UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF OHIO
EASTERN DIVISION

Parties		Case
OHIO PUBLIC EMPLOYEES RETIREMENT SYSTEM and STATE TEACHERS RETIREMENT SYSTEM OF OHIO, On Behalf of Themselves and all Others Similarly Situated,	:	CIVIL ACTION NO. C2-03-711
	:	JUDGE SARGUS MAGISTRATE JUDGE ABEL
Plaintiffs,	:	AMENDED CLASS ACTION COMPLAINT FOR VIOLATIONS OF THE FEDERAL SECURITIES LAWS
v.	:	
FREDDIE MAC, f.n.a. FEDERAL HOME LOAN MORTGAGE CORPORATION, LELAND C. BRENDSEL, VAUGHN A. CLARKE, DAVID W. GLENN, and GREGORY J. PARSEGHIAN,	:	JURY TRIAL DEMANDED
Defendants.	:	

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I. NATURE OF THE ACTION

1. Plaintiffs Ohio Public Employees Retirement System ("OPERS") and State Teachers Retirement System of Ohio ("STRS") bring this Action pursuant to §§ 10(b) and 20(a) of the Securities Exchange Act of 1934 (the "Exchange Act"), 15 U.S.C. § 78u-4, on behalf of themselves and other persons and entities that acquired the common stock of Freddie Mac (or the "Company") in the open market between July 15, 1999 and June 6, 2003, inclusive (the "Class Period"). The unlawful acts and conduct alleged herein either have been admitted by the defendants, or have been confirmed in a detailed investigative report issued by the Office of Federal Housing Enterprise Oversight ("OFHEO"), an independent governmental entity charged with ensuring the financial soundness of Freddie Mac.

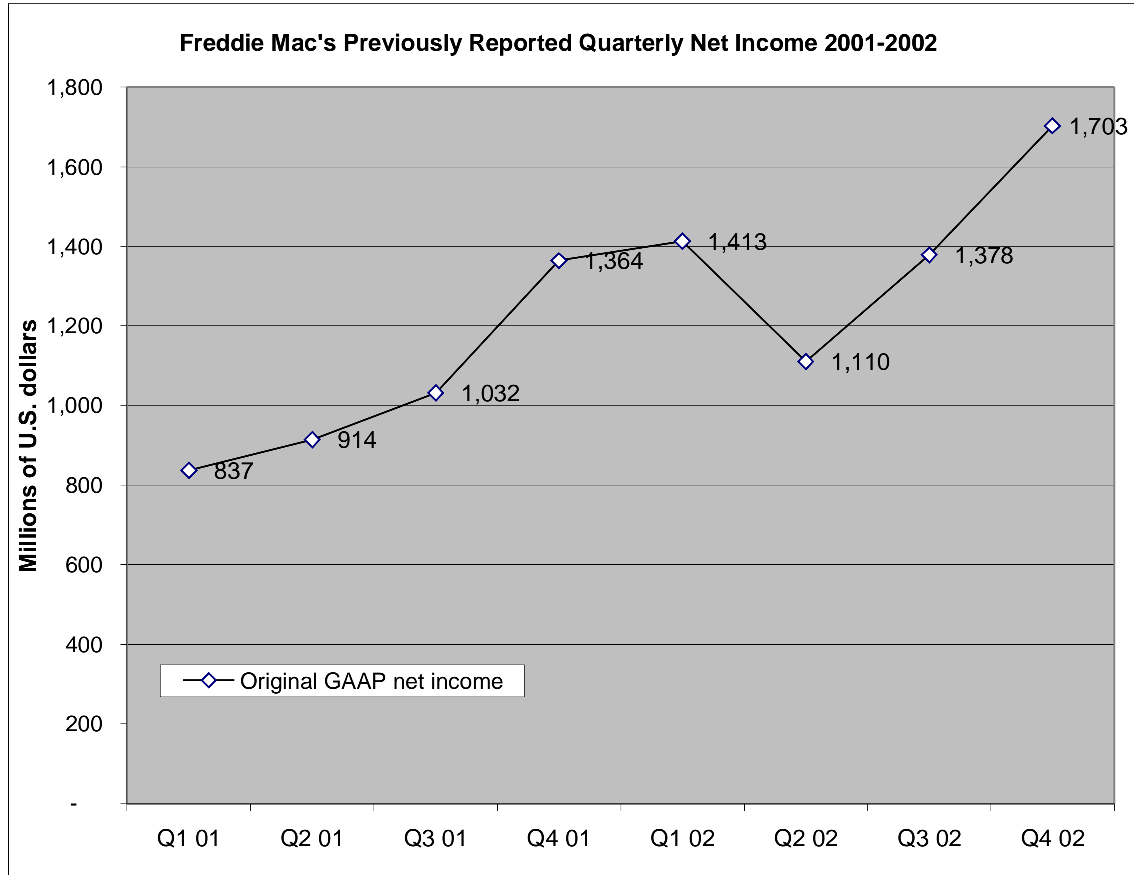
2. Freddie Mac is one of the largest purchasers of mortgages in the United States, and it also runs a very large mortgage securitization business. In the securitization side of its business, Freddie Mac issues securities to investors backed by pools of mortgage loans. Freddie Mac calls these securities Mortgage Participation Certificates ("PCs"). Principal and interest payments on the mortgages in the pool are passed through to PC holders by Freddie Mac on a monthly basis. Freddie Mac typically assumes the credit risk on the underlying mortgages, meaning the risk that borrowers will default on their payment obligations. Most of the interest-rate risk associated with PCs is borne by the buyers of the PCs, rather than Freddie Mac. Freddie Mac earns fee income for assuming the mortgage credit risk and administering the mortgage securities.

3. In addition to securitizing mortgages, Freddie Mac purchases mortgage loans and mortgage-related securities and holds them as on-balance sheet assets. Freddie Mac refers to mortgage investments that it intends to hold on its balance sheet as its

"retained portfolio." Freddie Mac funds these purchases of mortgages and mortgage-related securities by issuing short and long-term debt. When the Company holds mortgages in its retained portfolio, it is exposed to both credit risk and interest-rate risk. The Company earns money on its retained portfolio by funding its mortgage purchases with debt securities that have a lower yield than the mortgages being acquired.

4. During the Class Period, the size of Freddie Mac's retained portfolio skyrocketed from $324.44 billion as of December 31, 1999, to $583.27 billion as of December 31, 2002. This growth in the retained portfolio exposed Freddie Mac to substantial amounts of interest-rate risk, which is the risk that Freddie Mac's cost of issuing debt could become higher than the average yield on its mortgage investments. Wide fluctuations in market interest rates during the Class Period created the risk that Freddie Mac's "net interest income" from the retained portfolio would undergo substantial gyrations. Yet, Freddie Mac posted steadily increasing earnings from quarter to quarter throughout the majority of the Class Period. Freddie Mac's avoidance of

earnings volatility during the Class Period earned the Company the nickname "Steady Freddie," as illustrated in the graph set forth below:



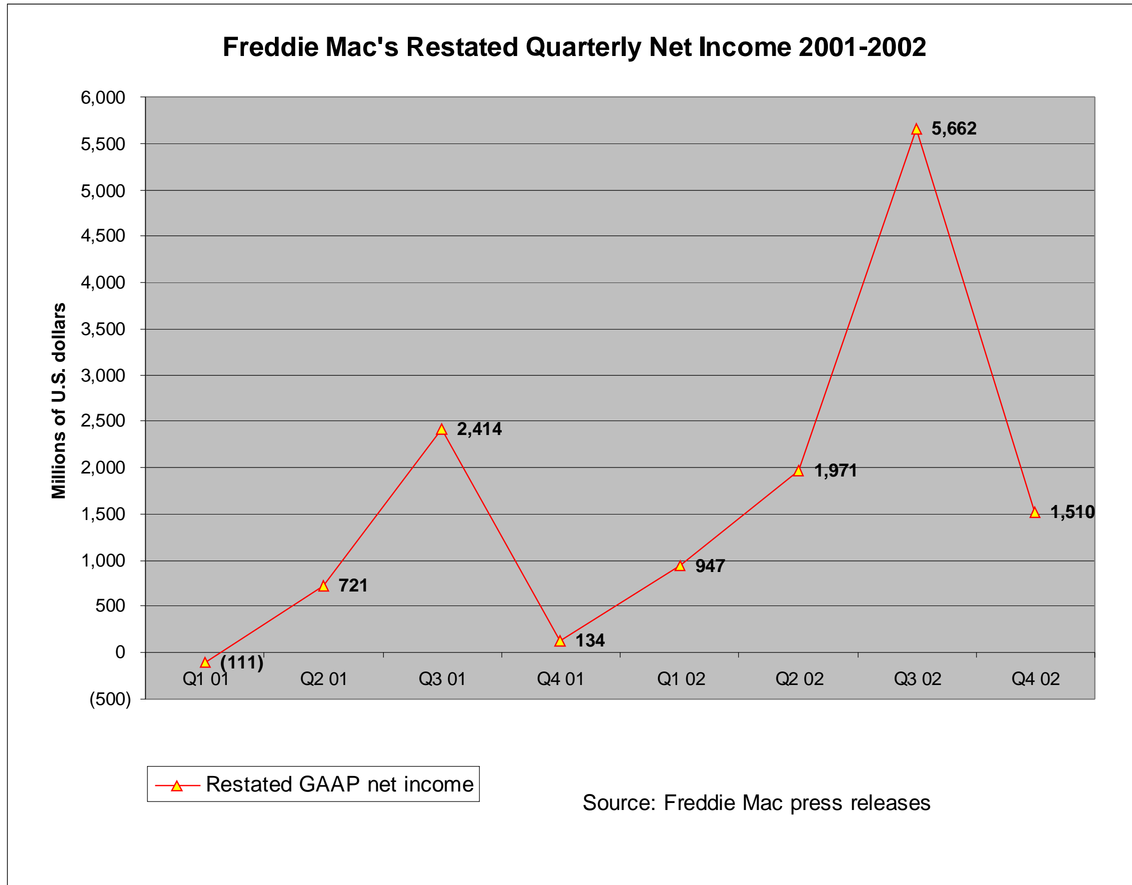
5. Freddie Mac has now admitted that it intentionally misstated its financial results by billions of dollars throughout the Class Period, in direct violation of generally accepted accounting principles ("GAAP"). On November 21, 2003, Freddie Mac announced restated financial results for 2000, 2001, 2002 and prior periods, revealing for the first time that the Company had overstated its net income for 2001 by approximately $1.4 billion (the "Restatement"), as set forth below:

Restated Financial Results for Three Years Ended December 31, 2002

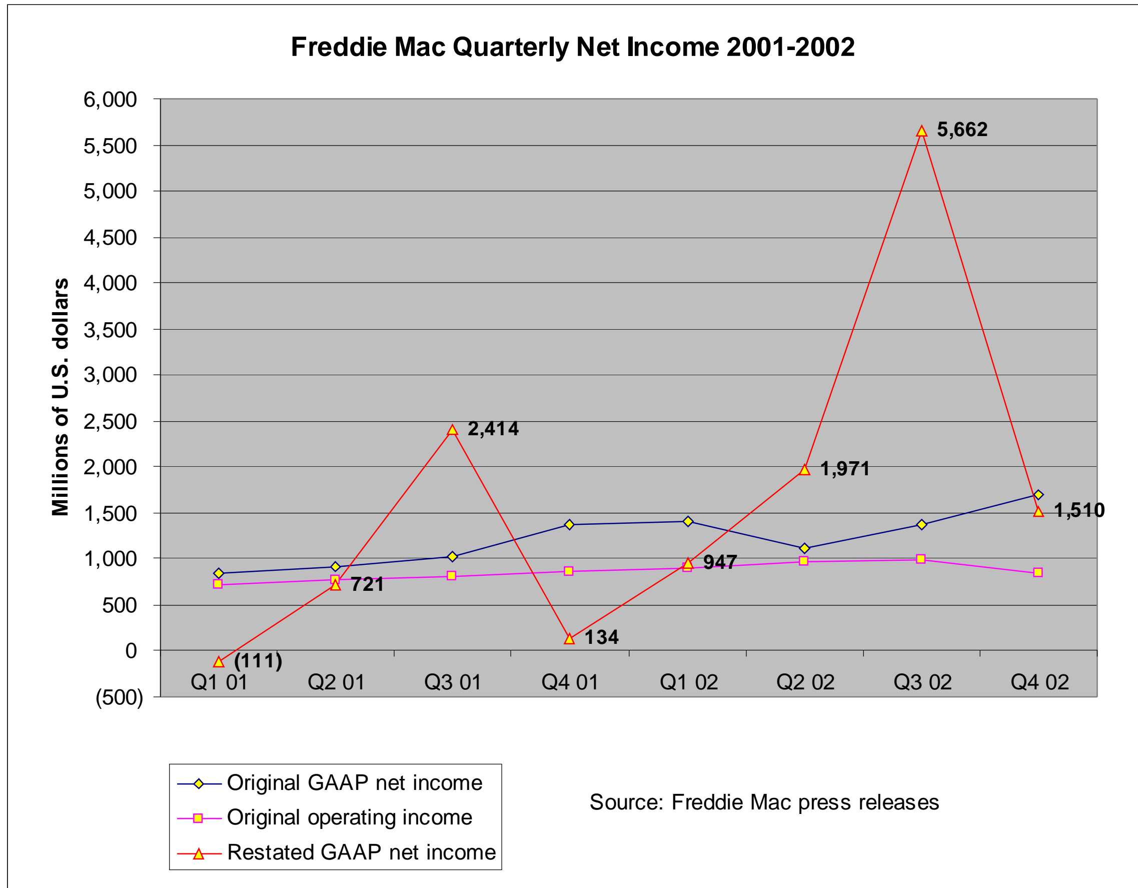
	Net Income (in millions) [1]			Diluted EPS (in dollars)			Stockholders' Equity (in millions)		
Year Ended	**As Previously Reported**	**As Restated**	**Change**	**As Previously Reported**	**As Restated**	**Change**	**As Previously Reported**	**As Restated**	**Change**
December 31, 2000	$2,547	$3,666	$1,119	$3.40	$5.01	$1.61	$14,837	$17,357	$2,520
December 31, 2001	$4,147	$3,158	($989)	$5.64	$4.23	($1.41)	$15,373	$19,624	$4,251
December 31, 2002	$5,764	$10,090	$4,326	$7.95	$14.18	$6.23	$24,629	$31,330	$6,701

(1) The net cumulative effect of the restatement through December 31, 2002 also includes $0.6 billion for periods prior to 2000.

6. Freddie Mac's restatement further reveals that, contrary to defendants' representations, the Company's financial results were highly volatile and subject to significant fluctuations, as illustrated by the chart below:



7. The chart below further serves to illustrate the highly volatile nature of the Company's results as restated versus its results as reported:



8. As set forth in a consent decree that the Company has entered into with OFHEO, Freddie Mac has admitted that the material misstatement of its financial results resulted from its "disregard[ ] [of] accounting rules, internal controls, disclosure standards, and ultimately, the public trust in the pursuit of steady earnings growth." Both the consent decree and Freddie Mac's own internal investigative report reveal the various machinations that the Company employed to hide its losses and volatility, and conform its publicly disseminated results to the image of "Steady Freddie," including the following: (i) creating "cookie jar" reserves to hide gains and mask losses; (ii) altering interest rate and prepayment assumptions on underlying mortgages to recognize income in amounts

that met prevailing investment analyst expectations; and (iii) engaging in sham option transactions for the purpose of misrepresenting recurring interest income.

9. Many of the accounting machinations that Freddie Mac employed during the Class Period were designed to work around or defeat a new accounting standard called Statement of Financial Accounting Standards ("SFAS") 133, *Accounting for Derivative Instruments and Hedging Activities*. Derivatives are financial instruments – such as forward contracts, options, and swaps – that financial institutions use to manage interest-rate and currency risk. Effective January 1, 2001, the Company adopted SFAS 133, which required most derivatives to be carried on the Company's balance sheet at their fair market values. In addition, under SFAS 133, gains and losses on many derivative positions, whether realized or not, flow into earnings in the period in which they occur. During the Class Period, Freddie Mac was an enormous user of derivatives. As of the end of 2001, the Company held derivatives with a notional amount exceeding $1 trillion, a $578 billion increase from December 31, 2000. As detailed herein, defendants knew that implementation of SFAS 133 would create huge fluctuations in quarterly net income and in the value of derivatives recorded on its balance sheet. In addition, the adoption of SFAS 133, would require Freddie Mac to record a large, one-time gain called the "transition gain." Freddie Mac's management believed that this volatility in income and the one-time gain would hurt the Company's stock price, especially since future earnings would appear lower following the one-time transition gain. Thus, Freddie Mac's management engaged in a complex series of sham transactions designed to work around or evade the new accounting standard, thereby making the Company's earnings seem much more stable than they actually were. This unlawful

conduct included: (i) falsely reclassifying securities that the Company intended to hold until maturity as "trading" and "available for sale," to allow Freddie Mac to record losses within its portfolio to offset unwanted gains; (ii) engaging in fabricated, circular "purchases" and "sales," in which the risks of ownership were not transferred, and no true purchase or sale ever occurred; and (iii) devising and adopting an unsupported methodology to value a segment of its securities portfolio on a one-time basis for the sole purpose of offsetting the remaining amount of unwanted gain. Through these unlawful means, now largely admitted by the defendants, Freddie Mac artificially manipulated the timing of its income so that present gains could be used to mask less impressive results in future quarters.

10. Defendants Leland Brendsel, Vaughn Clarke, David Glenn, and Gregory Parseghian, collectively, the "Individual Defendants," as the Company's Chief Executive Officer, Chief Financial Officer, Chief Operating Officer, and Chief Investment Officer, respectively, orchestrated the fraudulent scheme described herein. Each of these Individual Defendants was responsible for ensuring the accuracy of Freddie Mac's financial reports. Nevertheless, as set forth in the Consent Decree, each of these Individual Defendants, comprising the senior management of the Company, "established the goal of steady mid-teens earnings growth . . . [and] demanded whatever level of management of earnings was necessary and the execution of transactions to meet these goals. Those individuals were aware of and encouraged reserve adjustments to move earnings as necessary on a quarterly basis to meet analyst expectations." To further their scheme, these defendants caused Freddie Mac to award millions of dollars in bonuses to themselves and their subordinates not only for meeting analyst earnings expectations, but

for devising transactions by which the Company could hide "excess" earnings for use in future quarters.

11. The price of Freddie Mac common stock dropped significantly after the Company admitted misstating its financial results, declining from a class period high of $70.79 per share on November 7, 2001 to $50.26 on June 9, 2003, the date on which the Company announced that three of its top officers, Glenn, Brendsel and Clarke, had left the Company in the midst of its investigation into accounting improprieties. Significantly, Freddie Mac revealed that it had terminated Glenn's employment because of his lack of candor in the Company's investigation and that he had destroyed, lost and altered notes recording business meetings during the class period. In the wake of these revelations, OFHEO has formally charged Brendsel and Clarke with engaging in "a pattern of misconduct" that "involved recklessness and caused, or would be likely to cause, a material loss to the Enterprise." (Notice of Charges against Brendsel and Clarke, Notice No. 2003-2 and Notice No. 2003-3). Further, Glenn has entered into a consent order with OFHEO, pursuant to which he has agreed to pay a fine of $125,000 as a result of "serious and substantial issues regarding the management, operations and business practices of Freddie Mac for a period during which [he] served as an officer and director." (OFHEO Consent Order in the matter of David Glenn, Order No. 2003-01). Glenn also agreed to forfeit $13 million in bonuses and severance pay, and to cooperate in OFHEO's ongoing investigation. The misstatement of Freddie Mac's financial results also remains the subject of a formal Securities and Exchange Commission ("SEC") investigation and grand jury proceeding.

II. JURISDICTION AND VENUE

12. The claims alleged herein arise under §§ 10(b) and 20(a) of the Securities Exchange Act of 1934 (the "Exchange Act"), 15 U.S.C. §§ 78j(b) and 78t(a), and Rule 10b-5, 17 C.F.R. § 240.10b-5 promulgated thereunder.

13. The jurisdiction of this Court is based on § 27 of the Exchange Act, 15 U.S.C. § 78aa, and 28 U.S.C. §§ 1331 and 1337.

14. Venue is proper in this District pursuant to § 27 of the Exchange Act and 28 U.S.C. § 1391(b). Substantial acts in furtherance of the alleged fraud or the effects of the fraud occurred in this District and Plaintiffs maintain their principal places of business in this District.

15. In connection with the acts, transactions and conduct alleged herein, defendants used the means and instrumentalities of interstate commerce, including the United States mails, interstate telephone communications and the facilities of national securities exchanges and markets.

III. PARTIES

16. Plaintiff OPERS, formed in 1935, provides retirement, disability and survivor benefit programs for public employees throughout the State of Ohio who are not covered by another state or local retirement system. OPERS currently serves more than 620,000 members and over 130,000 retirees and surviving beneficiaries, and has assets exceeding $54 billion under management. OPERS purchased shares of Freddie Mac common stock on the open market during the Class Period at artificially inflated prices, in the amounts set forth in the certification previously filed with the Court, incorporated herein by reference, and suffered damages as a result of the violations of federal securities laws that are alleged herein.

17. Plaintiff STRS is one of the nation's premier retirement systems, serving more than 400,000 active, inactive and retired Ohio public educators, and has assets of approximately $48 billion under management. STRS purchased shares of Freddie Mac's common stock on the open market during the Class Period at artificially inflated prices, in the amounts set forth in the certification previously filed with the Court, incorporated herein by reference, and suffered damages as a result of the violations of federal securities laws that are alleged herein.

18. (a) Defendant Freddie Mac, f.n.a. Federal Home Loan Mortgage Corporation is a Government Sponsored Enterprise ("GSE") that has a public mission to create broad and liquid markets for mortgage-backed securities. Freddie Mac is a major purchaser of mortgages from loan originators. In this way, Freddie Mac purportedly provides liquidity for mortgage originators and reduces the interest rate paid by borrowers.

(b) Freddie Mac operates under a federal charter and is subject to regulation by OFHEO, which was established as an independent entity within the Department of Housing and Urban Development by the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (12 U.S.C. §§ 4501 *et seq.*). OFHEO's primary mission is ensuring the capital adequacy and financial safety and soundness of Freddie Mac and its main competitor, Fannie Mae.

(c) Freddie Mac is owned by its shareholders and its common stock is listed and traded publicly on the New York Stock Exchange ("NYSE") and the Pacific Stock Exchange ("PCX") under the ticker symbol "FRE." The Company operates on a calendar year, *i.e.*, its fourth quarter and fiscal year ended on December 31st.

(d) During the Class Period, Freddie Mac was exempt from the SEC registration and reporting requirements. At all times, however, the Company remained subject to the antifraud provisions of the federal securities laws, which the Company made known to investors in its public reports. In lieu of filing annual reports with the SEC on Form 10-K and quarterly reports on Form 10-Q, Freddie Mac issued "Information Statements" and "Information Statement Supplements," which contained business and financial information similar to that required to be disclosed in the Forms 10-K and 10-Q, including its financial results for each quarterly and annual period. The Company also published and made publicly available traditional Annual Reports for its shareholders.

19. (a) During the Class Period, defendant Brendsel served as Freddie Mac's Chairman of the Board and Chief Executive Officer ("CEO"), holding those positions since 1987 and 1989, respectively. Brendsel joined the Company in 1982 as its Chief Financial Officer ("CFO") and became Acting President in 1985. As Chairman of the Board and CEO, Brendsel's primary responsibilities included overseeing the overall success or failure of the Company; providing leadership for the formulation and achievement of the Company's vision, mission, strategy, financial objectives and goals; ensuring that effective and qualified management were retained by the Company; ensuring that the Company established appropriate controls, policies and procedures that were adequate to protect corporate assets; and directing the conduct and affairs of the Company in furtherance of its the safe and sound operation.

