recommended definition of possible mortgage fraud would require the reporting of loans where there is a “reasonable” or “justifiable” cause to believe, but not require reporting where a discrepancy or red flag suggests that the possibility of fraud may exist but there is no substantiation of that possibility. Fannie Mae’s recommended definition also contemplates that its “cause to believe” be based on a “review of the available evidence” which merely recognizes the further review process to which loans with discrepancies may be subjected. Such an analysis of available evidence is similar to that contemplated for financial institutions reporting on the SAR.¹⁵

¹² Because of the large number of loans that trigger red flags and the high false positive rate, only a sample of loans containing red flags is reviewed in more detail. As a result, many loans with red flags are not reviewed and so no determination as to the reason for the discrepancy can be made.

¹³ These factors may include: loans that default in the first few months after acquisition; non-delinquent loans randomly selected; loans delivered by certain lenders; foreclosed loans; loans located in certain at-risk markets; loans recommended for review by operations staff as a result of an operational, compliance or similar review; and loans determined to be at higher risk for default. In addition, loans are sometimes selected for review based on tips from third parties as to a potentially fraudulent transaction, potential pattern of fraud, or fraud directly involving a Fannie Mae lender. These tips might come from law enforcement agencies, lenders, contractors, vendors, and employees of mortgage-related entities.

¹⁴ A notable exception to this norm occurs where it appears that a pattern of mortgage fraud may exist that encompasses a number of Fannie Mae loans. In this case, Fannie Mae may reach the standard of a reasonable or justifiable cause to believe that possible mortgage fraud is occurring based on a partial investigation that suggests certain loans that have not been fully reviewed appear to have characteristics making it likely they fall into the same category as loans forming the suspected pattern fraud. Fannie Mae’s recommended language would require reporting in these instances.

¹⁵ The SAR instructs that financial institutions report on transactions which have “no business or apparent lawful purpose . . . and the financial institution knows of no reasonable explanation for the transaction *after examining the*

2. *Procedures for Reporting*

Fannie Mae requests that OFHEO clarify the following issues regarding when Fannie Mae and Freddie Mac would be required to report and the time periods within which the reports should be made.

A) *Knowledge of Mortgage Fraud*

Section 1731.4(a) of the Proposed Rule provides that "an Enterprise shall report mortgage fraud or possible mortgage fraud" Fannie Mae requests clarification of this language because the language as proposed omits the requirement that the Enterprise be aware of the mortgage fraud or possible mortgage fraud. Fannie Mae suggests the Proposed Rule be revised to require reporting only in cases "when an Enterprise *knows or has reason to know* about mortgage fraud or possible mortgage fraud."

This suggested language makes clear that the reporting requirement is contingent on the company knowing or having reason to know about suspected mortgage fraud.¹⁶ While this seems like an obvious prerequisite to reporting, the Proposed Rule's language could be interpreted to impose liability on the company for not reporting mortgage fraud, or possible mortgage fraud, where it has not detected, or has no reason to suspect, fraud. While the information about the transaction may be within the company, for example in the case of a loan purchased with a false appraisal, until the company has some reason to review that loan, it will not "know" about the mortgage fraud.

In addition, Fannie Mae's proposed language of "*knows or has reason to know*" clarifies what is meant by "identifying mortgage fraud" in Section 1731.4, which states that Fannie Mae and Freddie Mac shall report "within four days of identifying mortgage fraud. . . ." In light of the significant supervisory actions against the Enterprise or related individuals that proposed Section 1731.6 provides, clarification of the language is essential. Without such clarification, the severity of the consequences to the company of too narrowly interpreting the word "identifying" may cause the companies to report where any issue is identified even before the issue is determined to be related to mortgage fraud.

B) *Promptly Reporting*

Section 1731.3 of the Proposed Rule prohibits the company from declining to purchase or from requiring repurchase of mortgages or mortgage backed securities because of possible fraud, without "promptly reporting" the possible fraud under section 1731.4. This provision raises

available facts, including the background and possible purpose of the transaction." SAR Instructions 1.d.iii (emphasis added).