(b) Brendsel, along with defendants Clarke, Glenn and Parseghian, was responsible for ensuring the accuracy of Freddie Mac's public reports and statements

throughout the Class Period. Brendsel signed letters to shareholders contained in the annual reports and the management's report contained at the end of the Company's Information Statements.

(c) Brendsel also attested to and certified the accuracy of Freddie Mac's reported financial results on two separate occasions. On August 14, 2002, Brendsel submitted a certification to the SEC attesting to the completeness and accuracy of the Company's Information Statement for 2001, the Information Statement Supplements for the first and second quarters of 2002, and the definitive proxy materials dated April 2, 2002. Also, on or about November 14, 2002, Brendsel submitted a certification to the SEC attesting to the accuracy of the Third Quarter 2002 financials and acknowledging his responsibility for establishing and maintaining the Company's internal control policies.

(d) Brendsel, along with the other defendants, was principally responsible for the Company's communications with securities analysts and investors during the Class Period. Brendsel commented on the Company's financial performance in each of its earnings releases issued during the Class Period. Brendsel also communicated directly with investment analysts concerning the Company's financial operations in a conference call held during the Class Period on January 27, 2003.

(e) Brendsel and the other defendants created a corporate culture or "tone at the top" that was focused upon meeting, and not significantly exceeding, Wall Street earnings expectations. Indeed, it was well known in the organization that the tone of "Steady Freddie" came from its Chief Executive Officer and that employees in Funding and Investment Division (F&I), Corporate Accounting and other business units

were expected to take actions that would help achieve the goal of steady, nonvolatile earnings growth. This corporate culture compromised the integrity of Freddie Mac's own employees and led to intense and at times improper efforts to manage the Company's reported earnings. For example, in an admonishment of Brendsel, Glenn and Clarke, OFHEO stated that:

> [T]he efforts of Freddie Mac to inappropriately manage earnings were a direct result of an inappropriate tone at the top set by senior management – primarily CEO Brendsel, COO Glenn, and Chief Financial Officer (CFO) Vaughn Clarke. That tone at the top was the most important determinant of the corporate culture of the Enterprise in the 1999-2002 period covered by the restatement. ***Senior management established the goal of steady mid-teens earnings growth, as well as other more specific goals . . . demanded whatever level of management of earnings was necessary and the execution of transactions to meet those goals. Those individuals were aware of and encouraged reserve adjustments to move earnings as necessary on a quarterly basis to meet analyst expectations.***

(OFHEO Report, pp. 9-10 (footnotes omitted) (Emphasis added.)).

(f) Further, as admitted by defendant Parseghian, Brendsel met with Glenn and Clarke "weekly in private sessions," and "the earnings goals . . . would emanate from those meetings . . . *There was a clear goal to manage the interest income . . . [w]e would propose transactions and strategies that would attempt to meet those goals*." (Emphasis added.). Brendsel himself has admitted to OFHEO that there was "an informal practice" to hit earnings estimates within 1 to 2 cents per share, to attract a wider spectrum of investors who may not have invested in a volatile stock.

(g) To successfully portray the Company as "Steady Freddie," Brendsel, along with the other defendants, was aware of, and directly participated in many of Freddie Mac's accounting machinations during the Class Period. For example, one way in which the Company tried to manage earnings was through the use of reserves. Brendsel admitted to OFHEO investigators that throughout the Class Period the

Company would review its reserves "each quarter" to determine if they were appropriate or if there was any "flexibility" in changing them. Notes from a "dry run" of a Board presentation conducted in Brendsel's office on June 4, 1999, admit to the improper use of reserves to manage earnings, although Brendsel falsely minimized the use of this practice: "[w]e have managed earnings via reserves but that is not frequent or significant/material; *i.e.*, several cents." Additionally, Brendsel chaired at least one meeting where the participants discussed a transaction which the Company devised for the sole purpose of offsetting a transition gain realized from the adoption of SFAS 133,

(h) Brendsel and the other defendants took steps to conceal many of the accounting manipulations from the Board and investors, which included fostering weak accounting and internal controls to avoid detection. Despite Board members' increasing concern in the Fall of 2001 and Spring of 2002 over the lack of depth and expertise in Corporate Accounting and their demands for action, Brendsel failed to take corrective action.

(i) Through his direct participation and involvement in the Company's financial reporting functions, as detailed above, Brendsel knew or, but for his recklessness, should have known that, contrary to his representations: (i) he and the other defendants had inappropriately set a tone at the top which encouraged employees to meet earnings goals at any cost; (ii) Freddie Mac's internal controls suffered from material weaknesses, which made it easier for the Company to carry out schemes and resulted in numerous errors under GAAP, all of which gave rise to the restatement; (iii) the Company had devised and transacted numerous accounting schemes to smooth earnings

and avoid a gain from a change in accounting principle; and (iv) the Company devised transactions to avoid giving effect to another new accounting rule.

(j) Brendsel retired from the Company effective June 6, 2003. On December 18, 2003, OFHEO filed a Notice of Charges against Brendsel (Notice No. 2003-2), alleging that during the Class Period he engaged in "a pattern of misconduct" that "involved recklessness and caused, or would be likely to cause, a material loss to the Enterprise." In addition to other remedies, the Notice of Charges seeks to reclassify Brendsel's resignation as a "termination for cause" and demands that he forfeit his severance award and return bonuses that he received in fiscal 2000 and 2001.

20. (a) During the Class Period, defendant Clarke served as Freddie Mac's Executive Vice President and CFO. He was appointed Senior Vice President and CFO in March 2000, and was promoted to Executive Vice President and CFO on November 15, 2000.

(b) When Clarke joined the Company in 1998, he served as Senior Vice President of Finance. As Senior Vice President, he was responsible for developing and managing the Company's integrated long-term financial operating plans and budgets, its shareholder strategy and its capital structure. As CFO, Clarke was primarily responsible for ensuring the accuracy of the Company's financial statements, and for: providing leadership for financial strategy implementation to allow for maximizing shareholder value while protecting Freddie Mac's assets; tracking financial performance against forecasts; assessing operational and financial goals; managing the Company's short and long-term performance; and supervising the Corporate Accounting Department and the Company's control and finance functions.

(c) Clarke, along with the other Individual Defendants, was principally responsible for the Company's communications with securities analysts and investors during the Class Period. Specifically, during the Class Period, Clarke commented on the Company's financial performance in each of the conference calls with investment analysts that Freddie Mac convened after each quarterly and year end earnings release.

(d) Clarke, along with Brendsel, Glenn and Parseghian, was responsible for ensuring the accuracy of Freddie Mac's public reports and statements throughout the Class Period. Clarke signed letters to shareholders contained in the annual reports and the management's report contained at the end of the Company's Information Statements.

(e) Clarke also attested to and certified the accuracy of Freddie Mac's reported financial results on two separate occasions. On August 14, 2002, Clarke submitted a certification to the SEC attesting to the completeness and accuracy of the Company's Information Statement for 2001, the Information Statement Supplements for the first and second quarters of 2002, and the definitive proxy materials dated April 2, 2002. Also, on or about November 14, 2002, Clarke submitted a certification to the SEC attesting to the accuracy of the Third Quarter 2002 financials, as well as acknowledging his responsibility for establishing and maintaining the Company's internal control policies.

(f) Clarke participated in meetings with Brendsel and Glenn in which they established the goal of steady mid-teens earnings growth and "demanded whatever level of management of earnings was necessary and the execution of transactions to meet those goals." Clarke would then direct business units within Freddie Mac to meet those

earnings. For example, Lisa Roberts, then Deputy Controller, has admitted that Clarke typically informed F&I personnel what prevailing analysts EPS expectation were each quarter, and, if the unit needed to execute a transaction in order to meet that expectation, "those types of strategies and alternatives and options were discussed." Parseghian further admitted that Clarke would quote "***to the penny what they wanted us to produce***" to meet prevailing earnings estimates. The Senior Vice President and Corporate Controller Edmond Sannini, who joined Freddie Mac on October 1, 2001, has also stated that Clarke instructed him to come "as close as possible" to meeting analyst estimates.

(g) Accordingly, like the other Individual Defendants, Clarke directly participated in the use of accounting machinations when necessary to meet earnings goals, including using reserves to move earnings as necessary to meet analysts' expectations. On at least one occasion, Clarke directed employees to devise schemes to increase interest income. When the Company's external auditors balked at the scheme and told him to unwind the transaction, Clarke refused until the transactions had the desired accounting effect. Similarly, when Freddie Mac faced recognizing an enormous transition gain and revealing the true volatility of its earnings, Clarke participated in devising various accounting transactions that would help offset the gain and hide this volatility.

(h) Like Brendsel, Clarke fostered the maintenance for weak accounting and internal controls to facilitate the misstatement of Freddie Mac's results and avoid detection. For example, Gregory Reynolds, who had been the Company's Controller, complained to Clarke that the Company did not have sufficient internal

auditing resources to make decisions concerning SFAS 133. Clarke, however, refused to hire qualified personnel.

(i) Through his direct participation and involvement in the Company's financial reporting functions, Clarke knew or, but for his recklessness, should have known that, contrary to his representations: (i) he and the other defendants had inappropriately set a tone at the top which encouraged employees to engage in improper accounting machinations to meet earnings goals, in violation of GAAP; (ii) Freddie Mac's internal controls suffered from material weaknesses, which made it easier for the Company to carry out schemes and resulted in numerous errors under GAAP, all of which gave rise to the restatement; (iii) the Company had devised and transacted numerous accounting schemes to smooth earnings and hide its earnings volatility.

(j) Clarke retired from the Company effective June 6, 2003. On December 18, 2003, OFHEO filed a Notice of Charges against Clarke (Notice No. 2003-3) alleging that during the Class Period he engaged in "a pattern of misconduct" that "involved recklessness and caused, or would be likely to cause, a material loss to the Enterprise." In addition to other remedies, the Notice of Charges seeks to reclassify Clarke's resignation as a "termination for cause" and it demands that he forfeit his severance award and return bonuses that he received in fiscal 2000 and 2001.

21. (a) During the Class Period, defendant Glenn served as the Company's Vice Chairman of the Board, President and Chief Operating Officer ("COO"). As COO, Glenn was responsible for overseeing overall operations of the Company and, in particular, the credit risk activities, including Freddie Mac's credit risk oversight

function. Glenn joined Freddie Mac in 1987 as the CFO, and was promoted to COO in 1989 and President in 1990.

(b) Glenn, along with the other Individual Defendants, was principally responsible for the Company's communications with securities analysts and investors during the Class Period. Glenn commented on the Company's financial performance in each of its earnings releases issued during the Class Period. Glenn also communicated directly with investment analysts concerning the Company's financial operations in a conference call held during the Class Period on May 21, 2003.

(c) Glenn participated in the weekly meetings with Brendsel and Clarke during which earnings targets were discussed and, according to Parseghian, goals were handed down to manage Freddie Mac's interest income within prevailing analyst expectations. Glenn has admitted to the Company's outside attorneys that these unlawful earnings manipulations began as early as June 4, 1999.

(d) Glenn, along with the other Individual Defendants, directly participated in many of Freddie Mac's unlawful accounting machinations during the Class Period. For example, even after the Company's outside auditors made him aware of at least one transaction in the third quarter of 2001 which violated GAAP and should be unwound, Glenn allowed it to continue into the next quarter and until such time that the transaction had its desired effect on earnings. Glenn also approved at least one transaction which served no proper business purpose, but was undertaken only to help the Company manage its transition gain under SFAS 133 and hide future volatility.

(e) Like Brendsel and the other Individual Defendants, Glenn knew or, but for his recklessness, should have known of the material weaknesses in Freddie Mac's

accounting and internal control functions. Nevertheless, he failed to take corrective action even after Freddie Mac's Board became increasingly concerned over the lack of depth and expertise in the Corporate Accounting office.

(f) Glenn was "terminated for cause" on June 6, 2003 because of serious questions as to the timeliness and completeness of his cooperation and candor with the investigation of the fraudulent activity at Freddie Mac that give rise to the allegations set forth herein. Specifically, it was revealed that Glenn had altered and destroyed notes contained in his personal diaries which related to business meetings that he attended while he was COO of Freddie Mac, in part to obscure information provided to the Company's outside auditors. As discussed below, Glenn made several notations in his diary which indicated his awareness that the Company managed its earnings and that it lacked appropriate accounting controls.

(g) The Consent Order required Glenn to pay to the U.S. Treasury a $125,000 fine, which sum constituted a Civil Money Penalty pursuant to 12 U.S.C. § 4636. The Consent Order also requires Glenn to cooperate fully with OFHEO in the on-going special examination and any subsequent enforcement proceedings initiated by OFHEO, in what the Consent Order describes as "serious and substantial issues regarding the management, operations and business practices of Freddie Mac for a period during which Glenn served as an officer and director." (OFHEO Glen Consent Order, Order No. 2003-1). Glenn also forfeited approximately $13 million in severance pay and bonuses resulting from his termination.

22. (a) During the Class Period, defendant Parseghian was the Company's Chief Investment Officer ("CIO"), a position he held from 1996. Parseghian became a

Senior Vice President of the Company in 1996 and was elevated to Executive Vice President in June 2002. In June 2003, Parseghian replaced Brendsel as the Company's CEO. As CIO, Parseghian was responsible for the day-to-day management of the Company's F&I division. In that role, he developed key strategies to manage Freddie Mac's retained mortgage portfolio (which totaled almost $570 billion at the end of 2002), non-mortgage investments, and debt issuance. At the same time, Parseghian oversaw many of Freddie Mac's efforts to minimize financial risks to which the enterprise was exposed in the routine course of its business.

(b) Parseghian has admitted that he knew Brendsel, Glenn and Clarke met weekly in private sessions to set the earnings goals of the firm, and that from these meetings "***[t]here was a clear goal to manage the interest income . . . [w]e would propose transactions and strategies that would attempt to meet those goals***."

(c) Like the other defendants, Parseghian directly participated in the use of accounting machinations to achieve steady earnings, avoid a large transition gain from the adoption of SFAS 133 in 2001, and hide the Company's earnings volatility. Specifically, Parseghian presided over department meetings during which the participants discussed how the Company could lower the transition gain under SFAS 133 and the danger of earnings volatility. On at least two occasions, Parseghian approved memoranda detailing or describing accounting transactions which served no proper business purpose, but were entered into solely to create losses and offset the transition gain under SFAS 133.

(d) Parseghian, along with the other Individual Defendants, also deliberately or recklessly allowed for weak accounting and internal controls, which

served to ease defendants' efforts in engaging in transactions which violated GAAP and led to many accounting errors which gave rise to the restatement.

(e) On August 22, 2003, the Company announced that Parseghian had been asked to resign. On the same day, Armando Falcon, the OFHEO Director, declared in a press release that "[t]he special examination of accounting and management practices at Freddie Mac is ongoing. In the course of that special examination, OFHEO has reviewed the conduct of certain senior executives. Based on that review, I have concluded that CEO and President Greg Parseghian . . . should be replaced."

IV. CLASS ACTION ALLEGATIONS

23. Plaintiffs bring this action as a class action pursuant to Rules 23(a) and (b)(3) of the Federal Rules of Civil Procedure on behalf of a class consisting of all persons or entities who purchased Freddie Mac common stock during the period July 15, 1999 through and including June 6, 2003 (the "Class Period"), and who suffered damages thereby (the "Class"). Excluded from the Class are: (i) the defendants; (ii) members of the family of each of the Individual Defendants; (iii) any entity in which any defendant has a controlling interest; (iv) any parent or subsidiary of Freddie Mac; (v) any person who was an officer or director of Freddie Mac or any of its parents or subsidiaries during the Class Period; and (vi) the legal representatives, heirs, predecessors, successors or assigns of any of the excluded persons or entities specified in this paragraph.

24. The members of the Class are so numerous that joinder of all members is impracticable. At the end of 2002, there were approximately 689.57 million shares of Freddie Mac common stock issued and outstanding. While Plaintiffs do not know the exact number of Class members, Plaintiffs believe that there are, at minimum, thousands

of members of the Class who purchased Freddie Mac common stock during the Class Period.

25. Common questions of law and fact exist as to all members of the Class and predominate over any individual questions affecting members of the Class. Among the questions of law and fact common to the Class are:

a. whether Freddie Mac issued false and misleading statements during the Class Period;

b. whether defendants acted with scienter in issuing false and misleading statements during the Class Period;

c. whether the Individual Defendants are liable as control persons under the federal securities laws;

d. whether the market price of Freddie Mac common stock during the Class Period was artificially inflated because of the defendants' conduct complained of herein; and

e. whether the members of the Class have sustained damages and, if so, what is the proper measure of damages.

26. Plaintiffs' claims are typical of the claims of the other members of the Class as Plaintiffs and all members of the Class sustained damages arising out of defendants' wrongful conduct in violation of §§ 10(b) and 20(a) of the Exchange Act and Rule 10b-5.

27. Plaintiffs will fairly and adequately protect the interests of the members of the Class and have retained counsel competent and experienced in class actions and

securities litigation. Plaintiffs have no interests antagonistic to or in conflict with the Class.

28. A class action is superior to other available methods for the fair and efficient adjudication of the controversy since joinder of all members of the Class is impracticable. Furthermore, because the damages suffered by the individual Class members may be relatively small, the expense and burden of individual litigation make it impossible for the Class members individually to redress defendants' wrongful conduct. There will be no difficulty in the management of this action as a class action.

V. OVERVIEW OF THE FRAUDULENT SCHEME

A. General Background

29. Freddie Mac is a shareholder-owned enterprise that generates revenue and shareholder value through its participation in the secondary mortgage market. Before 1992, Freddie Mac limited its business primarily to buying mortgages and pooling them together into PCs, which it then sold to investors. In this regard, Freddie Mac acted much like a mortgage broker. In 1992, however, Freddie Mac began to increase the size of PCs that it held in its "Retained Portfolio." Holding mortgages in the retained portfolio was potentially profitable so long as the inflow of cash from the mortgage investments exceeded the cost of the debt securities that Freddie Mac issued to fund those investments.

30. Holding mortgages in its retained portfolio exposes Freddie Mac to tremendous risk. For example, most borrowers in the United States can prepay their mortgage at any time without penalty. Thus, when interest rates decline sharply, which occurred during the Class Period, borrowers rush to refinance their mortgages at lower rates, causing the mortgages to have a shorter life than originally projected. As a

consequence, when interest rates drop, the investment yield is reduced. When this occurs, Freddie Mac receives large amounts of cash as the older, higher-rate mortgages are paid off, but faces the risk that it will not be able to reinvest this cash at rates that are above the rates that it is required to pay on its debt securities. This form of risk is called "prepayment risk."

31. The second risk is linked to the short-term and long-term debt Freddie Mac issues to fund its mortgage purchases. When interest rates decline, which occurred during the Class Period, Freddie Mac's cost of issuing short-term debt also declines, but it is required to pay the original (higher) interest rate on its longer-term debt until that debt matures or can be called interest rate risk.

32. To offset these inherent interest-rate and prepayment risks, Freddie Mac typically engaged in a variety of sophisticated transactions that involved derivatives and related hedges. These transactions included issuing callable debt, interest-rate swaps, options to enter into interest-rate swaps (called "swaptions"), futures contracts, and interest-rate caps and floors. These risk management strategies, and the concomitant interest rate fluctuations that they are intended to offset, exposed Freddie Mac to tremendous earnings volatility from quarter to quarter.

B. Defendants' Decision To Manage Earnings And Hide Earnings Volatility

33. Throughout the Class Period, the defendants issued numerous false and misleading statements to give the false appearance that Freddie Mac's earnings were largely immune to interest rate fluctuations, and representing that the Company's senior management had engaged in highly effective risk management strategies. As has now been revealed, however, the Company's reported financial results were highly

manipulated by improper transactions and by accounting gimmickry that violated GAAP. As particularized in detail below, the fraud included the improper use of reserves to manage earnings, transactions for the sole purpose of hiding the effects of adopting a new accounting standard, sham transactions to manipulate net interest income or operating income, improper intra-company transfers to improve the quality of the retained portfolio, the use of unsupportable assumptions as a means of estimating future prepayments affecting net interest income, sham transactions to reclassify assets to avoid future earnings volatility a bogus revaluation of certain derivatives to achieve a desired accounting result, and entering into forward "sales" contracts to manage earnings, in addition to other improprieties set forth below.

34. The fact that Freddie Mac's senior management was obsessed with the appearance of steady earnings growth was underscored by Brendsel, who said that the Company began to focus on steady earnings growth in the early 1990s after some large investors, including Berkshire Hathaway, advised management that Freddie Mac should communicate a clear and simple message that the investing public would understand.

35. Brendsel has now admitted that, as the Company's retained portfolio grew, and the Company issued more debt to finance the portfolio, Freddie Mac became more sensitive to interest rate fluctuations and steady non-volatile earnings growth became a more challenging goal. Brendsel has further admitted that throughout the Class Period he was aware of the review of reserves "each quarter" to determine if they were appropriate or if there was any "flexibility" in changing them. Notably, Brendsel admitted to OFHEO's investigators that there was "an informal practice" to hit earnings estimates within 1 to 2 cents per share.

36. In fact, as the Company has now admitted in its Restatement, during the Class Period:

> [C]ertain capital market transactions were executed and certain accounting policies were implemented ***with a view to their effect on earnings in the context of Freddie Mac's goal of achieving steady earnings growth***, and the disclosure processes and disclosures in connection with those transactions and policies ***did not meet the standards that would have been required of Freddie Mac had it been a Securities and Exchange Commission ("SEC") registrant.***

(Restatement, App. II, p. 1 (Emphasis added.)) The Company also has admitted that:

> Certain reserve account and other adjustments, which were known departures of GAAP but were not considered to be material at the time, also were made with a view to their effect on earnings.

(Emphasis added.)

37. According to OFHEO, "a corporate culture [developed] that placed a very high priority on meeting [earnings] expectations, ***including, when necessary, using means that failed to meet its obligations to investors, regulators and the public."*** (Emphasis added.)

38. The improper efforts to manage earnings to meet Wall Street expectations began at least as early as June 4, 1999, when the Company's Board met. At that meeting, Gregory Reynolds, then the Controller of Freddie Mac, gave a presentation to the Board's Audit Committee titled "Management Assessment of Current SEC Accounting Concerns." This memorandum summarized the concerns from then SEC Chairman Arthur Levitt, who in a speech entitled the "Numbers Game" cautioned against the improper use of reserves or other accounting improprieties to manage earnings.

39. A Freddie Mac memorandum dated June 2, 1999 entitled "Earnings Management-Summary of Legal and Accounting" identifies the five accounting abuses highlighted by then former Chairman Arthur Levitt. Specifically, the memorandum

described the use of "cookie jar reserves," that is, "making unrealistic assumptions that will inflate estimates of contingent liability for such items as litigation, taxes, sales returns, loan losses or warranty costs." These unrealistic assumptions lead to an improper build up of reserves, thus creating "cookie jars" "during good times that can be tapped to boost earnings in bad times." The memorandum states that "[o]f the specific abuses identified by Chairman Levitt, this is the most relevant to Freddie Mac's business."

40. The second abuse described by the June 2, 1999 memorandum is "immaterial, but intentional, errors." This abuse entails the "practice of intentionally recording errors and arguing that the effect on earnings is immaterial." Notes from a "dry run" of that presentation conducted in Brendsel's office stated: "We have managed earnings via reserves but that is not frequent or significant/material; *i.e.*, several cents."

41. During the June 4, 1999 Board meeting, John Gibbons, then CFO of the Company, gave a slide presentation to the Board titled "Financial Review and Outlook." The first slide of the presentation noted that "[net interest income] is surging and we are undertaking transactions to smooth the time pattern over 1999-2000." According to Baker Botts LLP, a law firm retained by Freddie Mac's Board to investigate the financial misconduct that occurred during the Class Period, Gibbons told the Board that "1999 net interest income was running substantially above plan and that without rebalancing transactions '1999 net interest income would exceed 2000 net interest income.'" Slide four of Gibbons' presentation stated, "[w]e are undertaking transactions to smooth the time pattern in net interest income." To ensure there was no confusion, the final slide of Gibbon's presentation stated that, "NII [Net Interest Income] is surging and we are

undertaking transactions to smooth the time pattern over 1999-2000." Put simply, the Company's net income was "surging" beyond earlier estimates and senior management was undertaking transactions for the sole purpose of pushing earnings into later periods.

42. According to OFHEO, Glenn also informed the Company's outside investigators that the policy of earnings management began on or around the June 4, 1999 Board meeting. He added that "the Board knew about the Company's activities in conducting capital market trades with an eye toward shifting earnings. They were part of that culture."

43. Molly Roy, an Associate General Counsel with the Company, said that during the June 4, 1999 Board meeting, then Controller Gregory Reynolds gave a presentation on Arthur Levitt's "five deadly sins" (referring to techniques used to improperly manage earnings) described in his September 1998 speech "The Numbers Game." After that meeting, senior management carefully scrutinized the Board minutes to ensure there was no reference to improper earnings management.

44. Indeed, current and former employees – including certain defendants – that were interviewed by OFHEO's investigators pinpointed efforts on the part of the defendants to assess Wall Street earnings estimates and to implement strategies to improperly manage earnings to meet those estimates.

45. For example, Parseghian stated that:

> They [Brendsel, Glenn and Clarke] would meet weekly in private sessions. And it appeared to me the earnings goals of the firm, both . . . for the following year and then the management of those goals throughout . . . the year would emanate from those meetings in that group . . . ***There was a clear goal to manage the interest income . . . [w]e would propose transactions and strategies that would attempt to meet those goals***.

(Emphasis added.)

46. Parseghian also stated that Clarke would quote "***to the penny what they wanted us to produce***" to meet Wall Street earnings estimates. (Emphasis added.)

47. Senior Vice President and Corporate Controller Edmond Sannini, who joined Freddie Mac on October 1, 2001, stated that "[t]here was an objective to try to get as close to the analysts' estimates . . . as possible," and that "[t]he objective of cutting it as close to the analyst came in communications to me primarily from [defendant] Clarke."

48. When asked to describe the issue of meeting Wall Street expectations, the former Deputy Corporate Controller Lisa Roberts said, "I would describe it very simply as the company was very concerned relative to meeting analysts' expectations." During this interview, Roberts told investigators that Clarke was the person at the Company who was principally concerned with meeting these expectations. (*Id.*) She said that:

> [Clarke] would inform the group of where the expectation happened to be at that point given the information available to the Company. The Company would track and monitor where the analysts were expecting the Company to come out for a particular quarter…

When asked about the purpose of those discussions, Roberts stated:

> The purpose was to – if F&I [the Funding and Investments Division] needed to execute a transaction in order to meet that expectation, those types of strategies and alternatives and options were discussed. On the other hand, [Clarke] wanted to see actually what business activity had been executed for the month and wanted to look at where the results were coming in compared to where he felt the street expectations were, then options and alternatives were discussed.

(*Id.*)

49. An entry from Glenn's diary dated November 15, 2001 even noted his awareness of the Company's eroding accounting disciplines. Specifically, it stated: "Accounting discipline is being lost." and "Trying to hit an earnings number."

50. On January 3, 2002, during a senior staff meeting, that Glenn attended Usha Chaudhary, Glenn's assistant, noted: "*We may have gone to the extreme in managing earnings*." (Emphasis added.)

C. Examples Of Defendants' Accounting Machinations

51. As has now been revealed, only as a result of the improper transactions and numerous accounting improprieties complained of herein were defendants able to satisfy Wall Street expectations and make it appear as if the Company's earnings were characterized by steady growth and low volatility. In reality, the Company's financial results were heavily manipulated in ways that violated fundamental GAAP precepts. The financial results were driven by a reverse-engineered approach to achieve a pre-determined accounting objective, and to work around the impact of a new accounting standard (SFAS 133) that was intended to give investors a clearer picture of a company's use of derivatives and their impact on a company's financial condition and results of operations. When these accounting manipulations were finally exposed, top managers resigned under pressure or were terminated from the Company, and billions of dollars of shareholder value was destroyed. Now, by having restated three years of financial results, the Company has admitted that its financial statements were materially false and misleading at the time they were issued.

52. In particular, defendants used "cookie jar" reserves and transactions that lacked any proper business justification (or economic substance), such as the Linked Swaps transactions, J-Deals, and Blaylock Trades, as well as other earnings-driven accounting improprieties, as described in detail below. Several of the accounting improprieties that defendants undertook to manage earnings and avoid the appearance of volatility included financial transactions and accounting methods that were designed to

transact around SFAS 133, *Accounting for Derivative Instruments and Hedging Activities*. These improprieties included the CTUG transaction, J-Deals (J006 and J007), and a revaluation of the Company's Swaptions Portfolio. All of these transactions violated GAAP, as particularized below.

1. Improper Creation And Use Of "Cookie Jar" Reserves

53. Throughout the Class Period, Freddie Mac created improper "cookie jar" reserves and then utilized these reserves to inflate or reduce earnings in various reporting periods by either reversing them back into income or by charging expenses against them so that the Company could smooth out its earnings results. These actions, which violated GAAP, allowed defendants to systematically manage and misstate the Company's earnings and, thereby, mislead the investing public. For example, at one point in 2001, Glenn wrote in his business diary that Parseghian had expressed the opinion that he "needs help in earnings management of $1.3 billion above current target (5.37 v. 7.14). He can manage $1.1b. Needs help with $200m some sort of reserve account."

54. Specifically, defendants used inappropriate Loan Loss, Legal, Tax and SFAS 91 Amortization reserves to manage the Company's earnings throughout the Class Period. In its restatement, the Company has admitted it improperly used these reserves to manage earnings and in doing so violated GAAP, and has now reversed the effect that the improper reserves had on its results.

a. Improper SFAS 91 Amortization Reserve

55. One improper cookie jar reserve that Freddie Mac dipped into to meet earnings was known internally as the Amortization Reserve. In its restatement, Freddie Mac accounted for this improper reserve under the category of "All Other Corrections."

56. In 1988, Freddie Mac implemented SFAS No. 91, *Accounting for Loan Origination Costs* ("SFAS 91"). SFAS 91 required the Company to recognize loan fees, premiums and discounts as an adjustment to yield over the life of the loan. Freddie Mac anticipated that a certain portion of its loans would be prepaid, and therefore, as permitted by SFAS 91, incorporated an estimate for prepayments when amortizing fees, premiums and discounts. When Freddie Mac's estimated pre-payments differed from actual prepayments, SFAS 91 required that the Company record a "catch-up" adjustment to the income statement. Properly accounting for these differences between estimated and actual prepayments, however, would have caused large swings in the amount of the catch-up adjustments and created income volatility.

57. To circumvent this volatility, in 1994, John Gibbons, Freddie Mac's then CFO, directed the Company's Financial Research Group to find a method that could be used to lessen the volatility. After a six month process, the Financial Research Group decided that the Company should set up a reserve to absorb differences between the estimated and actual prepayments and their effect upon amortization. Going forward, Freddie Mac would record the catch up adjustment under SFAS 91 to the reserve on the balance sheet rather than recording it in the income statement as required under GAAP.

58. Freddie Mac created this SFAS 91 reserve from $200 million in "extra" income that it received from an unexpected favorable tax event. In doing so, Freddie Mac also avoided the one-time gain that would have been caused by the favorable tax event, using it instead to manipulate operating income.

59. Defendants and others within the Company remained very aware of the existence of the SFAS 91 reserve. Indeed, the reserve and the amount to be recorded to

the reserve were discussed quarterly at CFO 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 meeting analysts' earnings expectations. Typically after these meetings, the Controller would provide the CFO with his recommendation of what amount should be booked to the reserve. The CFO would make the final decision.

60. Management also informed the Audit Committee of the Board of the existence of the reserve account in a quarterly report entitled "Key Financial Reporting Estimates." The Audit Committee received this report every quarter from June 1, 1998 through the second quarter of 2001. The SFAS 91 reserve was one of the reserves discussed in the report. The presentation identified the rate of expected prepayments and whether the reserve needed to be increased to absorb any prepayment volatility. Although Freddie Mac's then outside auditors, Arthur Andersen ("Andersen"), warned that the reserve violated SFAS 91, the Company continued to maintain the reserve.

61. The reserve grew to as much as $216 million in the fourth quarter of 1999, representing almost 10% of total net income reported for the year ended December 31, 1999. As it grew, Andersen again expressed concern over the reserve. In the second quarter of 2001, Andersen's engagement partner, Robert Arnall, discussed his concerns with Deputy Controller Lisa Roberts and advised her that Freddie Mac should eliminate the reserve. Instead, Freddie Mac and Andersen reached a compromise: the Company agreed to narrow the acceptable amount of the catch-up adjustment recorded to the reserve on the balance sheet to plus or minus $25 million. Anything beyond that would

be recorded to income or expense. Thereafter, Freddie Mac went to great lengths to have the numbers fall within the range, sometimes requiring employees to stay all night. According to one employee, it was "classic" for Freddie Mac to "play with the numbers until they got the right one."

62. The "compromise" lasted from the second quarter of 2001 through the second quarter of 2002. In June 2002, after PricewaterhouseCoopers ("PwC") began scrutinizing its reserves Freddie Mac fully depleted the reserve and recorded the remaining amount in the income statement.

63. As part of its Restatement, Freddie Mac admitted that: (i) it improperly used the Amortization Reserve to offset the change in estimated prepayments; (ii) it knew that it did so in violation of GAAP; and (iii) the reserve was made "with a view toward its effect on earnings." (Restatement, App. II, p. 24)

Impact of Management Adjustment - SFAS 91 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 excl. 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

b. Improper Levels Of Loan Loss Reserves

64. In addition to the SFAS 91 Amortization Reserve, Freddie Mac also maintained a loan loss reserve to cover potential losses in the Company's mortgage portfolio. After defaults and loan losses decreased in the late 1990's (due to the improving economy), the Company chose not to reduce its loan loss reserve in

accordance with GAAP. As with the Amortization Reserve, in restating its results, Freddie Mac included the improper loan loss reserve under the "All Other Corrections Category."

65. The Company engaged in a three step process to set its loan loss reserve level. First, Corporate Accounting presented estimates to the CFO. Corporate accounting based its estimates on the analysis performed by the Single Family and Multi-Family Division.

66. Next, 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, management would present the figures to the Audit Committee.

67. The "Key Financial Reporting Estimates" presentation prepared by Corporate Accounting included three possible reserve levels: "Minimum GAAP"; "FM Standard" and "Adverse Case." For each quarter, the recorded amount of the loan loss reserve level approached or exceeded the Adverse Case level. Beginning June 7, 2002, the Company renamed the various levels: "base low," "best estimate" and "base high."

68. Some Freddie Mac employees warned against setting loan loss reserves at artificially high levels, in violation of GAAP. According to Jesse Abrahams, a Freddie Mac employee, Corporate Accounting, including Reynolds, frequently asked him to "shock" the model, resulting in more pessimistic results and a justification for a higher reserve level. For example, a July 1999 memorandum from Abraham's staff states that Reynolds asked the staff to run a "fourth EXTREME pessimistic scenario [sic]." In response, 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 possibility of the extreme pessimistic scenario, while not zero, to be extremely low." Others in Corporate Accounting, including Deputy Controller Lisa Roberts, also felt the reserve level was too high.

69. Despite these warnings, from 1998 to 2001, the Company kept its loan loss reserve at unjustifiably high levels in the face of declining loan losses:

1998-2001

Year	Net Losses ($ in millions)	Provision ($ in millions)	Loan Loss Reserve ($ in millions)	Loan Loss Reserve/Net Credit Losses
1998	($116)	$190	$768	7x
1999	($56)	$60	$772	14x
2000	($28)	$40	$784	28x
2001	($28)	$45	$801	29x

70. The amounts in those years contrasted sharply with Freddie Mac's practice in years 1989 through 1997, as shown by the following chart:

1989-1997

Year	Net Losses ($ in millions)	Provision ($ in millions)	Loan Loss Reserve ($ in millions)	Loan Loss Reserve/Net Credit Losses
1989	($173)	$260	$466	3x
1990	($251)	$450	$665	3x
1991	($290)	$407	$737	3x
1992	($377)	$425	$785	2x
1993	($325)	$300	$760	2x
1994	($227)	$200	$733	3x
1995	($305)	$255	$683	2x
1996	($323)	$320	$680	2x
1997	($296)	$310	$694	2x

71. Management and the Audit Committee remained well aware of the high level of loan loss reserve despite the strengthening economy and the decline in mortgage

defaults. In particular, management informed the Audit Committee in a September 11, 1998 presentation that "[p]rincipal losses continue to decline, largely due to the strength of the economy and loss mitigation initiatives." This language was included in at least ten subsequent presentations to the Audit Committee.

72. In March 2001, management informed the Audit Committee that "the current reserve balance is well in excess of the most probable case." In June 2001, management informed the Audit Committee that "[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."

73. Similarly, in September 2001, management again informed the Audit Committee that the "adverse case [of the three loan loss scenarios] reflects an immediate economic recession across all regions . . . . We consider this highly unlikely." At one Board meeting, the former chair of the Audit Committee Russell Palmer, indicated that the SEC may challenge the Company on its level of loan loss reserve.

74. In the Fall of 2001, Freddie Mac hired Edmond Sannini as its new Controller. Soon after starting, Sannini expressed concern over the loan loss reserve level. Specifically, in an interview with OFHEO, Sannini stated that he was concerned because he did not see the documentation to support the high level of reserve. Sannini worried that PwC, the Company's new auditors, who would begin auditing the Company

in March 2002, would seriously scrutinize the reserve based on the questionable documentation to support it.

75. According to the Company's disclosures relating to the Restatement, "during second and third quarter of 2002, [Freddie Mac] performed a detailed review of its Loan Loss Reserve policies, methodologies and processes." (Restatement, App. II, p. 25). This detailed review coincided with the Company's retention of its new auditor PwC in March 2002.

76. Rather than properly restate its results for prior periods, in the third quarter of 2002, the Company eliminated the entire $246 million excess reserve by transferring it to earnings in that quarter. Although the decrease in the loan loss amount increased earnings in that quarter, Freddie Mac largely counterbalanced the increase in the following quarter by donating $225 million in cash to the Freddie Mac Foundation (a foundation created by Freddie Mac to provide funds to various nonprofit organizations).

77. The Company has now admitted that it "inappropriately" maintained its loan loss reserves "in excess of the amounts permitted by GAAP in the amount of $246 million." (Restatement, App. II, p. 25). As part of the Restatement, the Company has reversed the one time cumulative $246 million credit to income that it took in the third quarter of 2002 and restated prior periods to reflect the adjustment in the correct periods related primarily to periods prior to 1999 (and reflected as part of the cumulative effect from inception to December 31, 1999).

78. Coupled with other errors related to loan loss reserves, credit accounting, and the population of loans subject to the reserve, the cumulative effect of correcting these errors was to increase income over the Class Period before taxes by $158 million.

c. Improper Use Of Tax And Legal Tax Reserves

79. In addition to the SFAS 91 Amortization Reserve and the Loan Loss Reserve, Freddie Mac used two other reserves as "cookie jars" to manipulate and smooth out earnings. In particular, the Company maintained its reserves for taxes and legal contingencies at improper levels. The Company's use of its reserves in this manner violated GAAP. In the restatement, Freddie Mac included the improper reserve for legal contingencies under "All Other Corrections" category, while it included the improper reserve for taxes in the "Other Accounting Changes" category.

80. According to the Company's Restatement, "[b]ased upon the review of contemporaneous documentation in place and other relevant factors," Freddie Mac has concluded that adjustments to its Tax Reserve were made in error and "with a view to their effect on earnings." (Restatement, App. II, p. 26). As part of the Restatement, the Company has corrected certain accruals for tax contingencies, resulting in a cumulative decrease of tax expense by $16 million. Additional tax-related corrections increased its tax expense by $31 million.

81. In fact, the Company manipulated the level of its Tax Reserves at least three times during the Class Period – in the fourth quarter of 1999, and in the third and fourth quarters of 2001. Each time, the Company used the reserve to lower earnings for the quarter so that it could report EPS results that were closer to analysts' estimates, as set forth below:

Impact of Management Adjustments To 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 excl. Tax Adj	$0.78	$0.75	$0.81	$0.81	$0.84	$0.86	$0.89	$0.96	$1.03	$1.10	$1.15

82. Similarly, Freddie Mac used its reserves for legal contingencies to manipulate earnings. In restating its results, as with the Tax Reserve, the Company admits that "[b]ased upon a review of contemporaneous documentation in place and other relevant factors, Freddie Mac has now concluded that these adjustments were in error" and "were made with a view to their effect on earnings."

83. The Company manipulated the level of its Legal Reserve eight times during the Class Period (two quarters in 1999, three quarters in 2000 and three quarters in 2001). Five times, the Company used the reserves to bring its EPS closer to or match analysts' estimates, as set forth below:

Impact of Management Adjustment To The Legal 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 excl. Legal Adj	$0.75	$0.76	$0.79	$0.81	$0.85	$0.87	$0.87	$0.95	$1.01	$1.08	$1.12

84. The maintenance of improper cookie jar reserves as set forth above, enabled the Company to dip into or add to the reserves when needed to smooth out

earnings. For example, notes from an April 1, 1998 meeting in the office of defendant Brendsel indicate that "JG [then-CFO John Gibbons] to determine whether to reduce the first quarter loan loss provision from $75 million to $60-65 million to maintain a flat earnings stream."

85. Similarly, according to a management presentation to the Investment Committee of the Board entitled "Multi-Year Net Interest Income Planning" dated June 4, 1999, "analyzing the adequacy of reserves (amortization and loan loss)' is among the strategies we are investigating for improving the time pattern of NII between 1999 and 2000."

86. Moreover, according to Deputy Controller Lisa Roberts, in 2001, defendant Clarke attempted to have Corporate Accounting raise the loan loss reserve by $5 million to narrow the gap between preliminary earnings results and the expectations of Wall Street analysts.

87. Freddie Mac has also admitted, in connection with the restatement, that "[c]ertain reserve account and other adjustments, which were known departures from GAAP but were not considered material at the time, also were made with a view to their effect on earnings." (Restatement, App. II, p. 1).

2. Improper Assumptions To Estimate Prepayment Rates

88. Freddie Mac also misstated its earnings throughout the Class Period by manufacturing loan prepayment assumptions that lacked any reasonable basis, in violation of GAAP. Specifically, to estimate the amount and timing of future prepayments, and thus the amortization and accretion of loan premiums and discounts into income under SFAS 91, Freddie Mac used various interest rate and yield curve assumptions. (A yield curve is a graph showing the relationship between rate of return

and maturity dates of a class of bonds having similar credit quality.) These assumptions can significantly affect the amounts and timing of fees, premiums and discounts amortized or accreted to income. From 1998 through 2002, Freddie Mac changed its interest rate assumption methodology six times.

89. OFHEO's outside investigators found no documentation, however, to support the rationale for such changes. Thus, at various times, the Company would use a forward yield curve, a 60-day average yield curve or a flat yield curve. Rather than choose an assumption that was grounded in reality and was management's best estimate of future interest and prepayment rates, as required under GAAP, Freddie Mac chose whichever methodology gave the Company the most desirable earnings number.

90. For example, in the first quarter of 2002, the Company became aware that the quarter was on pace to come in significantly above forecasted results. When the forward yield curve indicated the Company would have $141 million of additional income, Peter Zou directed Bob Davis in Corporate Accounting to come up with alternative scenarios. Davis and his supervisor Steve Bledsoe, an F&I accountant, considered using a static yield curve. Bledsoe raised the idea of a static yield curve with its new auditors PwC, who informed him that companies that used the static yield curve had very different businesses from Freddie Mac. When a static yield curve is used in a financial model, differing spot rates for various maturity points are held constant throughout the forecast period. In other words, interest rates are assumed to remain constant throughout the forecast period, although short-term rates may be assumed to be higher or lower than long-term ones.

91. Nonetheless, without PwC's approval, Freddie Mac used the static yield curve model. By using this model, the Company successfully reduced income for the first quarter of 2002 by $141 million, but increased income by a comparable amount in the second quarter of 2002. This static yield curve model had never been used by Freddie Mac prior to March 2002.

92. The Company has now admitted through the Restatement that in the first quarter of 2002, it "inappropriately incorporated interest-rate projections that were not supportable." (Restatement, App. II, p. 24). Based on a revised calculation of the error, the Restatement indicates that Freddie Mac understated its interest income for the first quarter of 2002 by $132 million. Further, the Company admits that in the second quarter of 2002, it used supportable interest rate projections to reverse the impact of the $132 million. Accordingly, Freddie Mac caused income for the second quarter of 2002 to be overstated, but with no cumulative effect. In restating its results, the Company used "appropriate" interest-rate projections to correct amortization results for the first and second quarters of 2002.

93. As part of the Restatement, the Company also corrected other errors affecting income recognition under SFAS 91. This had the effect of increasing pre-tax income by $159 million. Specifically, according to the Company, it corrected the security level assumptions that it used to project expected cash flows, which changed the timing of premium and discount amortization as well as deferred fee recognition. Moreover, the Company has admitted that certain deferred fees were amortized using a straight-line methodology, as opposed to an effective yield process required by SFAS 91.

94. Certain other corrections of errors included the Restatement had the effect of changing the cost basis of certain securities. This had a secondary impact of correcting the amount of premiums and discounts to be amortized or accreted with a related cumulative increase in pre-tax income of $217 million.

95. As depicted below, the cumulative effect of correcting the Company's accounting manipulations and violations of SFAS 91, including its improper use of the SFAS 91 Amortization Reserve, resulted in an increase of $492 million in pre-tax income and a decrease to pre-tax Accumulated Other Comprehensive Income (AOCI) of $56 million which the Company included within the "All Other Corrections" category:

Asset Amortization Summary of Financial Impacts ($ in millions)					
	Cumulative Effect from Inception – 12/31/1999	2000	2001	2002	Total
Income (Expense) Before Taxes	$177	$(54)	$187	$182	$492
Accumulated Other Comprehensive Income (Loss) Before Taxes	-	-	$15	$(71)	$(56)

(Restatement, App. II, p. 24).

3. <u>Short Dated Options Strategy</u>

96. Freddie Mac also misstated its results by improperly channeling one-time gains into recurring income on its income statement, in violation of GAAP, to curry favor with investors. For example, at the end of 1999 and early 2000, the Company began writing Short Dated Options ("SDO") as a means to capture the unrecognized value of certain "in-the-money" put swaptions, *i.e.*, options to enter into swap agreements, without selling them. In writing the SDO's, the Company sought to increase its Net Interest Margin ("NIM"), a measure of NII, to impress investors. The Company's SDO strategy

violated basic GAAP rules for accounting for options and disclosure policies. In restating its results, the Company included the correction of errors related to the SDOs under the category of "Accounting for Derivatives."