¹⁶ This suggested language tracks the reporting requirement language for financial institutions in the SAR, which is elucidated in several different ways. In the Instructions, the SAR states: "Whenever the financial institution detects any known or suspected Federal criminal violation . . ." (¶ 1(a), (b), (c)). In paragraph (d), the SAR provides that "if the financial institution knows, suspects, or has reason to suspect that . . .).

many timing concerns.

It appears, but is not clear, that by reporting within the timeframes provided in section 1731.4, the company satisfies the "promptly reporting" requirement of section 1731.3. Such an interpretation seems consistent with the intent of the Proposed Rule, and Fannie Mae requests clarification of this provision. Further, Fannie Mae requests that OFHEO clarify whether the company can begin taking steps to decline a purchase or initiate a request for a lender to repurchase mortgages prior to *actual* reporting under the Proposed Rule, provided it will be reporting within the timeframes provided. Should reporting be required prior to taking further action, delays in declining a purchase or in requesting a repurchase could disrupt business processes and could cause undue risk to the company.

Fannie Mae requests that section 1731.3 clearly state that it does not prohibit the companies from declining purchases or requiring repurchases, provided they are properly reporting mortgage fraud and possible mortgage fraud pursuant to section 1731.4.

C) Timing of Reports

1) Immediate Notification

The Proposed Rule requires in Section 1731.4(a)(2) that Fannie Mae and Freddie Mac report mortgage fraud and possible mortgage fraud to OFHEO immediately "in any situation requiring immediate attention by OFHEO." To facilitate such reports, Fannie Mae requests clarification of which types of cases require OFHEO's immediate attention, and the timing of the reports required.

2) Cases not Requiring Immediate Notification

In addition, the Proposed Rule would require that all cases not requiring immediate notification be reported to OFHEO within four business days. Fannie Mae is concerned that this requirement may not be an effective means for communicating possible fraud. The requirement to report large volumes of data on a broad definition of possible mortgage fraud to OFHEO within four days of identification would effectively mean that OFHEO would receive daily reports on hundreds of transactions. This volume and frequency of reporting would diminish the quality of the review OFHEO would be able to provide, limiting the effectiveness of the Proposed Rule and creating a potentially burdensome reporting requirement. These same issues would arise using Fannie Mae's suggested definitions of mortgage fraud and possible mortgage fraud because the shortness of time would preclude an opportunity for Fannie Mae to obtain any additional information about any problematic loans.

With procedures in place for immediate notification when warranted, Fannie Mae suggests that a monthly reporting process, rather than a requirement for reporting within four days as in the Proposed Rule, will provide OFHEO with sufficient and timely information on suspected mortgage fraud and material misstatements, misrepresentations and omissions. A monthly

reporting process would also be consistent with the requirements for SARs under the Bank Secrecy Act, which requires financial institutions to report suspicious activity within 30 days.¹⁷

D) Nondisclosure of Reports to Connected Parties

The Proposed Rule, in Section 1731.4, provides:

(c) Nondisclosure. An Enterprise may not disclose, without the prior written approval of the Director, to the party or parties connected with the mortgage fraud or possible mortgage fraud that it has reported such fraud under this part. This restriction does not limit an Enterprise from disclosing or reporting such fraud pursuant to legal requirement, including to appropriate law enforcement authorities.

OFHEO has stated that the proposed Mortgage Fraud Reporting rule is not intended to interfere with, or delay, the normal business operations of the company.¹⁸ However, the current proposed language can be interpreted to put a stop to a transaction or to prevent the clarification of apparent inaccurate data until prior written approval is received in order to prevent implicit notification of a connected party. Fannie Mae requests that the above language be clarified to eliminate this confusion.

The Proposed Rule requires Fannie Mae and Freddie Mac to file a report with OFHEO for mortgage fraud or possible mortgage fraud in connection with its loan transactions, and also defines the universe of mortgage fraud quite broadly. Thus, the current language could be interpreted to prevent the companies from taking required business actions, such as notifying a lender of a repurchase request, because such an action could also implicitly notify that lender that the Enterprise has filed a report. Whether or not a lender, or another party, is a "part[y] connected with the mortgage fraud or possible mortgage fraud," is also unclear in the current Proposed Rule language. In many cases, Fannie Mae cannot know who is responsible for submitting fraudulent information until there is further review. In order to obtain additional information, Fannie Mae will need to contact a lender. Thus, should the lender be considered a connected party, the review of a suspect loan may implicitly inform the lender that the incident was the subject of a report.