97. At the end of 1999 and early 2000, the Company had a large volume of deep-in-the-money put swaptions. Freddie Mac believed it was a good time to capture the value on its investment and began selling the puts. The sale of these put swaptions resulted in a gain of $200 million, which the Company recorded in "Other Income" for 2000.

98. Freddie Mac was dissatisfied, however, with simply recording the gain on the put swaption sales in "Other Income" because it knew that investors and analysts focused instead on NIM and NII, upon which the sale of the swaptions did not have a substantial effect. Investors viewed the steadiness of Freddie Mac's NII as a key indicator of the Company's financial health and management performance.

99. Around this time, then CFO John Gibbons asked Nasir Dossani ("Dossani"), Senior Vice President of Asset/Liability Management and Research in F&I to find a way to improve the Company's NIM. Dossani consulted Mustafa Chowdhury ("Chowdhury"), Vice President and F&I derivative specialist, who in turn devised a plan to stop selling "in-the-money" swaption puts, and instead write SDOs to offset them. Specifically, management wrote swaption contracts that had short exercise periods against swaptions that it had already purchased to hedge the retained mortgage portfolio. Purchasers of the contracts paid premiums to the Company for the option to enter into an interest rate swap with pre-specified terms a few months after the options were

purchased. Freddie Mac amortized the premiums through NII and recorded changes in the market value of the options in "Other Income."

100. The SDO strategy benefited the Company in two ways: (i) Freddie Mac could retain its swaptions and stop sacrificing the long term optionality of the puts; and (ii) the Company could record as income the premium it received from the SDO which would aid it in meeting its objective to increase its NIM.

101. As now admitted by the Company as part of its Restatement, Freddie Mac's use of SDOs in 2000 led to an increase of NII by $155 million, or approximately 5% of total NII for 2000. In Dossani's performance review for 2000 (dated January 11, 2001), Parseghian noted that the SDO portfolio was a key factor in achieving the NII and net interest margin objectives of their division.

102. The Company was well aware that it used the SDOs to improve its NIM results. According to a November 2, 2000 internal presentation, the Company noted that "We have been also able to smooth out NIM results when our profits were above expectations, by transferring derivatives with book value losses into SDO."

103. Freddie Mac also failed to disclose its accounting policy with respect to accounting for its SDO strategy in its Annual Report for 2000, even though the approximately $155 million in net interest income created by the strategy represented 5% of its net interest income of $2.838 billion for 2000 and approximately half of the increase in net interest income from 1999 to 2000. During its investigation of the wrongful conduct at Freddie Mac, the Company found no contemporaneous documentation indicating that Freddie Mac even considered disclosing the manner in which it accounted for the premium or the effect on its NII.

4. Blaylock Trades

104. The Blaylock trades were ten improper transactions between F&I and Freddie Mac's Securities Sales and Trading Group ("SS&TG") in 2000 and 2001 that involved securities previously classified as held-to-maturity ("HTM"). These transactions violated GAAP, and at least five of the transactions violated the Company's internal tax policies.

105. The purpose of the trades was to exchange less valuable HTM securities that were held in the Company's Retained Portfolio for more valuable HTM securities that were held by SS&TG. The effect of this exchange was purportedly to improve the quality of Freddie Mac's Retained Portfolio. However, F&I is restricted from selling HTM assets because to classify assets as HTM, the reporting enterprise must have the positive intent and ability to hold the securities to maturity. A sale could have "tainted" the Company's entire HTM portfolio forcing a reclassification of all such securities to either "available-for-sale" ("AFS") or trading. (*See* SFAS 115, ¶7)

106. F&I was allowed to engage in like-kind swaps with outside parties not SS&TG or any other arm of Freddie Mac. Furthermore, to prevent running afoul of federal tax regulations, internal Company tax policies also restrict F&I from purchasing securities from SS&TG directly if the assets have been held by SS&TG for more than 30 days. If F&I buys assets directly from SS&TG outside of the 30-day window, federal tax regulations require that the securities be marked-to-market, which would create volatility in taxable income for Freddie Mac.

107. To circumvent these restrictions, the Company engaged an intermediary entity, Blaylock Partners ("Blaylock"), a regional broker-dealer, to facilitate the trades between F&I and SS&TG. F&I engaged Blaylock because Byron Boston, Vice President

of F&I, previously worked with Al Seigel, a Blaylock trader, and Boston believed using a regional broker "would reduce the risk that the market would learn of his investment purchasing strategy."

108. To execute the transactions, F&I sold assets to Blaylock, which then sold the assets to SS&TG. In turn, SS&TG sold like-kind assets to Blaylock which then sold the assets to F&I. The trades occurred between May 8, 2000 and November 30, 2001, and totaled approximately $3 billion. For its role in the transactions, Blaylock received commissions totaling about $250,000. Consequently, "SS&TG was able to transfer securities with more desirable prepayment characteristics that would meet the return-on-equity (ROE) and present-value-added (PVA) thresholds set by F&I."

109. Corporate Accounting knew of the Blaylock trades and approved the transactions in advance. In fact, on May 4, 2000, Jane Gagen ("Gagen"), a trader from F&I, participated in a series of telephone conversations with Corporate Accounting and SS&TG. Gagen told Chip Jordan, the Director of Accounting Systems in Corporate Accounting, that "I'll sell the TBA [mortgage backed securities to be delivered at a future date] 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 the TBAs that I'm selling [to Blaylock]." Gagen later told Buck Buchanan, a trader in SS&TG, "we're going to call the dealer [Blaylock] and we are going to say, 'okay. You have to do this trade on both sides and take out 1/8 [as a commission]. 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 Joe Langhorn, a trader in SS&TG, that she received approval from Corporate Accounting, Legal and Tax to structure the trades

through Blaylock. Furthermore, before executing the trades, Richard Power from Corporate Tax warned Gagen and Mike Lynch, the Controller in SS&TG, that in order to obtain assets from Blaylock that had been previously 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." Additionally, Mike Lynch generated a memo dated August 31, 2000 entitled "SS&TG Retained Portfolio Trading Relationship: Summary of Accounting Rules/Restrictions." The memorandum stated: "the prices at which a third party purchases and sells assets must be negotiated separately, pricing cannot be prearranged or contingent on the other transaction and one side of the transaction cannot guarantee performance of the other sides." Moreover, the memorandum warned that F&I and SS&TG may trade through a third party only if the transactions are considered "arms length."

110. As evidenced by a recorded conversation on February 14, 2001, between Smriti Popenoe ("Popenoe"), a F&I trader, and Buck Buchanan, a trader in SS&TG, F&I knew that it would obtain the assets from SS&TG. During the call, Popenoe told Buck Buchanan that: "I am just going to sell you the TBSs [mortgage-backed securities to be delivered at a future date] through Blaylock and I'm just going to buy these bonds from you directly."

111. Five of the ten transactions that comprised the Blaylock trades included securities that SS&TG had held for more than 30 days before the transactions, and thus the transfer was in direct breach of the Company's internal tax policy and the specific written warning from Richard Power from Corporate Tax. The Blaylock trades also call into question Freddie Mac's intent to hold its HTM portfolio to maturity. As now

revealed, a large portion of the Company's Restatement resulted because of a reclassification of the Company's entire HTM portfolio to either AFS or trading. In reclassifying the securities, Freddie Mac had to mark these securities to market through income or OCI for all periods presented. The Company and its auditors determined that the Company's original classifications were unsupportable and in error, if not a complete sham, as evidenced by its willingness to sell HTM securities.

5. Accounting Improprieties To Transact Around SFAS 133

112. Even the various improper practices described in ¶¶51-111, above, however, were not sufficient for Freddie Mac in wanting to control earnings volatility. In June 1998, the Financial Accounting Standards Board ("FASB") issued new accounting rules for derivatives and hedging transactions (SFAS 133). In May 1999, FASB voted to delay the implementation date of SFAS 133 for one year, changing the implementation date to January 1, 2001. Thus, Freddie Mac was required to give effect to SFAS 133 beginning the first quarter of 2001.

113. SFAS 133 established accounting and reporting standards for certain derivative instruments, including PCs contained in Freddie Mac's retained portfolio. Prior to SFAS 133, the rules were inconsistent and lacked transparency. Companies could hide the effects of ineffective, imprecise and simply bad hedges "off balance-sheet."

114. The cornerstone of SFAS 133 is that it "requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial position and measure those instruments at fair value." (*See* SFAS 133, Summary) Pursuant to SFAS 133, for a derivative designated as hedging the exposure to changes in the fair value of a recognized asset or liability or a firm commitment (*i.e.,* interest rate swaps or swaptions

as a hedge against changes in the fair value of fixed rate assets or obligations caused by changing interest rates), the gain or loss in the derivative is recognized in earnings in the period of change together with the loss or gain in the fair value of the hedged item.

115. For derivatives properly designated as hedges of changes in future cash flows, such as with variable or floating rate assets or obligations, the effective portion of the change in the fair value of the derivative is initially recognized in other comprehensive income (OCI) (a component of equity) and later reclassified to earnings to match the change in cash flows (and impact on earnings) of the hedged item. "The effect of that accounting is to reflect in earnings the extent to which the hedge is not effective in achieving offsetting changes in fair value." Derivatives not properly designated in (or qualifying for) hedging relationships (and the ineffective portion of all hedges) are marked to fair value through the income statement.

116. SFAS 133 gave investors and analysts much greater clarity about the use of derivatives and effectiveness (and ineffectiveness) of a company's hedging activities. Volatility in earnings per share ("EPS") increases under SFAS 133 only to the extent that a company's derivatives fail to qualify for hedge accounting or to the extent that its hedges are ineffective in offsetting the specific risk being hedged. In other words, if there is a low correlation between changes in the value of a derivative and changes in the value of the hedged item, investors will observe this ineffectiveness through increased volatility of earnings. SFAS 133 creates a strong incentive for managers of publicly-traded companies to use hedges that are highly effective, as defined by the accounting standard and meet the requirements for hedge accounting.

117. As of June 30, 2000, the Company forecast that by the first quarter of 2001, when SFAS 133 compliance would become mandatory, it would realize a one-time SFAS 133 transition gain of approximately $300 million. This expected gain was largely the result of marking-to-market the fair value of certain derivatives, particularly swaptions. By the end of 2000, as the value of the Company's swaptions portfolio grew significantly, the estimated SFAS 133 transition gain increased to approximately $1.4 billion.

118. Rather than simply comply with the SFAS 133 mandate and report the one-time transition gain as the cumulative effect of a change in accounting principle (similar to an extraordinary item) – which the marketplace would have discounted as a one-time event and would thereafter have potentially exposed Freddie Mac to tremendous earnings volatility – defendants instead knowingly or recklessly engaged in numerous improper transactions and accounting methods that violated fundamental GAAP precepts, as particularized below, to avoid the large transition gain.

119. Indeed, defendant Parseghian has admitted to OFHEO investigators that there were "broad discussions in the firm" among members of senior management in Finance & Administration and F&I "to discuss techniques by which we could try to have as low as possible [SFAS 133] transition adjustment." Parseghian said that the SFAS 133 transition gain would have "detracted from future period earnings." In short, the SFAS 133 transition adjustment from a large derivative gain in the first quarter of 2001 was less desirable than having the same amount spread out over several quarters, which would better serve senior management's goal of steady, mid-teens earnings growth. Examples

of the various improper activities that Freddie Mac engaged in to hide the true impact of SFAS 133 from investors are set forth below:

a. Improper Use Of Coupon Trade-Up Giants ("CTUG")

120. The CTUG transaction was one of several sham transactions that defendants undertook to offset the anticipated SFAS 133 transition gain and avoid any appearance of earnings volatility by spreading the gain over later periods. In carrying out this CTUG transaction, the defendants violated basic GAAP precepts. In its Restatement, Freddie Mac included the effect CTUG had on its results under the category of "Security Classification."

121. To implement the CTUG transaction, defendants first identified assets that had losses in fair value that had not been recognized because the assets were classified as held-to-maturity (HTM). These assets were PCs that Freddie Mac held in its Retained Portfolio. To offset the SFAS 133 transition gain anticipated in the first quarter of 2001, defendants reclassified these PCs with "embedded" losses from HTM to "trading" because securities held in the trading category are marked-to-market through the income statement. These gains or losses are recognized in income and affect the Company's bottom line. SFAS 133 permitted a one-time reclassification of securities from HTM to either AFS or "trading" to facilitate hedge accounting.

122. For defendants, however, the exemption solved only half the problem. After the PCs with previously unrecognized losses were reclassified from HTM to trading, they would have to be marked-to-market (measured at fair value) through the income statement in all future periods, which exposed Freddie Mac to the danger of future earnings volatility as interest rates and values changed.

123. To achieve the desired loss in the first quarter of 2001, but to avoid earnings volatility in subsequent periods from holding the PCs in the trading category, defendants concocted a scheme to move the securities from HTM to trading and back to AFS. An asset designated as AFS is marked-to-market through other comprehensive income (OCI), a component of stockholder's equity, and thus does not produce earnings volatility because any subsequent changes in fair value would be confined to the balance sheet in OCI, and out of the income statement.

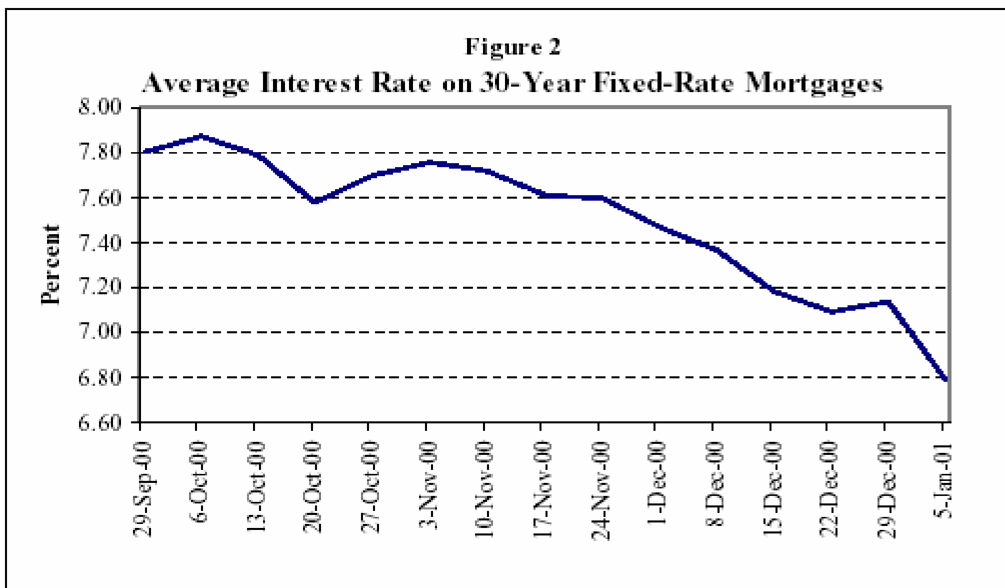
124. Additionally, the loss recorded to offset the SFAS 133 gain would be accreted back into earnings in subsequent periods through interest income as additional yield over the life of the securities, producing a steady stream of future earnings. To accomplish the objectives, defendants engaged in what was essentially a sham transaction that lacked any proper business justification, or economic substance, as detailed below.

125. On November 22, 2000, Chip Jordan, a leading Freddie Mac accountant, prepared a memorandum that outlined steps that the Company could undertake to offset the SFAS 133 one-time gain by moving the PCs with embedded losses from HTM to trading, but avoid future volatility by subsequently moving them from trading to AFS. As outlined in the memo, 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 PCs from [held-to-maturity] 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 resecuritize 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.

126. The counterparty to the CTUG transaction was Salomon Smith Barney ("Salomon") (now known as Citigroup Global Markets, Inc.). Initially, the CTUG transaction consisted of forward sale and purchase contracts for approximately $4 billion in 30-year 6% PCs and $10 billion in 30-year 6.5% PCs. Mortgage interest rates, however, continued to fall in November and December 2000, as shown below:



Sources: Mortgage Bankers Association, Bloomberg

127. The interest rate drop resulted in increased market value for the PCs that had been identified for transfer from HTM to trading. The revised losses were too small to cover the anticipated SFAS 133 gain, so defendants had to identify even more PCs with embedded losses to transfer from HTM to trading. As a result, by 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 transaction.

128. What is now clear from the CTUG transaction is that the "Giant" security that Freddie Mac "purchased" from Salomon was essentially the same security that Freddie Mac had "sold" to Salomon, thus ensuring that Freddie Mac's fundamental investment and risk management position had not changed. In fact, Salomon held the Giant security for fewer than 3 hours before "selling" it back to Freddie Mac. Through this sham transaction, the Company generated $726 million in losses that it then used to offset a significant portion of the SFAS 133 transition gain.

129. Equally important, this roundtrip transaction was used by the defendants to justify moving the PCs from the trading portfolio, where future gains and losses in market value would have been immediately recognized through the income statement, to the AFS portfolio, where subsequent market value changes are not recognized in income but instead are recorded as OCI. Furthermore, the $726 million loss that had been recorded to hide the SFAS 133 transition gain could be accreted back into earnings through interest income as additional yield over the life of the Giants.

130. Indeed, the Company has since admitted that:

> Freddie Mac resecuritized trading securities and then inappropriately classified the retained beneficial interests from those trading securities as either held-to-maturity or available-for-sale. In addition, Freddie Mac erroneously transferred securities from the trading category to either held-to-maturity or available-for-sale.

(Restatement, App. II, p. 3).

131. Regarding this impropriety of the CTUG transaction, the OFHEO Report concluded that:

> Put succinctly, the purpose of the CTUG transactions was to move securities with embedded losses from the held-to-maturity category (where losses are unrecognized) into trading (where losses would be immediately recognized in net income and would offset derivative gains), and then into available-for-sale (where securities gains and losses only hit "other comprehensive income," not "net income"). There is a "have-your-cake-

> and-eat-it-too" flavor to those maneuvers, as management wanted the benefit of having its securities in a trading account but only for enough time to realize a loss and reduce its FAS 133 transition gain.

(OFHEO Report, p. 29)

> ***The CTUGs are an example of a transaction with little or no economic substance that Freddie Mac manufactured to obtain a particular accounting result.*** Indeed, the economic aspects of the deal were negative when one considers the operational hazards created by the transaction, including the fact that CTUGs contributed to the Guaranteed Mortgages Securities (GMS) reconciliation problem that emerged as a significant control issue in 2001. It is just one example of the proclivity of management to assume operations risk in the quest to reduce earnings volatility.

(OFHEO Report, p. 36 (Emphasis added.))

132. Defendants were well aware of the CTUG transactions and the purpose behind them. On November 22, 2000, defendant Brendsel chaired a meeting where the CTUG transaction was discussed at length. Defendants Glenn and Parseghian had also approved a memorandum that authorized implementation of the CTUG strategy, and, on November 22, 2000, defendant Clarke met with employees from Corporate Accounting and F&I to discuss plans to minimize the SFAS 133 gain. The agenda for the meeting identified their strategic objective: "Recognize book losses in 1Q01 that offset the FAS 133 gain AND replace lost earnings in subsequent periods."

b. Improper Use Of J006 And J007 Trusts

133. Like the CTUG transaction, defendants executed the J006 and J007 trusts to help offset the SFAS 133 transition gain and to subsequently reclassify assets to avoid future earnings volatility. In executing the trusts, defendants also violated fundamental GAAP principles and distorted Freddie Mac's financial results. As with the CTUG transaction, Freddie Mac accounted for the J006 and J007 trusts in its Restatement under the "Security Classification" category.

134. The J006 and J007 transactions were intended to generate one-time losses to offset the onetime SFAS 133 transition gain in the first quarter of 2001, and to re-designate and combine the underlying assets and related swaps to avoid having to mark-to-market the value of assets and the swaps in subsequent periods through the income statement. The Company knew that the swaps, although economic hedges, would fail to qualify for hedge accounting under SFAS 133. The intent and effect of these transactions were very similar to the CTUG transactions discussed above.

135. The underlying assets that comprised J006 and J007 were PCs that were held in Freddie Mac's HTM portfolio along with the related interest rate swaps. As described in a January 1, 2001 memorandum, approved by Parseghian, the express purpose of the J006 and J007 transactions was to "maintain[] the investment returns associated with [the PCs] without incurring the earnings volatility of having to mark the swap to market."

136. To accomplish this goal, defendants sold the PCs and related interest rate swaps to Morgan Stanley. Morgan Stanley placed the swaps and 90% of the PCs into trusts, and sold the remaining 10% to qualified investors. The trusts paid the Company the same variable interest rate received in the swap until the swap expired, and thereafter paid the same fixed rate as the underlying PCs.

137. The J006 transaction, executed on January 5, 2001, resulted in reclassifying $1.9 billion of fixed-rate collateral from HTM to trading, and then back to HTM. The effect of the reclassification from HTM to trading was to create a $9 million loss, which offset a portion of the SFAS 133 transition gain. Equally important, the combining of the PCs and swaps into a single security and reclassification from trading

back to HTM eliminated the need to mark-to-market future changes in value of either the PCs or the related swaps (because assets and obligations in the HTM classification are not measured at fair value).

138. The J007 transaction involved the reclassification of $700 million of collateral from HTM to trading and $1.7 billion of AFS to trading and then back to AFS. The Company "sold" the collateral, along with the related swaps, to Morgan Stanley, which then sent them to Freddie Mac's resecuritization group, which securitized the assets and combined the terms of the two instruments. The securities were held in a trust (J007), and the Company bought 90% of the beneficial interest in the trust and classified the investment as AFS.

139. The net effect of the J007 transaction was to generate an $11 million loss, which was recorded to offset the SFAS 133 transition gain. Equally important, by combining the PCs with the swaps into a single security and reclassifying the assets and obligations from HTM to trading and then to AFS, the defendants avoided having future changes in the value of the assets or the swaps pass through the income statement (changes in values of AFS securities are recorded in OCI on the balance sheet rather than the income statement).

140. In connection with the Restatement, Freddie Mac has admitted that the classification of virtually its entire Retained Portfolio -- including securities included in the CTUG, J006 and J007 transactions -- had been inappropriate ***from inception***. As of December 31, 2000, approximately 80% of Freddie Mac's Retained Portfolio had been classified as HTM, with the balance classified as AFS. As part of the Restatement, from inception, all securities previously classified as HTM were reclassified as either trading

or AFS, and certain securities previously classified as AFS were reclassified as trading. The result of the Restatement is that all such securities have been marked-to-market with the resulting gains or losses included in either income or OCI for all periods presented.

141. As a result of the far-reaching reclassification of the securities held in Freddie Mac's Retained Portfolio, for the period covered by the Restatement, the net cumulative effect to income before taxes is an increase of $1.7 billion and the net cumulative impact to accumulated OCI, before taxes, is an increase of $2.669 billion.

Security Classification Summary of Financial Impacts ($ in millions)					
	Cumulative Effect from Inception – 12/31/1999	2000	2001	2002	Total
Income (Expense) Before Taxes	$(774)	$640	$924	$910	$1,700
Accumulated Other Comprehensive Income (Loss) Before Taxes (1)	$(8,401)	$8,950	$2,562	$(442)	$2,669

(1)Accumulated Other Comprehensive Income adjustment for periods prior to 2000 relates to the reclassification of securities from held-to-maturity to available-for-sale.

c. Improper Valuation Of The <u>Company's Swaption Portfolio</u>

142. In addition to the improper CTUG and J006 and J007 transactions, the defendants executed another scheme in the fourth quarter of 2000 to offset the remaining SFAS 133 gain by implementing a temporary and improper revaluation of the Company's swaption portfolio. Like the CTUG transaction, this scheme was also intended to hide earnings volatility. In its Restatement, Freddie Mac accounted for the effect the change in valuation had on its financial results under the category "Valuation of Financial Instruments."

143. The Company's Retained Portfolio consisted mainly of mortgages with embedded prepayment options (the borrowers' right to prepay). The Company attempted to manage the risk associated with these prepayment options with a combination of callable debt and derivatives. Swaptions were a key component of the hedging strategy. A swaption is an option to enter into an interest rate swap at some future date or to cancel an existing swap in the future.

144. The value of swaptions is not quoted in the market but is measured using option pricing models based on interest rate volatility. In late November 2000, volatility began increasing significantly as the demand for derivatives to hedge mortgage prepayment risk increased with the decline in mortgage rates.

145. This rise in volatility resulted in a large increase in the value of the Company's swaptions portfolio, which exacerbated the expected SFAS 133 transition gain. As a result of the increase, the $700 million SFAS 133 transition gain that the Company estimated in early November had grown to approximately $1.4 billion by early December. The Company could not offset the gain by engaging in additional CTUG transactions because the supply of PCs with embedded losses had been exhausted. In other words, the "cupboard was bare."

146. To address this economic reality, the Company held a "SFAS 133 Transition Strategy Meeting" on December 8, 2000. Clarke and Parseghian participated in this meeting. During the meeting the participants discussed five options to offset the remaining SFAS 133 gain and the earnings volatility from the rapid increase in the value of the Company's swaptions portfolio. These five strategies included: (i) changing the method used to value the Company's swaptions portfolio; (ii) increasing the SFAS 91

amortization reserve; (iii) taking an impairment adjustment to the Interest Only securities portfolio; (iv) funding Freddie Mac's Foundation with stock; and (v) not offsetting the full amount of the transition adjustment gain.

147. Changing the method for valuing the swaptions portfolio was the only option that provided a line item match on the income statement to offset the SFAS 133 transition gain that was not already offset by the CTUG transaction, thereby eliminating the appearance of earnings volatility.

148. The Company had previously valued its swaptions portfolio by using "implied volatility" quotes from BlackRock, Inc., a New York based global investment and risk management firm. The problem was, however, that its valuation procedure and use of BlackRock data was exposing the volatility in swaptions while driving up the value of the Company's portfolio, thus exacerbating the SFAS 133 gain. To avoid this problem, Robert Dean, Senior Vice President of Risk Oversight, and Mustafa Chowdhury, Vice President and F&I derivative specialist, concocted a reverse-engineered and results-oriented change in the swaption valuation procedure. This temporary procedure eliminated approximately $700 million of gain in the swaptions portfolio, which offset the remainder of the SFAS 133 transition gain, and valued the swaptions at an artificial price to hide their exposure to market volatility. As described below, there was no basis for this self-serving change in valuation procedures other than to improperly manage earnings.

149. The new method "flagged" any change in implied volatility that was greater than two standard deviations. If ten such flags occurred in any 20-day period, the Company would unilaterally deem the market to be "illiquid" and would instead value

the swaptions portfolio based on the market volatility that existed on the tenth day ***prior*** to the first flag. However, "only a cursory effort was made to determine if other parties were transacting, or whether Freddie Mac would be able to transact at the prices indicated by the current volatility." This change in valuation methodology allowed the defendants to value their swaptions portfolio based not on available current market data but on ***prior*** market volatility that more properly suited their earnings needs.

150. Unbeknownst to investors, under this methodology (the "Dean-Chowdhury" method) the Company valued its swaptions portfolio for its fiscal 2000 year-end financial results (and January 1, 2001, SFAS 133 implementation) based on volatility that existed on November 20, 2000. By back-dating the market volatility, Freddie Mac reduced the value of its swaptions portfolio by approximately $731 million, which, not coincidentally, eliminated the remainder of the SFAS 133 transition gain that was not offset by the earlier CTUG and J006 and J007 transactions. Moreover, the defendants gave the false appearance that its swaptions portfolio was somehow immune from the volatility that the rest of the market was then experiencing.

151. The following facts surrounding the transaction indicate that Freddie Mac changed its valuation method solely to achieve a desired accounting result:

- By December 21, 2000 F&I had asked BlackRock to model swaptions using the November 20 volatility quote. This call occurred ***before*** the new methodology started and 7 to 10 days ***before*** the occurrence of the tenth "flag," which would have triggered November 20 as the date to measure market volatility under the model.;

- Although the new methodology hinged on the premise that the swaptions market had become "illiquid," the Company made little or no effort to determine whether other parties were transacting in the swaptions market, or whether the Company could transact swaptions at the then existing prices.;

- The fact that market (volatility) quotes were available from several market sources, including Bloomberg, BlackRock and Salomon Yield Book,

indicates that there was a market for swaptions transactions during the period of increased volatility.;

- Dean was unable to produce the tenth "flag" required by his method using the BlackRock data, which the Company used for virtually every aspect of its swaptions business, so he plugged in data from Yield Book, in order to produce the requisite number of flags;

- The Company continued to use ***current*** market volatility in all its other business and risk models, including for determining its "portfolio market value sensitivity" or PMVS, a metric that is reported in the Company's financial results;

- The Company failed to prepare the customary "VIU" (visible, high impact or unique) memorandum for this new swaptions valuation methodology despite its high impact on Freddie Mac's financial results;

- OFHEO investigators found no evidence that management discussed the new valuation method with the Board of Directors or any of its committees. Indeed, one member of the Audit Committee, Thomas Jones, told OFHEO that he would have expected management to bring such a methodology change with this much impact to the Board for pre-approval;

- The Company never amended or supplemented its public disclosure of its valuation policy to reflect the adoption of the Dean-Chowdhury policy;

- The Dean-Chowdhury policy was reversed on February 5, 2001, 39 days after it was adopted, even though the volatility of the swaptions market was still significantly higher than on November 20, 2000; and

- The reversal of the new policy coincided with a desire by F&I to resume transacting in the swaptions market.

152. Freddie Mac adopted the Dean-Chowdhury methodology on January 2, 2001 (effective December 2000) through a memorandum entitled "FAS 133 Valuation Approach on Options Portfolio," ostensibly written by Chowdhury and approved by Parseghian, Dossani and Dean, and dated just one day after Freddie Mac was to record the transition gain under SFAS 133.

153. As has now been revealed, however, Dean and his staff at Market Risk Oversight actually authored the memorandum, not Chowdhury. Dean sought to hide his authorship of the memorandum because he was responsible for overseeing F&I, and

ostensibly would be approving his own swaption revaluation policy. (*Id.*) F&I effectively created and approved its own accounting policy instead of seeking a written policy from Corporate Accounting.

154. The Company jettisoned the methodology once it accomplished its objective of offsetting $731 million of SFAS 133 transition gain. By February 5, 2001, F&I wanted to resume trading in the swaption market, and the new Dean-Chowdhury methodology was promptly discarded.

155. Moreover, the fact that the new methodology was earnings driven to offset the SFAS 133 transition gain is evidenced by the fact that although swaptions volatility was high in December 2000, it was not the only time it reached that level of volatility. Indeed, it reached significantly higher levels in later years. Freddie Mac, however, made no further use of its Dean-Chowdhury valuation method because there was no longer a one-time SFAS 133 gain to offset.

156. Both Glenn and Clarke were aware of the change. Rob Arnall, Freddie Mac's engagement partner from Andersen, discussed the change in a meeting with Glenn and C.E. Andrews, Andersen's advisory partner. Moreover, the policy change and its significance was discussed at an April 2001 Asset Liability Management Forum which Glenn attended.

157. Similarly, Clarke prepared Dean's performance evaluation for 2000 on or about January 5, 2001. Dean's evaluation credits him with the "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." Glenn approved Dean's evaluation on or about the same day.

158. As a result of implementing the flawed Dean-Chowdhury methodology in direct contravention of fundamental GAAP precepts, defendants eliminated approximately $730 million from the income statement. Defendants then abandoned the methodology just weeks later, after the desired accounting results were achieved, and failed to disclose to investors the change in significant assumptions or the massive implications that it had on the Company's income.

159. The Company now admits that "the fair value of [the swaptions] was misstated at December 31, 2000 because Freddie Mac inappropriately applied constant volatility assumptions as of an earlier date (*e.g*. November 20, 2000) instead of available contemporaneous market-implied volatilities in the option-pricing model." (Restatement, App. II, p. 20). According to the Restatement, this had the effect of understating the swaptions by approximately $550 million, which was recorded on January 1, 2001 as part of adopting SFAS 133.

6. <u>Linked Swaps</u>

160. Another way in which Freddie Mac managed earnings was through the use of Linked Swaps. Freddie Mac devised the transactions as a way of shifting income from 2001 into later periods. In restating its results, the Company had to increase earnings in 2001 and decrease earnings in 2002. In the Restatement, the Company has included the "Linked Swaps" under the category of "Accounting for Derivative Instruments."

161. By August 2001, Freddie Mac determined that it expected to earn much more net interest income than planned in 2001. Robert Dean, Vice President of Market Risk Oversight, noted in an August 6, 2001 memorandum to Glenn that as of June 30, 2001, net interest income for the year was about $650 million higher than Freddie Mac had forecast in December 2000. In essence, Freddie Mac had placed a bet on the

direction of interest rates in 2001 and had won. This sudden windfall in earnings raised a question among Freddie Mac's managers (whose objective was smooth earnings growth) about whether they should attempt to spread the gain among multiple periods or somehow offset it with a loss item.

162. During an August 7, 2001 Asset Liability Management Forum, Glenn, Clarke, Parseghian and others, including Paul Peterson, Dossani, Rob Dean, Bob Ryan, Byron Boston, Gary Kain, Jim Hendricks and Dan Dugan, discussed the unexpected windfall. According to the meeting's minutes, Parseghian stated the "continuing challenge for Freddie Mac is managing the tradeoffs between achieving current period earnings, managing risk and meeting 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 note the group "decided to take up this discussion outside this meeting." The minutes also note that net interest income "was $5.87 per share, which is $0.89 per share higher than plan."

163. According to attendees, a follow-up meeting took place immediately after the meeting concluded. No notes or minutes recorded who attended this meeting or what transpired. Witnesses told OHFEO's outside investigators, however, that either at the follow-up meeting or some time soon thereafter, Clarke approached two F&I managers – Dossani and Federico (Vice President, Asset and Liability Management) – and told them to develop a strategy for addressing the unexpected surplus of net interest income.

164. In response to Clarke's directive, Frederico, Dossani and others developed the idea of "Linked Swaps" or "Key Rate Duration" ("KRD") swaps. A week later, beginning on August 14, 2001, Freddie Mac's management executed the first of several

interest rate swap transactions known as the "Linked Swaps." Over a period of three weeks, Freddie Mac entered into eight sets of Linked Swaps or paired trades.

165. The terms of each pair of swaps essentially offset each other. In each, there was a swap that began immediately by which Freddie Mac would pay a fixed interest rate to a counterparty and receive a floating rate of interest. This exchange was coupled with a forward-swap starting one to nine months later when Freddie Mac would pay the counterparty a floating rate of interest and receive a fixed-rate of interest. Because the fixed rates exceeded the floating rates, each pair of linked swaps had the effect of decreasing net interest income in the immediate reporting period, with an equivalent increase in net interest income in subsequent periods.

166. Each of the pay-fixed and receive-fixed legs of the first eight linked swaps had a notional amount of $5 billion ($10 billion combined). On September 7, 2001, Freddie Mac entered into a ninth linked swap with each leg having a notional amount of $10 billion ($20 billion combined). Moreover, Parseghian devised the plan to leverage the ninth swap by a factor of five, resulting in a total leveraged amount of the ninth Linked Swap of $100 billion.

167. In total, the Linked Swaps had the effect of transferring approximately $420 million in net interest income or operating earnings from the third and fourth quarters of 2001 to later periods (2002 and beyond).

168. Freddie Mac entered into the nine Linked Swaps with five different investment banking firms.

Date	Notional Amount	Counterparty
8/14/01	$10 billion	Morgan Stanley
8/15/01	$10 billion	UBS Warburg
8/16/01	$10 billion	Lehman Brothers
8/17/01	$10 billion	Merrill Lynch
8/20/01	$10 billion	Goldman Sachs
8/22/01	$10 billion	UBS Warburg
8/23/01	$10 billion	Merrill Lynch
8/27/01	$10 billion	UBS Warburg
9/7/01	$20 billion leveraged x 5 (unleveraged equivalent = $100 billion)	Goldman Sachs

169. The Linked Swaps had no true business purpose and were entered into solely because of their effect on operating income. During OFHEO's investigation, Parseghian informed the agency that as a risk management tool, the usefulness of the swaps were like traveling from Washington, DC to McLean, Virginia via St. Louis, Missouri. A Freddie Mac accounting policy written in 2003 also noted that the swaps were "primarily executed for their impact on Operating Earnings, with a distant secondary purpose of risk management."

170. For example, Ray Powers, a Freddie Mac employee, called Morgan Stanley on August 14, 2001 to obtain pricing for the swap trades. Because Powers' request was unusual, Brendan Lavalle, the Morgan Stanley trader who would have to approve the transaction, called Powers. Freddie Mac's recording system, which recorded calls on the trading floor, taped the conversation. During the call, Lavalle expressed his concern over the questionable nature and purpose of the trades:

> Lavelle (Morgan Stanley): We've been trained whenever people come in and start doing this kind of stuff, we gotta ask why. Like not why, but like, everything's . . .yeah. I don't want to be taken off in handcuffs here for doing something that's not kosher.
>
> Powers (Freddie Mac): How much are you making off this trade? (Laughs)
>
> Lavelle: I don't know.
>
> Powers: You haven't even looked at it. (Laughs)
>
> Lavelle: I'm just . . . You know what I'm saying . . . I mean, I don't mind if there's an accounting reason for you to do this and it makes you guys money. That's fine. You know, we're okay with it.
>
> Powers: That's where we are. We have an accounting reason for doing it. And, um, we're basically . . . we're offsetting some . . .
>
> Lavelle: I mean you could tell me there's some asset liability reasons for you to be doing this, and I'm okay with that.
>
> Powers: Yeah, I think that's as much as I'd . . . I don't want to tell you . . . .
>
> Lavelle: I don't want to be like taken into a courtroom, though, Ray, is what I'm saying, okay?
>
> Powers: Yeah . . . No, no, no. This is not . . . .This is basically an asset liability, cash flow management issue.

171. After the conversation, Lavelle approved the trade. Soon after, David Wong, an operations officer at Morgan Stanley with compliance responsibilities, became aware of the trades. Wong informed another Morgan Stanley employee to check with him first before entering in any more such trades. When Powers called Morgan Stanley again to price more interest rate swaps, Morgan Stanley priced the transactions unattractively to deter Freddie Mac from wanting to enter into any more trades with it. Freddie Mac was forced to look elsewhere.

172. During another call on August 17, 2001, Sean Flanagan ("Flanagan"), an F&I trader, told another counterparty that the purpose behind the trades is to "book expense now and get it back in six months." Flanagan warned the trading party to "keep

that under your hat." On August 22, 2001, Flanagan explained that the Company has so "much good carry around here that we don't need it all . . . . [B]ut it's like, you just to have to manage expectations . . . [N]ext year we all know it's not going to be so easy."

173. The effect of transferring $420 million in operating earnings from the second half of 2001 to later periods was significant. Without the Linked Swaps and the shift in earnings, the anticipated NII was $0.57 per share over analysts' expectations.

174. This $420 million increase in operating earnings was particularly significant because in 2001, Freddie Mac introduced "Operating Earnings", a non-GAAP measure, as a supplemental performance measure. The Company devised this metric, together with "operating revenue," "operating net interest income" and similar measures to exclude the effect of SFAS 133 (which the Company adopted in January 2001).

175. The Company encouraged investors to gauge Freddie Mac's performance on its operating earnings. Specifically, according to the Company's Annual Report for 2001, management "believes that results presented on an operating basis are beneficial in understanding and analyzing Freddie Mac's financial performance because they *better reflect* the economic impact of Freddie Mac's risk management activities." (Emphasis added.) In choosing to engage in the Linked Swaps, the Company sought to smooth out this important metric, deferring its unexpected windfall in net interest income from 2001 into future periods. Indeed, employees at Freddie Mac informed OFHEO's outside investigators that but for the effect the Linked Swaps had in transferring operating earnings from 2001 into later periods, the Company would not have entered into the transactions, or they would have taken very different form.

176. In providing details of the Restatement on November 21, 2003, Freddie Mac included a discussion of the Linked Swaps and admitted to their improper accounting treatment under GAAP. Specifically, the Company stated:

> In August and September 2001, Freddie Mac entered into nine pairs of [Linked Swaps]. . . . These transactions and the related, inappropriate accounting effected a reduction in Operating Earnings, a non-GAAP supplemental performance measure previously used by Freddie Mac. As a result . . . previously reported Operating net interest income ("Operating NII") was reduced by an estimated $400 million in the third and fourth quarters of 2001. As a result of these transactions, the [C]ompany expected Operating NII to increase by an estimated $400 million over the original remaining life of the swaps, which had maturity dates ranging from August 2004 to September 2006.

177. Consequently, Freddie Mac restated its results for 2001 and 2002 to reflect the effect of properly accounting for these swaps. As shown in its Restatement, the Company had to increase its earnings before taxes by $422 million in 2001 and decrease its income before taxes by $139 million in 2002. The effect or changes the Linked Swaps would have had on future years fell outside the period covered by the Restatement.

7. J008 and J009 Trusts

178. Defendants executed the J008 and J009 trusts to avoid an impairment loss of approximately $226 million in the second quarter of 2001, and future earnings volatility in subsequent periods, under a new accounting standard, Emerging Issues Task Force 99-20, "*Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interest in Securitized Assets*" (EITF 99-20), that became effective April 1, 2001. Freddie Mac included the Restatement of its results to give effect to EITF 99-20 under the "Asset Transfers and Securitizations" category.

179. EITF 99-20 requires that stand alone interest only ("IO") and IO-like assets be subjected to tests for impairment, with related write-downs recorded in the

income statement. The standard applied even to securities classified as AFS, for which changes in fair value normally are recorded in OCI, rather than in income.

180. An IO is a security based solely on interest payments from an obligation. For example, the cash flowing from a pool of mortgages can be divided into principal payments and interest payments. Holders of IO securities receive the interest payments for as long as the mortgages in the pool continue to pay interest. By contrast, a principal-only ("PO") security is based solely on payments tied to the principal of the obligation.

181. Freddie Mac sought to combine its free standing IO securities with PO securities through a securitization. In this way, Freddie Mac planned to treat the assets as a combined security, avoiding EITF 99-20's requirements relating to stand alone IO securities. The "new" securities were to be classified as AFS, under which all changes in value would flow through OCI, rather than through the income statement. In total, the J008 and J009 trusts avoided an anticipated loss of $226 million that would have been recognized in the second quarter of 2001 as a reduction in pre-tax income if EITF 99-20 had been properly applied to Freddie Mac's $10 billion portfolio of IO and IO-like assets.

182. According to the OFHEO's outside investigators, the J008 and J009 trusts were "well researched and the subject of an extensive planning and approval process." Freddie Mac's chief financial officer was briefed on the effect EITF 99-20 would have on the IO and IO-like portfolio, and the purpose of the transactions was detailed in a memorandum dated March 8, 2001, approved by Parseghian, which stated that the Trusts were intended to avoid the "loss of approx. $226 million [which] will have to be recognized in 2Q 2001 if EITF 99-20 is implemented."

183. The mechanics of the transactions involved transferring IO and PO securities from Freddie Mac's AFS portfolio to trusts at Morgan Stanley. By matching the IO securities with PO securities, the J008 and J009 trusts were intended to remove standalone IO or IO-like securities from Freddie Mac's balance sheet and thus avoid the impact of EITF 99-20. Freddie Mac held virtually the entire interests in the J008 and J009 trusts such that from an economic, business and legal standpoint, the underlying substance of Freddie Mac's holdings had not changed, requiring the application of EITF 99-20 and the recognition of the impairment loss in the second quarter of 2001.

D. Defendants' Disregard For Proper Accounting Controls

184. Defendants deliberately or recklessly allowed weak staffing, skills, and resources in the Company's internal accounting and auditing functions to exist. These nonexistent accounting policies, weak accounting management and controls and over reliance on manual systems, ultimately led to numerous additional accounting improprieties, including the following:

1. Violation of SFAS 133's Hedging Requirements

185. As discussed above, throughout the Class Period, Freddie Mac used derivatives to hedge interest-rate, cash flow and prepayment risks associated with its mortgage related investments and debt financing, including the risks associated with the prepayment rights embedded in its mortgage loan portfolio. SFAS 133 requires that all derivatives be assigned a "fair value," "cash flow" or "no hedge" designation at the time of execution and throughout the period they are held. SFAS 133 also specifies criteria for when derivatives may be accounted for as a fair value hedge or cash flow hedge.

186. Although SFAS 133 sets forth basic documentation and effectiveness measurement requirements in order to qualify for the application of hedge accounting, Freddie Mac has admitted that:

> In the context of the restatement, Freddie Mac concluded that there were errors in identifying and measuring the accounting effectiveness of the hedges employed. As a result, Freddie Mac has concluded that the documentation and testing performance to determine whether the embedded options hedging strategy qualified for hedge accounting under SFAS 133 were inadequate and therefore, the application of hedge accounting in connection with the embedded options hedging strategy did not comply with GAAP.

(Restatement, App. II, p. 4).

187. In addition, the Company stated that "[b]ecause of the security reclassifications discussed above [CTUG, J006 and J007] and because securities classified as trading are not eligible for hedge accounting under SFAS 133, Freddie Mac was required to reverse part of the embedded hedging strategy." (*Id.*)

188. By failing to adhere to SFAS 133, and as a result of having to reclassify securities as "trading" securities, previously unrecognized or deferred gains and losses were moved into earnings, and the effect of correcting these errors was to increase income by a cumulative $6.5 billion in 2001 and 2002.

189. In addition to the hedge accounting errors related to the Company's embedded option hedging strategy and the effects on hedge accounting of the required reclassification of its retained portfolio the Company also failed to properly meet other SFAS 133 requirements for hedge accounting. In connection with its Restatement, Freddie Mac determined that $66 billion notional amount of pay-fixed swaps that had been redesignated as cash flow hedges on January 1, 2001, were invalid because the Company had failed to document the assessment of hedge effectiveness. In addition, the Company had failed to amortize the deferred gains and losses recorded at the time of

SFAS 133 implementation. On a combined basis, these errors had resulted in an overstatement of income before income taxes totaling $3.8 billion ($2.151 billion in 2001 and $1.676 billion in 2002) and corresponding understatements of OCI.

190. Thus, on a net basis, these errors related to hedge accounting had resulted in a cumulative understatement of income before income taxes of approximately $2.7 billion with 2001 having been overstated by $2.3 billion and 2002 having been understated by $5.0 billion. In the Restatement, these errors were classified as "Accounting for Derivative Instruments."

2. Transactions Cleared Through The Government Securities Clearing Corporation

191. Prior to the fourth quarter of 2000, Freddie Mac typically entered into synthetic forward contracts using a single counterparty. These "spreadlock" contracts and their corresponding short sale contracts, simulate the purchase, and simultaneous repurchase, of US Treasury securities. At the time, Freddie Mac properly viewed these transactions as derivatives that qualified for hedge accounting treatment, viewing each set of contracts as a single unit.