The Proposed Rule's nondisclosure language could also be read to prohibit the disclosure of the fraud to third party fraud prevention databases, such as those managed by the Mortgage Asset Research Institute (MARI).¹⁹ It may also interfere with the completion of any on-going investigations and result in the delay of real estate property sales.

¹⁷ 31 U.S.C. §5318.

¹⁸ Statement of Alfred M. Pollard, General Counsel, OFHEO Before the House Financial Services Subcommittee on Oversight and Investigations (March 10, 2005) states that "[t]he proposal calls for the Enterprises to inform OFHEO when they have a suspicion of mortgage fraud prior to requiring repurchase or refusing to purchase a mortgage . . . ; they may continue with the transaction, if they determine appropriate, once OFHEO has been informed."

¹⁹ MARI is a well-known and respected industry aggregator of suspected mortgage fraud information. MARI's systems are endorsed by the Mortgage Bankers Association and used by over 300 lenders, mortgage insurers, both Fannie Mae and Freddie Mac, HUD and Ginnie Mae. Fannie Mae currently participates with MARI's Mortgage

In order to clarify that OFHEO (1) intended to limit this nondisclosure provision to prohibiting specific nondisclosure of the fact of filing the report, and (2) that this provision was not meant to prevent the enterprise from continuing with its business after the filing of a report, Fannie Mae proposes the following language:

Proposed 1731.4

(c) Nondisclosure. An Enterprise may not disclose, without the prior written approval of the Director, to the party or parties connected with the mortgage fraud or possible mortgage fraud that it has filed an OFHEO Mortgage Fraud Report under this part. This restriction does not limit an Enterprise from disclosing or reporting such fraud pursuant to legal requirement, including to appropriate law enforcement authorities. This restriction also does not limit the Enterprise from reporting the fraud to a third party, or from taking any legal or business action it may deem appropriate, including an action involving the party or parties connected with the mortgage fraud or possible mortgage fraud.

3. Safe Harbor From Disclosure

Fannie Mae also submits that the proposed Mortgage Fraud Reporting rule exposes Fannie Mae and Freddie Mac to significant legal risk because no safe harbor exists to protect the companies from actions that may result from their disclosure of information. This increase in legal risk could diminish the safety and soundness of Fannie Mae and Freddie Mac.

The lack of a safe harbor from liability leaves open the possibility that Fannie Mae would be subject to civil lawsuits after reporting to OFHEO suspected mortgage fraud that was later determined to be negligent or non-fraudulent activity. Because the Proposed Rule's definition of "mortgage fraud" and "possible mortgage fraud" is extremely broad, and requires the reporting of misstatements, misrepresentations and omissions that are the result of errors, as well as knowing activity, the risk of reporting a transaction which is ultimately determined to not contain fraudulent activity is high. Moreover, if the definitions of mortgage fraud and possible mortgage fraud contained in the Proposed Rule are adopted without change, lenders will assume that OFHEO is investigating many loans they have originated, thus increasing the liability risk.

The civil lawsuits that Fannie Mae could face include actions for interference with contractual relations. It is an intentional tort to "intentionally and improperly interfere with the performance of a contract... between another and a third party by inducing or otherwise causing the third person not to perform the contract."²⁰ It is also actionable to interfere with "prospective contractual relation[s]."²¹ Although, under the Proposed Rule, Fannie Mae may not directly inform the party suspected of fraud of its reporting the possible fraud to OFHEO, such reporting may result in, for example, OFHEO informing another potential buyer of the mortgage, resulting

Industry Data Exchange (MIDEX) and expects to expand this participation to include reporting to MARI's Mortgage Fraud Alert System (MFAS) system.

²⁰ Restatement of the Law, Second, Torts 2d, §766.

²¹ *Id.*, §766B.

in the sale of the mortgage not being consummated. Fannie Mae's reporting may therefore amount to "causing... the third party not to perform the contract."