192. In the fourth quarter of 2000, Freddie Mac began to clear and settle these agreements with multiple counter parties through an entity called the Government Securities Clearing Corporation ("GSCC") and continued to use the same accounting. By using multiple counterparties however, the transactions could no longer be viewed as a unit and failed to qualify for hedge accounting under GAAP based upon SFAS 133 Derivatives Implementation Group Issue K-1. Yet, Freddie Mac continued to treat the transactions as a unit applying hedge accounting in violation of GAAP. In restating its results, the Company had to reverse previously deferred hedging gains and losses and

record an increase of $768 million in pre-tax income through December 31, 2002 and increase OCI by $404 million (included in the "Accounting for Derivative Instruments" section of the Restatement).

3. Real Estate Investment Trust Hedges

193. In restating its results, the Company admits that it improperly accounted for the preferred stock of two majority-owned Real Estate Investment Trust ("REIT") subsidiaries. Freddie Mac incorrectly classified the REIT preferred stock on its balance sheet as part of "debt securities," with dividends included in long-term debt interest expense. In its Restatement, the Company admitted that recording the preferred stock as debt was an error, which it corrected by recording the preferred stock issued by the REITs as "minority interest." As a minority interest, the REIT preferred stock is not eligible for hedge accounting treatment as it no longer considered an asset or liability, a requirement of SFAS 133. Accordingly, Freddie Mac had to reverse the hedging gains and losses related to the REIT preferred stock. The cumulative effect of correcting this error (included in the "Accounting for Derivative Instruments" section of the Restatement) increased the Company's pre-tax income by $583 million. In addition, correction of this error also resulted in the reclassification of the related $1.1 billion in dividends from "long-term debt expense" (a component of NII) to "minority interest in earnings of consolidated subsidiaries." (Restatement, App. II, p. 6).

4. Forward Purchase And Sale Commitments (Other Than CTUGs)

194. The Company routinely enters into forward purchase and sale commitments for mortgage securities and mortgage loans. As part of its Restatement, Freddie Mac conceded that its accounting practices with respect to certain commitments,

including transactions executed between Freddie Mac business units were not in accordance with GAAP. These violations of GAAP on forward purchase and sale commitments extend beyond the CTUG transactions described above in this Complaint.

195. With respect to commitments executed prior to 2001, Freddie Mac has concluded that it should have recorded changes in the fair values of commitments to acquire available-for-sale securities in Accumulated Other Comprehensive Income (AOCI) in accordance with EITF 96-11 "Accounting for Forward Contracts and Purchased Options to Acquire Securities Covered by FASB Statement No. 115."

196. For commitments executed in 2001 and 2002, Freddie Mac now recognizes that substantially all mortgage-related forward purchase and sale commitments were derivatives under SFAS 133. As a result, Freddie Mac should have recorded the change in fair value of these commitments in OCI to the extent that they qualified for hedge accounting under SFAS 133. To the extent that the trades did not qualify for hedge accounting, the Company should have recorded the change in fair value in current period earnings.

197. Separately, Freddie Mac admitted as part of the Restatement that it did not properly account for commitments to purchase or sell trading securities. The Company accounted for such trades on a trade date basis, instead of accounting for them as derivatives in all periods, as GAAP required. To correct this error, Freddie Mac had to reverse the effects of trade date accounting and report the fair values of such trades as derivative assets or liabilities.

198. Also separately, Freddie Mac admitted that it failed to account properly for transfers of securities related to its PC market-making and support activities, including

intracompany transactions with the retained portfolio. Freddie Mac's SS&TG division routinely makes a market in the Mortgage Participation Certificates (PCs) that the Company creates and guarantees. Freddie Mac sells PCs to outside investors and to its own retained portfolio group. As part of the Restatement, Freddie Mac said that it failed to properly account for transfers of these securities in accordance with SFAS 115, *Accounting for Certain Investments in Debt and Equity Securities*. As one example, securities acquired with the intent of holding them in the retained portfolio should not have been marked to fair value through income as trading securities, but instead should have been marked to fair value through OCI as available-for-sale securities. As another example, securities acquired in the trading portfolio but subsequently transferred to the retained portfolio and classified as available-for-sale or held-to-maturity were not valid transfers under SFAS 115.

199. Correcting these errors in accounting for purchase and sale commitments increased Freddie Mac's pre-tax income by a cumulative $495 million and decreased pre-tax OCI by a cumulative $732 million (included in the "Accounting for Derivative Instruments" section of the Restatement).

5. Mortgage Security Hedges Using Forward Sales of TBA Securities

200. Beginning in 1999, Freddie Mac designated forward sales of to-be-announced ("TBA") securities as accounting hedges of the fair value of certain mortgage-related securities held by the Company. As part of the Restatement, Freddie Mac concluded that some of these hedges failed to qualify for hedge accounting treatment. The cumulative effect of correcting those errors through December 31, 2002 was a $91

million increase in pre-tax income (included in the "Accounting for Derivative Instruments" section of the Restatement).

6. Agency Forward Agreements

201. With regard to "agency forward agreements" designated as hedges of long-term debt, Freddie Mac has concluded that it failed to properly test for hedge accounting effectiveness. As a result, these agreements failed to qualify for hedge accounting treatment. Freddie Mac has corrected this error by reversing the hedge accounting treatment of these agreements and the related amortization. The cumulative effect of correcting this error was an increase to pre-tax income through December 31, 2002 of $57 million (included in the "Accounting for Derivative Instruments" section of the Restatement).

7. Government National Mortgage Association Asset Swap Hedge

202. In various periods of 2001 and 2002, Freddie Mac designated an $800 million swap transaction as a fair value hedge of certain Government National Mortgage Association mortgage-backed securities (GNMA MBS) it held. As part of the Restatement, Freddie Mac concluded that the documentation and testing required to ensure that the swap transaction was an effective hedge was inadequate. Therefore, the changes in fair value of the GNMA MBS recorded due to hedge accounting were reversed from earnings. Freddie Mac also concluded that some of the prices originally used to value the swap were incorrect. The cumulative effect of correcting these errors on Freddie Mac's pre-tax income through December 31, 2002 was an increase of $16 million (included in the "Accounting for Derivative Instruments" section of the Restatement).

8. Accounting For Transfers Of Mortgage Loans And PCs

203. Freddie Mac generates revenue from its mortgage securitization financing activities primarily by charging a management and guarantee fee on PCs it creates and guarantees. The Company deducts these amounts from the interest cash flows it receives on securitized mortgages before passing through the remaining cash flows to the holders of its PCs. Prior to the Restatement, Freddie Mac included these fees in income as received. As part of the Restatement, Freddie Mac admitted that it did not properly account for the guarantee fee receivable on mortgages and PCs that it sells to outside investors. Under GAAP (SFAS 125 and SFAS 140), Freddie Mac should have recorded the fair value of this guarantee fee receivable as a "retained interest" in the asset being sold.

204. Additionally, the Company admitted that it did not value its obligation under guarantee contracts when measuring the gain or loss on its sale of mortgages or PCs. Instead, the expense related to this obligation was accrued over the life of the guarantee contracts as incurred. To correct these errors, Freddie Mac had to recognize the fair value of its right to receive guarantee fees as a "retained interest" in transfers of mortgage loans and PCs. In addition, the Company had to recognize the fair value of the corresponding guarantee obligation as a reduction of the sales proceeds.

205. Separately, Freddie Mac admitted that it accounted for repurchases of its own PCs improperly and that it incorrectly accounted for "buy-up fees," which are upfront cash payments Freddie Mac makes to increase the guarantee fee it receives from investors in its mortgage securities.

206. Freddie Mac said that the cumulative effect of correcting these errors in accounting for sales of mortgages and PCs was an increase of $502 million in pre-tax income and an increase in pre-tax OCI of $476 million (included in the "Asset Transfers and Securitization" section of the Restatement).

9. Investments In Securities

207. As part of the Restatement, Freddie Mac identified numerous errors in estimating the fair value of its investments in securities in accordance with SFAS 115. As of the end of 2002, Freddie Mac held about $101 billion in investments in mortgage and non-mortgage related securities, not including its $589.7 billion retained portfolio. The Company admitted that, in certain instances, the models it used to value its securities holdings failed to consider all relevant facts, including available market data. For example, the method used to value certain manufactured housing bonds failed to acknowledge significant market price declines in 2002. Also, Freddie Mac overstated the value of some of its mortgage revenue bonds where it had tried to value the bonds by using proxy securities. In other cases, making erroneous inputs into otherwise reasonable models resulted in misstatements of fair value. Freddie Mac admitted that it made errors in valuing certain investments in Treasury securities. Instead of using observable market prices, Freddie Mac estimated the value of these investments using models, resulting in an overstatement of fair value. Correcting these errors involving securities valuation ("Valuation of Financial Instruments") resulted in a cumulative net decrease to pre-tax income of $147 million and a decrease to pre-tax OCI of $268 million.

10. Mortgage Loan Accounting Based On Lower Of Cost Or Market (LOCOM)

208. When Freddie Mac purchases mortgage loans from lenders, the loans are classified as "held-for-sale" until sold to third parties or transferred to Freddie Mac's retained portfolio in the form of mortgages or mortgage-related securities. SFAS 65, "Accounting for Certain Mortgage Banking Activities," requires mortgage loans classified as held-for-sale to be reported at the lower of cost or fair value, with losses reported through earnings. As part of the Restatement, Freddie Mac disclosed that it failed to perform a "lower of cost or market" test on its mortgage loan purchase commitments, as required by SFAS 65. The cumulative effect of correcting this error was a decrease to pre-tax income of $180 million and a cumulative decrease to pre-tax OCI of $28 million (included in "All Other Corrections").

VI. GAAP VIOLATIONS

209. The responsibility for preparing financial statements that conform to GAAP rests with corporate management as set forth in § AU110.03 of the AICPA Professional Standards:

> The financial statements are management's responsibility . . . Management is responsible for adopting sound accounting policies and for establishing and maintaining internal control that will, among other things, record, process, summarize, and report transactions (as well as events and conditions) consistent with management's assertions embodied in the financial statements. The entity's transactions and the related assets, liabilities, and equity are within the direct knowledge and control of management . . . Thus, the fair presentation of financial statements in conformity with [GAAP] is an implicit and integral part of management's responsibility. . . .

210. Pursuant to these requirements, Freddie Mac's Information Statements for fiscal years 1999 through 2001, contained the following assurance:

> The management of [Freddie Mac] is responsible for the preparation, integrity and fair presentation of the corporation's annual Consolidated

> Financial Statements. The annual Consolidated Financial Statements presented have been prepared in accordance with generally accepted accounting principles and, as such, include amounts based on judgments and estimates made by management. Management also has prepared the other information included in this annual report, and is responsible for its accuracy and consistency with the Consolidated Financial Statements.

211. Freddie Mac further represented that the financial results in its Information Statements for years 1999-2001 presented fairly its financial position for the years depicted in each Information Statement.

212. Similarly, Freddie Mac represented in its Information Statement Supplements issued during the Class Period that its financial results were presented appropriately, in accordance with GAAP.

213. Brendsel and Clarke signed sworn certifications attesting to the truthfulness of the Information Statement for 2001, the Information Statement Supplements for the first and second quarters of 2002 and the definite proxy materials dated April 2, 2002. Defendants also signed sworn certifications attesting to the truthfulness of the statements made in the Information Statement Supplement prepared and issued for the third quarter of 2002.

214. In restating its results, the Company has admitted that material errors existed at the time the financial statements were prepared and thus it failed to provide a fair presentation of its financial results during the Class Period. *See* SFAS 16 and APB Opinion No. 20 (restatements of prior periods are required for material accounting errors that existed at the time the financial statements were originally issued).

215. The Company also disclosed in its press release issued November 21, 2003, which described the Restatement, that PwC has determined that its internal controls during the periods covered by the Restatement suffered from “material weaknesses.”

According to "Communication of Internal Control Related Matters Noted in an Audit" Statement on Auditing Standards No. 60, a "material weakness" is defined as:

> [A] reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level of risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. (AU 325.15)

216. Freddie Mac deliberately or recklessly concealed the existence of the material weaknesses existing in its controls during the Class Period. To address this severe condition and the events giving rise to the Restatement, Freddie Mac has had to effect "sweeping changes" in the Company's financial reporting and management functions, including initiatives relating to "corporate culture, governance, accounting staffing and expertise, accounting policies, processes and controls as well as financial reporting and disclosure."

217. Further, despite their assurances, defendants manipulated the Company's earnings during the Class Period by engaging in various accounting manipulations and by knowingly or recklessly hamstringing its Corporate Accounting office to prevent interference or resistance with their accounting schemes.

218. Each of the accounting machinations described above violated certain GAAP provisions, requirements which defendants chose to ignore or recklessly disregarded in pursuing their overarching objective – to portray Freddie Mac as immune to earnings volatility:

CTUG

219. The Company now admits that the CTUG transaction violated GAAP because the transfer of the Giant security to Salomon was not a proper sale under SFAS

No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* ("SFAS 125"), and the subsequent reclassification of securities from trading to AFS violated SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, ("SFAS 115"), which restricts such transfers.

220. SFAS 125 provides that a transfer of financial assets in which the transferor surrenders control over those financial assets shall be accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. (SFAS 125, ¶ 9)

221. The CTUG transaction fails to meet the criteria of SFAS 125 for treatment as a sale inasmuch as Freddie Mac received as consideration essentially the same or equivalent asset as it had transferred. Furthermore, Freddie Mac did not surrender control over the assets because they were transferred to Salomon for just a "couple of hours" and because Freddie Mac had committed to repurchase essentially ***the same securities*** that it transferred. Put simply, the transaction had little or no economic substance and was designed for the sole purpose of achieving a desired accounting result.

222. Furthermore, SFAS 115 requires securities to be classified as HTM, AFS or trading based on a company's intent, and states that transfers from the HTM classification, or into or from the trading classification, should be rare. (SFAS 115, ¶15) Because Freddie Mac's transfers from HTM to trading and then to AFS had no real business or economic purpose other than achieving an accounting treatment, and involved the same or nearly the same securities both before and after the "sale" with no real change in management's intent with respect to holding the securities, such reclassifications were not permitted under SFAS 115.

223. The CTUG and other transfers call into question management's stated intent with respect to holding such securities and in effect tainted the entire HTM portfolio. Indeed, the Company has since admitted that "a majority of its retained portfolio securities were erroneously classified under SFAS 115." (Restatement, App. II, p. 3).

J006 and J007

224. As with the CTUG transaction, the reclassification of the reacquired securities from trading to HTM and AFS violated fundamental GAAP precepts. Following the sales, Freddie Mac had reacquired essentially the same assets that it had sold. Transfers of securities out of a trading classification are all but prohibited under SFAS 115:

> [T]ransfers from the held-to-maturity category should be rare . . . [and] given the nature of a trading security, transfers into or from the trading category also should be rare.

(SFAS 115, ¶ 15d).

Swaption Valuation Method

225. In revaluing the swaptions to arrive at the desired accounting result, defendants violated both SFAS 133 and SFAS No. 107, *Disclosure about Fair Value of Financial Instruments* ("SFAS 107"). SFAS 133 requires the following with respect to the measurement of derivatives:

> An entity shall recognize all of its derivative instruments in its statement of financial position as either assets or liabilities depending on the rights or obligations under the contracts. All derivative instruments shall be measured at fair value. The guidance in FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, as amended, shall apply in determining the fair value of a financial instrument (derivative or hedged item). If expected future cash flows are used to estimate fair value, those expected cash flows shall be the best estimate based on reasonable and supportable assumptions and projections. All available evidence shall be considered in developing estimates of expected

> future cash flows. The weight given to the evidence shall be commensurate with the extent to which the evidence can be verified objectively. If a range is estimated for either the amount or the timing of possible cash flows, the likelihood of possible outcomes shall be considered in determining the best estimate of future cash flows. (¶17). (Emphasis added.)

226. SFAS 107 provides that:

> [T]he fair value of a financial instrument is the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.

(SFAS 107, ¶ 5)

> Quoted market 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 based on the quoted market price of a financial instrument with similar characteristics or on valuation techniques (for example, the present value of estimated future cash flows using a discount rate commensurate with the risks involved, option pricing models, or matrix pricing models).

(SFAS 107, ¶11)

227. SFAS 133 and 107 required that management make its ***best*** estimate of the amount at which the swaptions could be exchanged in a ***current*** transaction based on ***reasonable*** and ***supportable*** assumptions and ***all available evidence***. There was no evidence to support the change in valuation assumptions which substituted historic for current market volatility. Accordingly, this change in methods did not constitute management's best estimate as required by GAAP.

228. With respect to the swaption revaluation, the Company now admits in the Restatement that "Freddie Mac's implementation of the models failed to incorporate all relevant pricing information available in the market as required under GAAP." (Restatement App. II, p. 20).

229. Additionally, SFAS 107 requires that where there is no quoted market price available, an entity shall:

> [D]isclose, either in the body of the financial statements or in the accompanying notes, the fair value of financial instruments . . . [and] shall disclose the methods and significant assumptions used to estimate the fair value of the financial instruments.

(SFAS 107, ¶10)

230. Freddie Mac failed to disclose the change in its assumptions used to revalue the swaptions derivatives resulting in a $731 million reduction in their value.

<u>The SFAS 91 Amortization Reserve</u>

231. SFAS 91 does not permit companies to establish a reserve in connection with its obligation to recognize a "catch up" adjustment in current income. Freddie Mac's decision to establish and use such a reserve to offset amounts required to be charged or credited to the income statement was a clear violation of GAAP.

232. SFAS 91 requires that entities recognize catch-up adjustments in current income resulting from differences between anticipated and actual prepayments:

> If the enterprise anticipates prepayments in applying the interest method and a difference arises between the prepayments anticipated and actual prepayments received, the enterprise shall recalculate the effective yield to reflect actual payments to date and anticipated future payments. The net investment in the loans shall be adjusted to the amount that would have existed had the new effective yield been applied since the acquisition of the loans. ***The investment in the loans shall be adjusted to the new balance with a corresponding charge or credit to interest income***. Enterprises that anticipate prepayments shall disclose that policy and the significant assumptions underlying the prepayment estimates . . . .

(SFAS 91, ¶19) (Emphasis added.)

233. Freddie Mac's use and establishment of an Amortization Reserve also violated SFAS No. 5, *Accounting for Contingencies* ("SFAS 5") which provides that:

> An estimated loss from a loss contingency (as defined in paragraph 1) shall be accrued by a charge to income if both of the following conditions are met:
>
> - 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. It is implicit in this condition that

> it must be probable that one or more future events will occur confirming the fact of the loss.
>
> - The amount of loss can be reasonably estimated. (¶8)

234. Moreover, SFAS No. 5 prohibits the establishment of a reserve for general or unspecified business risks, which by their nature cannot meet the requirement of ¶8. Freddie Mac's establishment of a reserve under SFAS 91 was not based on a probable or estimable contingency and thus represented a general reserve prohibited by SFAS 5.

Improper Assumptions To Estimate Rates Of Prepayment

235. Freddie Mac's ad hoc changing of the methodology to estimate future loan prepayments violated GAAP. While SFAS 91 permits the use of estimated future prepayments in determining current amortization and accretion of premiums and discounts, the estimated timing and amount of such prepayments must be based on reasonable (and supportable) assumptions:

> If the enterprise holds a large number of similar loans for which prepayments are probable and the timing and amount of prepayments can be reasonably estimated, the enterprise may consider estimates of future principal prepayments in the calculation of the constant effective yield necessary to apply the interest method (¶19).

236. Freddie Mac's selection of a static yield curve, in substitution for the more typical forward or 60-day yield curve, was not based on an effort to make a reasonable estimation of future events but rather was based solely on its desired accounting impact.

Loan Loss Reserve

237. The Company's loan loss level also violated SFAS No. 5, which (as noted above) requires that a company record loss contingencies only when such losses are both probable and estimable.

238. Contrary to GAAP, Freddie Mac did not maintain its loan loss reserve based upon probable levels of loss. Rather, the Company set the reserve at a level high

enough to absorb a loss that forecasting models and Corporate Accounting personnel deemed were unlikely.

239. Additionally, by choosing an improbable or the Adverse Case scenario (and then exceeding the Adverse Case) as its reserve level, the Company violated FIN 14, *"Reasonable Estimation of the Amount of a Loss"* which serves as an interpretation of SFAS 5 and was issued in September 1976. FIN 14 requires that when reasonable estimates of the loss exist, but a company cannot decide which scenario is most likely, the company must then choose the minimum reserve level.

240. Freddie Mac well knew that the Adverse Case was the least likely scenario, but chose it as the benchmark and then set its reserve higher than the Adverse Case. Under FIN 14, any uncertainty as to the proper level of reserve required that Freddie Mac choose the minimum reserve level.

Tax and Legal Reserve

241. Freddie Mac's use of its Legal and Tax Reserves to meet, come closer to, or exceed analysts' expectations violated GAAP, specifically SFAS No. 5. The Company increased or decreased the level of its reserves not because of some probable or estimable loss, but because it wanted to report favorable and stable EPS results. As admitted by Freddie Mac, documents show that the adjustments to the reserve in prior quarters were with a "view to their effect on earnings," in other words, to manipulate Freddie Mac's reported EPS results.

242. Moreover, SFAS No. 5 prohibits the establishment of a reserve for general or unspecified business risks, which by its nature cannot meet the requirement that the reserve be based on probable and estimable losses. Freddie Mac's adjustments to its tax

and legal reserves to smooth out earnings were not based on probable or estimable loss contingencies and thus represented a general reserve prohibited by SFAS 5.

The Linked Swaps

243. The Linked Swaps had no real economic effect and were transacted solely to shift income from present to future periods. Accordingly, by engaging in the Linked Swaps, the Company violated several of the most basic accounting precepts as set forth in FASB's Statement of Accounting Concepts No. 2, Qualitative Characteristics of Accounting Information ("CON 2"). In particular, to be useful, information must be reliable as well as relevant. Relevance and reliability are the two primary qualities that make accounting information useful for decision making. To be relevant, information must be timely and it must have predictive value or feedback value or both. To be reliable, information must have representational faithfulness and it must be verifiable and neutral. Under GAAP:

- The reliability of a measure rests on the faithfulness with which it represents what it purports to represent, coupled with an assurance for the user that it has that representational quality.
- Representational faithfulness refers to the correspondence or agreement between the accounting numbers and the resources or events those numbers purport to represent.

244. The Linked Swaps did not represent what was purported in the Company's financial results. The amounts reported in the financial statements and their timing of recognition, which included the effect of the Linked Swaps, did not correspond to real economic events or results. Moreover, by purposefully disguising the true nature of the transactions, the reported results lacked representational faithfulness and failed to meet the predictive quality required to make them useful for decision making.

245. The Company's accounting for the Linked Swaps also violated SFAS 133. Freddie Mac had reflected the cash flows from the Linked Swaps in the Net Interest Income with changes in their fair values reported in other income. Because the transactions were executed with the same counterparty, in contemplation with each other, and the accounting effect was disproportionate to the risk management effect, the Company should have accounted for them as a combined derivative and applied SFAS 133. In correcting this error, the Company had to reverse certain hedge accounting entries for the Linked Swaps, causing the entire $422 million error in 2001 to flow through to income before taxes rather than just affect the top line net interest income.

J008 and J009

246. The structure of J008 and J009 violated basic GAAP principles because the trusts established at Morgan Stanley did not meet the requirements of special purpose entities ("SPEs") as they were not legally distinct from Freddie Mac. To treat the asset transfers as a sale under SFAS 125 *(Transfers of Financial Assets and Extinguishment of Liabilities)*, the trusts would need to be independent from Freddie Mac such that the Company could be considered to have surrendered control over those assets. To qualify as an SPE, SFAS 125 requires that:

> It has standing at law distinct from the transferor. Having standing at law depends in part on the nature of the special-purpose entity. For example . . . if a transferor of assets to a special-purpose trust holds all of the beneficial interests, it can unilaterally dissolve the trust and thereby reassume control over the individual assets held in the trust, and the transferor can effectively assign his interest and his creditors can reach it . . . [i]n that circumstance, the trust has no standing at law, is not distinct, and thus is not a qualifying special-purpose entity.

(SFAS 125, ¶ 26b (internal quotations omitted)) SFAS 125 further requires that interests in the trusts received by Freddie Mac be distinct from the assets that Freddie Mac held at the start of the transactions.

247. In connection with the Restatement, the Company admitted that, because the Company held virtually the entire interests in the two trusts, the trusts were not legally distinct from the Company and, therefore, had to be consolidated within the Company's financial statements. Accordingly, and as the Company now admits, the IO collateral should have been accounted for separately with the appropriate application of EITF 99-20 and the Company should have recognized an impairment charge of $231 million in earnings in the second quarter of 2001.

Short Dated Options

248. The Company's accounting for the SDOs violated GAAP. Specifically, Freddie Mac violated the GAAP guidance provided by the American Institute of Certified Public Accountants Issue Paper dated March 6, 1998, "Accounting for Options." This guidance, which predated SFAS 133, required that, for written options, the time value component should not be treated separately from its intrinsic value. Both were required to be marked-to-market through income on a combined basis and reported in other income based on the net change in value. By recording the amortization of the premium as part of NII and recording the largely offsetting change in fair value through other income, Freddie Mac's policy violated GAAP.

249. Further, Freddie Mac's failure to reveal this accounting ploy violated GAAP. Paragraph 8 of Accounting Principles Board Opinion No. 22, "Disclosure of Accounting Policies" states that "information about the accounting policies adopted by a reporting entity is essential for financial statement users," and requires that reporting entities disclose all significant accounting policies. Because the premiums it received for the SDO's increased its NII by $155 million or 5% of its total NII for 2000, the Company

should have disclosed the manner in which it accounted for the SDOs to investors in order to make the financial statements not misleading.

250. In this regard, the Discussion section of APB Opinion 22 provides the following guidance:

> The accounting policies adopted by a reporting entity can affect significantly the presentation of its financial position and results of operations. Accordingly, the usefulness of financial statements for purposes of making economic decisions about the reporting entity depends significantly upon the user's understanding of the accounting policies followed by the entity. (¶7.)

Improper Hedge Accounting

251. During the Class Period, Freddie Mac used derivatives to hedge interest rate, cash flow and prepayment risks associated with its mortgage related investments and debt financing.

252. Although SFAS 133 sets forth basic designation, documentation, and effectiveness measurement requirements for fair value and cash flow hedges, in order to qualify for hedge accounting treatment, Freddie Mac admitted that:

> In the context of the restatement, Freddie Mac concluded that there were errors in identifying and measuring the accounting effectiveness of the hedges employed. As a result, Freddie Mac has concluded that the documentation and testing performance to determine whether the embedded hedging strategy qualified for hedge accounting under SFAS 133 were inadequate and therefore, the application of hedge accounting in connection with the embedded options hedging strategy did not comply with GAAP.

(Restatement, App. II, p. 4)

253. To meet the criteria for a cash flow or fair value hedge under SFAS 133, an entity must, at the inception of a hedge, create formal documentation of the hedge relationship and the entity's risk management objective and strategy, including: a) the identification of the hedge instrument, the hedged item (in the case of a fair value hedge) or the hedged transaction (in the case of a cash flow hedge); b) the nature of risks being

hedged; c) the basis upon which effectiveness will be measured; and d) there must be a reasonable basis to expect that the hedge will be highly effective. (SFAS 133, ¶¶20, 21, 28, 29)

254. Furthermore, SFAS 133 requires a company to assess the effectiveness of each hedge transaction on an ***ongoing basis***. An assessment of effectiveness is required whenever financial statements or earnings are reported, and at least every three months.

255. During the Class Period, and as now admitted by the Company, Freddie Mac failed to comply with the basic designation, documentation, and effectiveness measurement requirements set forth in SFAS 133. In addition to the many other errors made by Freddie Mac in accounting for derivatives in accordance with SFAS 133, its failures to meet the documentation and effectiveness measurement requirements of the standard led to understatements of income before taxes totaling $6.5 billion in connection with its embedded options hedging strategy (coupled with the effect of reclassifications of securities) and overstatements of income before taxes totaling $3.8 billion in connection with certain pay-fixed swaps.

Blaylock Trades

256. The ten Blaylock trades violated SFAS 115 "A*ccounting for Certain Investments in Debt and Equity Securities.*" SFAS 115 provides that investments in debt securities shall be classified as HTM only if at the time the company acquires the security it has the intent and the ability to hold the securities to maturity. A company may not classify a debt security as HTM if the company had the intent to hold the security for only an indefinite period.

257. In doing the trades, Freddie Mac sought to exchange less valuable HTM securities held in the Company's Retained Portfolio for more valuable HTM securities that were held by SS&TG. The effect of this exchange was purportedly to improve the quality of the Freddie Mac's Retained Portfolio. GAAP, however, restricts F&I from selling HTM assets because to classify assets as HTM in the first instance, at the time Freddie Mac acquired the securities it must have had the intent and ability to hold the securities to maturity. In concert with Freddie Mac's other trades of HTM securities (CTUG, J-6, J-7), by engaging in the manufactured trades of its HTM securities with Blaylock, simply to shuffle out the less desirable ones, Freddie Mac "tainted" the Company's entire HTM portfolio forcing a reclassification of all such securities to either AFS or trading. (*See* SFAS 115, ¶7)

GAAP Fundamentals

258. In addition to the specific GAAP principles discussed above, Freddie Mac violated some basic GAAP precepts: it is fundamental that "financial statements are management's responsibility" and that the Company's "transactions and related assets, liabilities, and equity are within [their] direct knowledge and control . . . ." *See* AICPA Statements on Auditing Standards No. 78 and No. 82, AU 110.03. Part of that responsibility is to assure that staffing levels and experience in financial accounting are sufficient to ensure that significant errors are prevented or detected at an early stage.

259. Additionally, in preparing financial statements, management must take into consideration the fundamental objectives and concepts upon which GAAP are based, which include:

(i) The principle that financial reporting should provide information that is useful to present and potential investors and creditors in making rational investment decisions and that information should be comprehensible to those who have a reasonable understanding of business and economic activities (FASB Statement of Concepts No. 1, ¶ 34);

(ii) The principle of materiality, which provides that the omission or misstatement of an item in a financial report is material if, in light of the surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item (FASB Statement of Concepts No. 2, ¶132);

(iii) The principle that financial reporting should provide information about how management of an enterprise has discharged its stewardship responsibility to owners (stockholders) for the use of enterprise resources entrusted to it. To the extent that management offers securities of the enterprise to the public, it voluntarily accepts wider responsibilities for accountability to prospective investors and to the public in general. (FASB Statement of Concepts No. 1, ¶50);

(iv) The principle that financial reporting should provide information about an enterprise's financial performance during a period. Investors and creditors often use information about the past to help in assessing the prospects of an enterprise. Thus, although investment and credit decisions reflect investors' expectations about future enterprise performance, those expectations are commonly based at least partly on evaluations of past enterprise performance. (FASB Statement of Concepts No. 1, ¶42);

(v) The principle that financial reporting should be reliable in that it represents what it purports to represent. The notion that information should be reliable as well as relevant is central to accounting. FASB Statement of Concepts No. 2, ¶¶58-59);

(vi) The principle of completeness, which means that nothing is left out of the information that may be necessary to ensure that it validly represents underlying events and conditions. (FASB Statement of Concepts No. 2, ¶80); and

(vii) The principle that conservatism be used as a prudent reaction to uncertainty to try to ensure that uncertainties and risks inherent in business situations are adequately considered. The best way to avoid injury to investors is to try to ensure that what is reported represents what it purports to represent. (FASB Statement of Concepts No. 2, ¶¶95, 97).

VII. FALSE AND MISLEADING STATEMENTS

260. Throughout the Class Period, defendants knowingly or recklessly made materially false and misleading statements concerning the Company's business and financial results. The defendants' misrepresentations and material omissions caused the Company's stock price to become and remain artificially inflated throughout the Class Period, causing harm and damages to Plaintiffs and the other Class members.

Fiscal Year 1999

Second Quarter

261. On July 15, 1999, Freddie Mac announced "record" earnings for the second quarter of 1999. In particular, the Company reported diluted earnings per share of $0.74.

262. On or about August 13, 1999, Freddie Mac made publicly available its Information Statement Supplement dated August 13, 1999. This supplement contained

the Company's information for the quarterly period ended June 30, 1999 and served to supplement the Information Statement dated March 31, 1999 (the "Second Quarter 1999 Supplement"). The Second Quarter 1999 Supplement contained the same false and misleading financial results as reported in the July 15 Press Release.

263. The statement identified above was false and misleading because the Company used its tax and legal reserves to lower its earnings per share in order to report earnings more in line with analysts' expectations. Specifically, without the reserve adjustments, defendants would have reported earnings per share of $0.79, well above analysts' expectations of $0.71. Defendants sought to avoid such a result because they wanted to avoid any appearance of volatility.

Third Quarter

264. On October 19, 1999, Freddie Mac announced "record" earnings for the third quarter of 1999. Specifically, the Company reported diluted earnings per share of $0.75.

265. On or about November 15, 1999, Freddie Mac made publicly available its Information Statement Supplement dated November 15, 1999. This information supplement contained the Company's information for the quarterly period ended September 30, 1999 and served to supplement the Information Statement dated March 31, 1999 (the "Third Quarter 1999 Supplement"). The Third Quarter 1999 Supplement contained the same false and misleading financial results as reported in the October 19 Press Release.

266. The statements identified in paragraphs 264 through 265 were false and misleading because defendants knowingly or recklessly established an amortization

reserve under SFAS 91 in violation of GAAP and used this reserve and the Company's legal reserve to meet analysts' expectations. Specifically, without the improper adjustments to its reserves, the Company would have reported earnings per share of $0.72. By using the reserve, the Company reported earnings per share which matched analyst estimates of $0.75.

Fourth Quarter/Year End

267. On January 18, 2000, Freddie Mac announced record earnings for fiscal 1999. In the press release, the Company reported diluted earnings per common share for the quarter of $0.79. The Company also reported stockholders' equity of $11.5 billion.

268. On or about January 31, 2000, Freddie Mac made publicly available its Information Supplement dated January 31, 2000. This information supplement contained the Company's results for the year ended December 31, 1999 and served to supplement the Information Statement dated March 31, 1999 (the "1999 Supplement"). The 1999 Supplement contained the same false and misleading statement as the January 18 Press Release.

269. On or about January 18, 2000, Freddie Mac made publicly available its Information Statement for fiscal year 1999 (the "1999 Information Statement"). The 1999 Information Statement contained the same or substantially the same false and misleading statements as the January 18 Press Release. Moreover, the 1999 Information Statement stated: "Over the long term, Freddie Mac has consistently produced earnings growth. . . . Through risk management and capital deployment strategies, management believes that Freddie Mac has built a foundation for mid-teens earnings growth over the next few years."

270. With respect to loan losses, the 1999 Information Statement stated: "Management maintains the corporation's [reserve for mortgage losses] at levels it deems adequate to absorb estimated losses incurred on the total mortgage portfolio."

271. Moreover, in discussing Freddie Mac's "operational risk," Freddie Mac assured investors that it had controls in place to reduce operational risk:

> Operational risk is the risk of loss due to human error, system failures, fraud or circumvention or overriding of internal controls. Freddie Mac mitigates operational risk by following comprehensive financial and operating policies and procedures, and by regularly evaluating the effectiveness of its internal control structure. The corporation's policies and procedures include controls to ensure that system-generated data are reconciled to source documentation in a timely fashion. Freddie Mac also performs reasonableness and validity tests to ensure the accuracy of its financial information. The corporation's Internal Audit Division regularly monitors Freddie Mac's compliance with established policies and procedures, and evaluates Freddie Mac's internal control structure.

272. At the end of the 1999 Information Statement, Freddie Mac included a section entitled "Management's Report on Consolidated Financial Statements and Internal Control Structure." According to this report:

> The management of [Freddie Mac] is responsible for the preparation, integrity and fair presentation of the corporation's annual Consolidated Financial Statements. The annual Consolidated Financial Statements presented have been prepared in accordance with generally accepted accounting principles and, as such, include amounts based on judgments and estimates made by management. Management also has prepared the other information included in this annual report, and is responsible for its accuracy and consistency with the Consolidated Financial Statements.

273. The report also assured investors that Management reviewed the Company's internal controls and found them adequate:

> In addition, management is responsible for establishing and maintaining an internal control structure over financial reporting, including controls over the safeguarding of assets. The objective of the internal control structure is to provide reasonable assurance to management and the Board as to the preparation of the financial statements in accordance with [GAAP].
>
> Management has made its own assessment of the effectiveness of the corporation's internal control structure over financial reporting, including controls over the safeguarding of assets, as of December 31,

> 1999 . . . Based on this assessment, management believes that, as of December 31, 1999, the corporation's internal control structure was effective in achieving the objective stated above.

274. Finally, the report commented on the corporate culture at the Company:

> Management also recognizes its responsibility for fostering a strong ethical climate so that Freddie Mac's affairs are conducted according to the highest standards of personal and corporate conduct. This responsibility is characterized and reflected in Freddie Mac's Code of Conduct, which is publicized throughout the corporation. The Code of Conduct addresses among other things, . . . potential conflicts of interest, . . . acceptable financial activities, . .ethical business conduct and compliance with the Code of Conduct. Freddie Mac maintains a systematic program to assess compliance with the Code of Conduct.

Brendsel and Clarke signed this report from management.

275. The 1999 Information Statement also reported that:

> management's assertion that Freddie Mac maintained an effective system of internal controls over financial reporting, including controls over the safeguarding of assets, as of December 31, 1999, is fairly stated, in all material respects, based upon criteria established in 'Internal Controls-Integrated Framework' issued by the Committee of Sponsoring Organizations of the Treadway Commission.

276. Additionally, the 1999 Information Statement indicated that: "the financial statements referred to above present fairly, in all material respects, the financial position of Freddie Mac as of December 31, 1999 and 1998, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 1999, in conformity with [GAAP]."

277. The Company's Annual Report to shareholders for fiscal 1999 contained the same or substantially the same false and misleading statements identified in the 1999 Information Statement.

278. The statements identified in paragraphs 267 through 277 were materially false and misleading because:

a. Defendants knowingly or recklessly built up Freddie Mac's loan loss reserves to an improper level in violation of GAAP. As the Company partially admitted in the second quarter of 2002, the level of Freddie Mac's loan loss reserve in 1999 exceeded the acceptable level permitted by GAAP by $246 million. The Company further admitted to this GAAP violation by restating the prior periods during which the Company had been over-reserved in violation of GAAP. In connection with its Restatement finally announced on November 21, 2003, the Company admitted it had kept reserves at an excessive level for the purpose of managing its reported earnings and restated periods prior to 1999, reversing the previous adjustment to third quarter 2002 pre-tax income of $246 million. Freddie Mac used its reserves (i.e., loan loss, legal tax and amortization) to manage earnings and meet analysts' expectations.

b. In correcting its accounting errors, Freddie Mac restated its previously issued income statements for each of the separate years 2000, 2001 and 2002. With respect to the errors occurring prior to 2000, Freddie Mac made a cumulative adjustment to its beginning balance sheet as of January 1, 2000. The cumulative effect on the Company's previously reported stockholders' equity as of December 31, 1999 was to decrease such balance by approximately $4.6 billion. The Company had previously reported total stockholders' equity of $11.5 billion and, as a result of the Restatement; the corrected total stockholders' equity was $6.9 billion. Thus, Freddie Mac had overstated its previously reported total stockholders' equity as of December 31, 1999 by approximately 40%. The cumulative errors included a net increase in retained earnings of $576 million and a net decrease in other comprehensive income of approximately $5.3 billion. The principal component of the errors was a pre-tax decrease in other

comprehensive income of $8.4 billion caused by the required reclassification of securities from the held-to-maturity category to the available-for-sale category resulting in marking all such securities to market as of December 31, 1999 and recognizing the accumulated losses in value as of that date.

c. Contrary to defendants' claims, management did not foster a strong ethical climate at Freddie Mac. Rather, defendants encouraged employees violate GAAP principles or internal policies if and when necessary to meet management's objective of steady mid-teens earnings growth.

d. The statements identified above was false and misleading because the Company used its tax reserve to lower its earnings per share in order to report earnings more in line with analysts' expectations. Specifically, without the tax reserve adjustment, defendants would have reported earnings per share of approximately $0.82, well above analysts' expectations of $0.77. Defendants sought to avoid such a result because they wanted to avoid any appearance of volatility.

e. Defendants did not provide a "fair presentation" of the Company's financial results, nor were Freddie Mac's financial results prepared in accordance with GAAP. Defendants failed to disclose the accounting manipulations listed in (a) and (d) above and that the Company's internal controls suffered from a material weakness. Moreover, despite defendants' claims, they failed to reduce operating risk and ensure the accuracy of their financial information. Rather, defendants kept the accounting office understaffed with employees who could not sufficiently deal with or control the accounting issues affecting Freddie Mac or the machinations devised by management and employees within F&I.

Fiscal Year 2000

First Quarter

279. On April 18, 2000, Freddie Mac issued a press release announcing "record" diluted earnings per share of $0.81 for the first quarter of 2000.

280. On April 18, 2000, Freddie Mac held a conference call to discuss it results for the first quarter of 2000. Clarke, Parseghian, Mitch Delk, Senior Vice President of Government Relations, and Bill Stevens, Vice President of Shareholder Relations, hosted the call. During the call, Clarke reiterated Freddie Mac's earnings results of $0.81 per diluted share.

281. On or about May 15, 2000, Freddie Mac made publicly available its Information Statement Supplement dated May 15, 2000. This supplement contained the Company's information for the quarterly period ended March 31, 2000 and served to supplement the Information Statement dated March 31, 2000 (the "First Quarter 2000 Supplement"). The First Quarter 2000 Supplement contained the same or substantially the same false and misleading financial results as reported in the April 18 Press Release.

282. The First Quarter 2000 Supplement also stated: "In the opinion of Freddie Mac, the preceding unaudited Consolidated Financial Statements, prepared from the corporation's books and records, contain all adjustments necessary for a fair presentation of the corporation's financial condition as of March 31, 2000, December 31, 1999 and March 31, 1999 . . . Freddie Mac's financial reporting and accounting policies conform to [GAAP]."

283. The statements identified in paragraphs 279 through 282 were false and misleading because:

a. Defendants failed to disclose that they used Freddie Mac's improper reserve under SFAS 91 to exceed analysts' expectations of $0.80 by $0.01. Without the reserve adjustment, the Company would have reported $0.79 earnings per share; and

b. Defendants did not provide a "fair presentation" of the Company's results because they failed to disclose the accounting manipulations listed in (a) above and that the Company's internal controls suffered from material weaknesses.

Second Quarter

284. On July 18, 2000, Freddie Mac announced record earnings for the second quarter of 2000. Specifically, the Company announced "record" diluted earnings per share of $0.84, a 14% increase over the second quarter of 1999. In the press release, Brendsel commented on the results stating: "Freddie Mac achieved record earnings in the second quarter, demonstrating our ability to generate shareholder value under a wide range of economic conditions."

285. On July 18, 2000, Freddie Mac held a conference call to discuss its financial results for the second quarter of 2000. Clarke and Parseghian along with Bill Stevens, Vice President of Shareholder Relations, and Mitch Delk, Senior Vice President for Government Relations, hosted the call.

286. During the call, Clarke reiterated that Freddie Mac's diluted earnings per share for the second quarter equaled $0.84.

287. On or about August 14, 2000, Freddie Mac made publicly available its Information Statement Supplement dated August 14, 2000. This supplement contained the Company's information for the quarterly period ended June 30, 2000 and served to

supplement the Information Statement dated March 31, 2000 (the "Second Quarter 2000 Supplement"). The Second Quarter 2000 Supplement contained the same or substantially the same false and misleading financial results as reported in the July 18 Press Release.

288. The Second Quarter 2000 Supplement also stated: "In the opinion of Freddie Mac, the preceding unaudited Consolidated Financial Statements, prepared from the corporation's books and records, contain all adjustments necessary for a fair presentation of the corporation's financial condition as of June 30, 2000, March 31, 2000, December 31, 1999 and June 30, 1999 . . . Freddie Mac's financial reporting and accounting policies conform to [GAAP]."

289. The statements identified in paragraphs 284 through 288 were false and misleading because:

a. Defendants failed to disclose that they used Freddie Mac's improper reserve under SFAS 91 and its legal reserve to exceed analysts' expectations of $0.83 by $0.01 and thus report "record earnings." Without the reserve adjustments, which boosted the Company's earnings per share by $0.02, the Company would have reported earnings per share of $0.83;

b. Defendants failed to disclose that during the second quarter, Freddie Mac's F&I and SS&TG divisions began engaging in the Blaylock trades to improve the quality of Freddie Mac's Retained Portfolio. As discussed above, these trades violated GAAP and/or the Company's own internal tax policy; and

c. Defendants did not provide a "fair presentation" of the Company's results because they failed to disclose the accounting manipulations listed in (a) and (b) above and that the Company's internal controls suffered from material weaknesses.

Third Quarter

290. On October 17, 2000, Freddie Mac issued a press release announcing "record" earnings for the third quarter of 2000. Specifically, the Company reported "record" diluted earning per common share of $0.86 for the third quarter of 2000, a 15% increase over the third quarter of 1999.

291. On or about November 14, 2000, Freddie Mac made publicly available its Information Statement Supplement dated November 14, 2000. This supplement contained the Company's information for the quarterly period ended September 30, 2000 and served to supplement the Information Statement dated March 31, 2000 (the "Third Quarter 2000 Supplement"). The Third Quarter 2000 Supplement contained the same or substantially the same false and misleading financial results as reported in the October 17 Press Release.

292. The Third Quarter 2000 Supplement also stated: "In the opinion of Freddie Mac, the preceding unaudited Consolidated Financial Statements, prepared from the corporation's books and records, contain all adjustments necessary for a fair presentation of the corporation's financial condition as of September 30, 2000, June 30, 2000, December 31, 1999 and September 30, 1999 . . . Freddie Mac's financial reporting and accounting policies conform to [GAAP]."

293. The statements identified in paragraphs 290 through 292 were false and misleading because:

a. Defendants failed to disclose that they used Freddie Mac's improper reserve under SFAS 91 and the Company's reserve for legal contingencies to surpass analysts' expectations for the fourth quarter of 2000 of $0.85 by $0.01 and thus

report "record earnings." Without the reserve adjustments, the Company would have reported earnings per share of $0.85;

b. Defendants failed to disclose that during the second quarter and continuing until the third quarter of 2001, Freddie Mac's F&I and SS&TG divisions began engaging in the Blaylock trades to improve the quality of Freddie Mac's Retained Portfolio. As discussed above, these trades violated GAAP and/or the Company's own internal tax policy; and

c. Defendants did not provide a "fair presentation" of the Company's results because they failed to disclose the accounting manipulations listed in (a) and (b) above and that the Company's internal controls suffered from material weaknesses.