Although interference with the performance of contracts may be justified where the proposed contracts are "illegal... or having a purpose or effect in violation of an established public policy,"²² the time requirements for reporting will not allow Fannie Mae to be certain of the fraudulent nature of the mortgage sales they may report to OFHEO. Also, where Fannie Mae is reporting "possible" mortgage fraud Fannie Mae may never be able to determine the existence of fraud. Thus, exposure to interference with contracts lawsuits remains a real possibility under the Proposed Rule.

Other potential civil lawsuits could include actions for libel (if written) or slander (if spoken). Commercial defamation is "the communication to a third party of a derogatory and false statement concerning the plaintiff's reputation which the third party understands to be both derogatory and about the plaintiff."²³ In this case, an assertion by Fannie Mae in a report to OFHEO pursuant to the Proposed Rule that a party is engaged in mortgage fraud or possible mortgage fraud could be found to be derogatory because such a statement may be harmful to the business reputation of the party. A derogatory statement only gives rise to liability if it is communicated to a third party, known as "publication." In this case, Fannie Mae might be deemed to have published the statement regarding the third party it suspects of "mortgage fraud" or "possible mortgage fraud" when it reports the matter to OFHEO pursuant to the requirements of the Proposed Rule. The published derogatory statement must also be false for it to amount to defamation. Because the Proposed Rule timing requirements would require Fannie Mae to report matters for which there is no certainty of actual mortgage fraud, the Proposed Rule may result in Fannie Mae making reports on matters which later turn out not to be fraud.

In addition to the above actions, reporting a suspicion of fraud or making allegations that later turn out to be unfounded could raise potential privacy and confidentiality claims. While certainly defenses exist to the civil claims described above, the existence of a safe harbor would prevent the lodging of such actions and would be an important step to a successful reporting regime.

Financial institutions, faced with the same type of concerns discussed above, are protected by the Safe Harbor provision provided in the Bank Secrecy Act²⁴ for filing SARs. That Safe Harbor provision provides complete protection from civil liability to the full extent provided by 31 U.S.C. §5318(g)(3). Because the risks to the companies are identical to those faced by financial institutions required to file SARs, Fannie Mae believes that full protection, such as provided for filers of SARs, should be provided through a statutory safe harbor.

OFHEO recently testified to the agency's support of such a provision before the House Financial Services Committee (March 10, 2005), stating that "Congress recognized that banks may make mistakes in good faith efforts to report activity that they think is suspicious; since the information is provided to the government, the Congress determined that the banks should not be

²² *Id.* at §774.

²³ *Business Torts*, §6.02[4].

²⁴ 31 U.S.C. §5318(g)(3).


Alfred M. Pollard, Esq.
Page 12
April 4, 2005

sued for damages.” Both the Federal Bureau of Investigation and the Mortgage Bankers Association have also testified in Congress in favor of a safe harbor provision that would protect any reporter of mortgage fraud from liability.²⁵ The FBI views the safe harbor provisions as an essential element of the reporting requirements that would provide the “necessary protections to the mortgage industry under a mandatory reporting mechanism.

In light of the above, Fannie Mae requests that OFHEO seek and support legislation to provide the companies with safe harbor protections from the risks associated with the reporting regime proposed by OFHEO’s Proposed Rule. At a minimum, until such time as a Safe Harbor can be provided, Fannie Mae requests that OFHEO maintain the confidentiality of reports made under the Final Rule. Fannie Mae also requests that the mortgage fraud reports be exempt from disclosure under the Freedom of Information Act.

We hope these comments are helpful as OFHEO develops its final rule and related guidance. We are available to discuss these comments with you at any time.

Sincerely,



Ann Kappler

²⁵ See statement of Mr. Chris Swecker, Assistant Director for Criminal Investigations, Federal Bureau of Investigation, Before the House Financial Services Subcommittee on Housing and Community Opportunity (Oct. 7, 2004). See statement of Marta McCall, Senior Vice President for Risk Management, American Mortgage Network (on behalf of the Mortgage Bankers Association), Before the House Financial Services Subcommittee on Housing and Community Development (Oct. 7, 2004).