Fourth Quarter/Year End

294. On January 18, 2001, the Company once again announced record earnings. This time, Freddie Mac reported record diluted earnings per common share of $3.40 for 2000, a 15% increase over 1999. The Company also reported net income of $2.547 billion, another 15% increase over 2000.

295. In the press release, Brendsel praised the Company's results stating:

> We ended the year with rock-solid financial strength, well protected from economic volatility and ready to meet the nation's housing finance need for years to come. Our tremendous success in fulfilling our mission has earned us broad public support. The enhancements to our capital management and disclosure practices that we announced in October raise the already high standard of information we provide to investors and far exceed current industry practice.

296. On or about January 31, 2001, Freddie Mac made publicly available its Information Statement Supplement for fiscal year December 31, 2000 and served to supplement the Information Statement dated March 31, 2000 (the "2000 Supplement").

The 2000 Supplement contained the same or substantially the same false and misleading financial results as reported in the January 18 Press Release.

297. The 2000 Supplement also stated: "In the opinion of Freddie Mac, the preceding unaudited Consolidated Financial Statements, prepared from the corporation's books and records, contain all adjustments necessary for a fair presentation of the corporation's financial condition as of December 31, 2000, September 30, 2000, and December 31, 1999 . . . Freddie Mac's financial reporting and accounting policies conform to [GAAP]."

298. On or about March 26, 2001, Freddie Mac made publicly available its Information Statement dated March 26, 2001 which contained its results for the quarter and year ended December 31, 2000 (the "2000 Information Statement"). In the 2000 Information Statement, the Company reported the same or substantially the same financial results described in the January 18 Press Release. In addition, Freddie Mac stated: "Over the long term, Freddie Mac has consistently produced high-quality earnings growth. . . . Management expects continued high-quality earnings growth in 2001." The Company also reported that net interest income on earning assets totaled $2.838 billion in 2000.

299. Moreover, Freddie Mac assured investors that it had controls in place to reduce its "operational risk:"

> Operational risk is the risk of loss due to human error, system failures, fraud or circumvention or failure of internal controls. Freddie Mac mitigates operational risk by following comprehensive financial and operating policies and procedures, and by regularly evaluating the effectiveness of its internal control structure. The corporation's policies and procedures include controls to ensure that system-generated data are reconciled to source documentation in a timely fashion. Freddie Mac also performs reasonableness and validity tests to ensure the accuracy of its financial information. The corporation's Internal Audit Division, which reports to the Board as well as to the corporation's management, regularly

> monitors Freddie Mac's compliance with established policies and procedures, and evaluates Freddie Mac's internal control structure.

300. In the 2000 Information Statement, Freddie Mac disclosed the adoption or expected adoption of at least two significant account policies. Specifically, Freddie Mac disclosed that on January 1, 2001, it would implement SFAS 133. The Company disclosed that " it 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."

301. The Company also disclosed that in July 2000, the Emerging Issues Task Force of FASB released Issue No 99-20, "Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets." Freddie Mac reported that it "will implement this standard on April 1, 2001" and that "Management does not expect the implementation of this accounting guidance to materially affect the corporation's reported results of operations and financial position."

302. With respect to its reserves for mortgage losses, the Company stated that it maintained the reserves "at levels it deems adequate to absorb estimated losses incurred on the total mortgage portfolio."

303. At the end of the 2000 Information Statement, Freddie Mac included a section entitled "Management's Report on Consolidated Financial Statements and Internal Control Structure," which was signed by Brendsel and Clarke. According to this report:

> The management of [Freddie Mac] is responsible for the preparation, integrity and fair presentation of the corporation's annual Consolidated Financial Statements. The annual Consolidated Financial Statements presented have been prepared in accordance with generally accepted accounting principles and, as such, include amounts based on judgments

> and estimates made by management. Management also has prepared the other information included in this annual report, and is responsible for its accuracy and consistency with the Consolidated Financial Statements.

304. The report also assured investors that Management reviewed the Company's internal controls and found them adequate:

> In addition, management is responsible for establishing and maintaining an internal control structure over financial reporting, including controls over the safeguarding of assets. The objective of the internal control structure is to provide reasonable assurance to management and the Board as to the preparation of the financial statements in accordance with [GAAP].
>
> Management has made its own assessment of the effectiveness of the corporation's internal control structure over financial reporting, including controls over the safeguarding of assets, as of December 31, 2000 . . . . Based on this assessment, management believes that, as of December 31, 2000, the corporation's internal control structure was effective in achieving the objective stated above.

305. Finally, the report commented on the corporate culture at the Company:

> Management also recognizes its responsibility for fostering a strong ethical climate so that Freddie Mac's affairs are conducted according to the highest standards of personal and corporate conduct. This responsibility is characterized and reflected in Freddie Mac's Code of Conduct, which is publicized throughout the corporation. The Code of Conduct addresses among other things, . . . potential conflicts of interest, . . . acceptable financial activities, . . ethical business conduct and compliance with the Code of Conduct. Freddie Mac maintains a systematic program to assess compliance with the Code of Conduct.

306. The 2000 Information Statement also reported that:

> Management's assertion that Freddie Mac maintained an effective system of internal controls over financial reporting, including controls over the safeguarding of assets, as of December 31, 2000 is fairly stated, in all material respects, based upon criteria established in "Internal Controls-Integrated Framework" issued by the Committee of Sponsoring Organizations of the Treadway Commission.

307. Additionally, the 2000 Information Statement indicated that: "the financial statements referred to above present fairly, in all material respects, the financial position of Freddie Mac as of December 31, 2000 and 1999, and the results of its operations and

its cash flows for each of the three years in the period ended December 31, 2000, in conformity with [GAAP].”

308. The Company’s Annual Report to shareholders for fiscal year 2000 contained the same or substantially the same false and misleading statements identified in the 2000 Information Statement. In addition, in a letter to shareholders signed by Brendsel and Glenn, the Company stated: “Freddie Mac is a source of stability in increasingly volatile markets. Quarter after quarter, year after year, again and again, Freddie Mac delivers consistently strong results.”

309. The statements identified in paragraphs 294 through 308 were false and misleading because:

a. As Freddie Mac admitted in restating its results, the Company understated net income by approximately $1.119 billion and diluted earnings per share by $1.61. As restated, the Company earned net income of approximately $3.666 billion and diluted earnings per share of $5.01. Similarly, the Company understated its net interest income by approximately $920 million. Defendants sacrificed this gain in 2000 to smooth out earnings so that they could continue portraying Freddie Mac as a stable, growing company, immune from large swings in earnings;

b. Defendants failed to disclose that they used Freddie Mac’s improper reserve under SFAS 91 and the Company’s reserve for legal contingencies to meet analysts’ expectations for the fourth quarter of 2000 of $0.89 and thus report “record earnings.”;

c. Defendants failed to disclose that during the second quarter and continuing until the third quarter of 2001, Freddie Mac’s F&I and SS&TG divisions

began engaging in the Blaylock trades to improve the quality of Freddie Mac's Retained Portfolio. As discussed above, these trades violated GAAP and/or the Company's own internal tax policy;

d. During 2000, defendants embarked on its SDO scheme (described above) to increase net interest income, which resulted in an increase of net interest income by $155 million. Defendants failed to disclose in its publicly reported 2000 financial results that it had adopted this accounting policy despite that fact that selling the SDO's accounted for approximately 5% of the Company's net interest income;

e. Defendants failed to disclose that they were searching for ways to counter the financial effects expected to be caused by the adoption of EITF 99-20;

f. Contrary to defendants' claims, management did not foster a strong ethical climate at Freddie Mac. Rather, defendants encouraged employees to violate GAAP principles or internal policies if and when necessary to meet management's objective of steady mid-teens earnings growth; and

g. Defendants failed to provide a "fair presentation" the Company's financial results, nor were Freddie Mac's financial results prepared in accordance with GAAP. Defendants failed to disclose the accounting manipulations listed in (a) - (f) above and that the Company's internal controls suffered from material weaknesses. Moreover, despite defendants' claims, they failed to reduce operating risk and ensure the accuracy of their financial information. Rather, defendants kept the accounting office understaffed with employees who could not sufficiently deal with or control the accounting issues affecting Freddie Mac or the machinations devised by management and employees within F&I.

Year 2001

First Quarter

310. On April 24, 2001, Freddie Mac issued a press release announcing its financial results for the first quarter of fiscal 2001. In the press release, the Company announced "operating earnings" for the quarter of $719 million. (The Company's operating earnings exclude the accounting effects from Freddie Mac's adoption of SFAS 133.) The Company reported net income and earnings per share for the first quarter (which included the effect of SFAS 133) of $837 million and $1.13, respectively. The Company also reported net interest income of $976 million.

311. In the press release, Brendsel touted the Company's results stating: "Freddie Mac ended the quarter with rock-solid financial strength, well protected from economic volatility and positioned to produce strong high-quality earnings growth in 2001."

312. In the press release, Freddie Mac also purported to disclose the effect that the adoption of SFAS 133 had on the Company's financial results. In particular, the Company assured investors that the adoption of SFAS 133 resulted in a cumulative net after-tax increase to net income of just $5 million ($0.01 per diluted share).

313. On April 24, 2001, Freddie Mac held a conference call to discuss its financial results for the first quarter of 2001. Clarke, Parseghian and Joseph Amato, Vice President of Finance, hosted the call. During the call, Clarke reiterated that diluted operating earnings per share were $0.96 cents. Additionally, Clarke discussed the effect that application of SFAS 133 would have on Freddie Mac's earnings per share. Specifically, Clarke stated that the Company's "one-time transition impact on earnings

was a net gain of $5 million or one penny per diluted share, which is consistent with our earlier guidance."

314. In response to questioning, Clarke assured listeners that the Company complied with GAAP, despite management's desire to have smooth earnings growth:

> I would prefer to have smooth growing earnings. I think Wallstreet (sic) doesn't like to have a lots (sic) of spikes, what we're trying to do over the long-term, Jonathan, is to enhance shareholder value and that, I think, is delivering strong high-quality earnings growth consistently, and that's really our goal. I will also tell you though that we're very transparent in the way we operate and there is only so much you can do obviously under the accounting rules, and we do, what we do within the context of those, but in terms of philosophically (sic), we would rather have a consistent strong earnings growth pattern than a very erratic earnings growth pattern.

315. On or about May 15, 2001, Freddie Mac made publicly available its Information Statement Supplement dated May 15, 2001. This supplement contained the Company's information for the quarterly period ended March 31, 2001 and served to supplement the Information Statement dated March 26, 2001 (the "First Quarter 2001 Supplement"). The First Quarter 2001 Supplement contained the same or substantially the same false and misleading statements as the April 24 Press Release.

316. The First Quarter 2001 Supplement also stated that due to its implementation of SFAS 133, the Company had to recognize a one-time, net cumulative after-tax adjustment increase to net income of $5 million.

317. Additionally, the report stated: "In the opinion of Freddie Mac, the preceding unaudited Condensed Consolidated Financial Statements, prepared from the corporation's books and records, contain all the adjustments necessary for a fair presentation of the corporation's financial condition as of March 31, 2001, December 31, 2000 and March 31, 2000 . . . Freddie Mac's financial reporting and accounting policies conform to accounting principles generally accepted in the U.S. ("GAAP")."

318. The statements identified in paragraphs 310 through 317 were false and misleading because:

a. As the Company now admits in its Restatement, defendants overstated Freddie Mac's net income and earnings per share. In the first quarter, the Company actually suffered a loss of $111 million and a loss per share of $0.23. For the quarter, as restated, net income interest equaled $1.295 billion;

b. Defendants failed to disclose that the relatively minor gain caused by the implementation of SFAS 133 resulted because they had devised numerous accounting schemes to minimize the actual transition gain under SFAS 133. In particular, defendants concealed the fact that they inappropriately devised and used CTUGs (described above), J006 and J007 deals, and a different method to value Freddie Mac's swaptions so that defendants could offset the SFAS 133 transition gain and maintain the appearance of steady, stable growth;

c. Defendants failed to disclose that the Company's earnings growth, and "rock-solid financial strength" stemmed in part from the Company's efforts to manipulate its financials, in violation of GAAP, to hide volatility in its reported financial results;

d. Defendants failed to disclose that they were searching for ways to counter the financial effects expected to be caused by the adoption of EITF 99-20;

e. Defendants failed to disclose that during the second quarter and continuing until the third quarter of 2001, Freddie Mac's F&I and SS&TG divisions began engaging in the Blaylock trades to improve the quality of Freddie Mac's Retained

Portfolio. As discussed above, these trades violated GAAP and/or the Company's own internal tax policy;

f. Defendants failed to disclose that they were improperly using reserves to manipulate earnings; and

g. The financial results contained in the supplement were not a "fair presentation" of the Company's financial results nor were they prepared in conformity with GAAP. Defendants failed to disclose the accounting manipulations listed in (a) - (f) above and that the Company's internal controls suffered from material weaknesses.

Second Quarter

319. On July 18, 2001, Freddie Mac issued a press release announcing "record" earnings for the second quarter of 2001. In particular, the Company reported that operating earnings for the quarter totaled $769 million and diluted operating earnings per common share were $1.03. Including the effect of SFAS 133, the net income and diluted earnings per share equaled approximately $914 million and $1.24, respectively. Freddie Mac also reported net interest income for the quarter of $1.104 billion.

320. In the press release, Brendsel once again praised the economic and financial strength of the Company stating: "We have rock-solid financial strength, and are well protected from economic volatility . . . With our excellent first half results, we are well – positioned to produce strong, high - quality earnings growth in 2001."

321. On July 18, 2001, Freddie Mac held a conference call to discuss its financial results for the second quarter of 2001. Clarke, Parseghian, and Joe Amato, Vice President of Finance, hosted the call. In discussing Freddie Mac's results, defendant Clarke stated: "Freddie Mac delivered outstanding second quarter results at a time when

many companies are reporting disappointing earnings or (sic) diluted operating earnings per share were $1.03 up 23% over the second quarter of 2000."

322. On or about August 14, 2001, Freddie Mac made publicly available its Information Statement Supplement dated August 14, 2001. This supplement contained the Company's information for the quarterly period ended June 30, 2001 and served to supplement the Information Statement dated March 26, 2001 (the "Second Quarter 2001 Supplement"). The Second Quarter 2001 Supplement contained the same or substantially the same false and misleading statements as the July 18 Press Release. This report also informed investors that Freddie Mac "expects continued high-quality operating earnings growth in 2001."

323. Additionally, the Company once again reported that the implementation of SFAS 133 resulted in an increase to the first quarter net income of only $5 million.

324. The Second Quarter 2001 Supplement also reported that: "In the opinion of Freddie Mac, the preceding unaudited Condensed Consolidated Financial Statements, prepared from the corporation's books and records, contain all the adjustments necessary for a fair presentation of the corporation's financial condition as of June 30, 2001, March 31, 2001, and June 30, 2000 . . . Freddie Mac's financial reporting and accounting policies conform to [GAAP]."

325. The statements identified in paragraphs 319 through 324 were false and misleading because:

a. As the Company now admits in its Restatement, defendants overstated Freddie Mac's net income and earnings per share. In the quarter, the Company actually earned $721 million in net income and earnings per share of $0.96, rather than

$914 million and earnings per share of $1.24. The Company also understated net income interest. For the quarter, as restated, net interest income equaled $1.518 billion. Defendants failed to disclose that they expected high quality operating earnings growth in 2001 because they ensured such growth by engaging in accounting schemes that violated GAAP and Freddie Mac's own internal policies;

b. Defendants failed to disclose that the relatively minor gain caused by the implementation of SFAS 133 resulted because they had devised numerous accounting schemes to minimize the actual transition gain under SFAS 133. In particular, defendants concealed the fact that they inappropriately devised and used CTUGs (described above), J006 and J007 deals, and a different method to value its swaptions so that they could offset the SFAS 133 transition gain and maintain the appearance of steady, stable growth immune from volatility;

c. Defendants failed to disclose that the Company's earnings growth and "rock-solid financial strength" stemmed in part from the Company's efforts to manipulate its financials, in violation of GAAP, to hide volatility in its reported financial results;

d. Defendants failed to disclose that they devised a scheme, known as the J008 and J009 deals to avoid implementing EITF 99-20 and thus avoided recording an impairment loss of $231 million;

e. Defendants failed to disclose that during the second quarter and continuing until the third quarter of 2001, Freddie Mac's F&I and SS&TG divisions began engaging in the Blaylock trades to improve the quality of Freddie Mac's Retained

Portfolio. As discussed above, these trades violated GAAP and/or the Company's own internal tax policy;

f. Defendants failed to disclose they were improperly using reserves to manipulate earnings; and

g. Defendants failed to provide a "fair presentation" of the Company's financial results, nor were they prepared in conformity with GAAP. Defendants failed to disclose the accounting manipulations listed in (a) - (f) above and that the Company's internal controls suffered from material weaknesses.

Third Quarter

326. On October 17, 2001, Freddie Mac issued a press release announcing its financial results for the third quarter for 2001. The Company reported operating earnings of $813 million and diluted operating earnings per common share of $1.08, a 26% increase over the year ago period. The Company reported operating net interest income of $1.015 billion. Including the effects of SFAS 133, the Company reported net income and diluted earnings per share of $1.032 billion and $1.40, respectively. The company also reported net interest income of $1.320 billion.

327. In the press release, Brendsel commented on the stability of Freddie Mac's performance:

> We are all saddened by the terrible events of September 11. . . . As a leader in the housing finance system, Freddie Mac again proved to be a rock of stability, providing an uninterrupted supply of mortgage funds. Even with greater uncertainty in the economy, Freddie Mac is well positioned to produce mid-teens earnings growth in 2002.

328. On or about November 14, 2001, Freddie Mac made publicly available its Information Statement Supplement dated November 14, 2001. This supplement contained the Company's information for the quarterly period ended September 30, 2001

and served to supplement the Information Statement dated March 26, 2001 (the "Third Quarter 2001 Supplement"). The Third Quarter 2001 Supplement contained the same or substantially the same false and misleading statements as the October 17 Press Release.

329. In the Third Quarter 2001 Supplement, Freddie Mac informed investors that "in 2001, management expects continued high-quality operating earnings growth" and in "2002, Freddie Mac expects operating earnings growth in the mid-teens."

330. In the Third Quarter 2001 Supplement, the Company encouraged investors to rely on the Company's non-GAAP measure, "Operating Earnings":

> Beginning with its first quarter 2001 reporting, Freddie Mac began providing a supplemental performance measure known as 'operating earnings'. Management believes that results presented on an operating basis are beneficial in understanding and analyzing Freddie Mac's financial performance because they better reflect the economic impact of the corporation's risk management activities.

331. Additionally, the Company once again reported that the implementation of SFAS 133 resulted in an increase to the first quarter net income of only $5 million.

332. The Third Quarter 2001 Supplement also reported that: "In the opinion of Freddie Mac, the preceding unaudited Condensed Consolidated Financial Statements, prepared from the corporation's books and records, contain all the adjustments necessary for a fair presentation of the corporation's financial condition as of September 30, 2001, June 30, 2001, December 31, 2000 and September 30, 2000 . . . Freddie Mac's financial reporting and accounting policies conform to [GAAP.]"

333. The statements identified in paragraphs 326 through 332 were false and misleading because:

a. As the Company now admits in its Restatement, defendants understated Freddie Mac's net income and earnings per share. In the quarter, the

Company actually earned $2.414 billion in net income and earnings per share of $3.38, rather than $1.032 billion and earnings per share of $1.40. The Company also understated net interest income. For the quarter, as restated, net income interest equaled $2.158 billion, rather than $1.438 billion;

b. Defendants failed to disclose that Freddie Mac remained well positioned to produce mid-teens growth because they ensured such growth by engaging in accounting schemes which violated GAAP and Freddie Mac's own internal policies;

c. Defendants failed to disclose that the relatively minor gain caused by the implementation of SFAS 133 resulted because they had devised numerous accounting schemes to minimize the actual transition gain under SFAS 133. In particular, defendants concealed the fact that they inappropriately devised and used CTUGs (described above), J006 and J007 deals, and a different method to value the Company's swaptions so that it could offset the SFAS 133 transition gain and maintain the appearance of steady, stable growth immune to volatility;

d. Defendants failed to disclose that, beginning in the third quarter of 2001, they engaged in the Linked Swaps transactions in an effort to increase earnings, particularly operating earnings, in future periods, in violation of GAAP;

e. The Company failed to disclose that it used its tax reserve to report its earnings per share results closer to analysts' expectations;

f. Defendants failed to disclose that during the second quarter and continuing until the third quarter of 2001, Freddie Mac's F&I and SS&TG divisions began in engaging in the Blaylock trades in an effort to improve the quality of Freddie

Mac's Retained Portfolio. As discussed above, these trades violated GAAP and/or the Company's own internal tax policy; and

g. Defendants did not provide a "fair presentation" of the Company's financial results. As the Company admits, its financial results were not prepared in conformity with GAAP. Defendants failed to disclose the accounting manipulations listed in (a) - (f) above and that the Company's internal controls suffered from material weaknesses.

Fourth Quarter/Year End

334. On January 22, 2002, Freddie Mac announced its financial results for the fourth quarter and year end 2001. In particular, the Company reported operating earnings for 2001 of $3.154 billion and diluted operating earnings per common share of $4.21. Freddie Mac also reported operating earnings for the fourth quarter of $853 million, and diluted operating earnings per common share of $1.14. Including the effects of SFAS 133, for the year 2001 the Company reported net income and diluted earnings per share of approximately $4.147 billion and $5.64, respectively. For the quarter, the Company reported net income and diluted earnings per share of $1.364 billion and $1.87, respectively. The Company reported net interest income of $5.480 billion.

335. On January 22, 2002, Freddie Mac held a conference call to discuss its financial results for the year end and fourth quarter of 2001. Clarke, Parseghian, and Joe Amato, Vice President of Finance, hosted the call. During the call, Clarke reiterated that Freddie Mac's operating earnings per share for the year was $4.21, respectively. Moreover, Clarke remarked that: "We enter 2002 well positioned to deliver mid-teens

earnings growth. This strong performance will be driven by mid-teens retained portfolio growth, a stable net interest margin and low credit costs."

336. In the press release, Brendsel once again praised the Company's performance, stating "We ended the year with rock-solid financial strength, well protected from economic volatility and positioned to produce mid-teens earnings growth in 2002."

337. Freddie Mac included in its 2001 earnings release, its outlook for 2002. The Company stated that in 2002, it "expects operating earnings growth in the mid-teens."

338. On or about April 1, 2002, Freddie Mac made publicly available its Information Statement Supplement dated January 31, 2002 to the Information Statement dated March 26, 2001. This supplement contained the Company's information for the year ended December 31, 2001 ("2001 Supplement"). The 2001 Supplement contained the same or substantially the same false and misleading statements as the January 22 Press Release.

339. The 2001 Supplement reported that: "Management believes that results presented on an operating basis, while not a defined term under GAAP, are beneficial in understanding and analyzing Freddie Mac's performance because they better reflect the economic impact of the corporation's risk management activities."

340. The 2001 Supplement also reported that: "In the opinion of Freddie Mac, the preceding unaudited Condensed Consolidated Financial Statements (excluding the full-year 2000 Condensed Consolidated Statements of Income and December 31, 2000 Condensed Consolidated Balance Sheets), prepared from the corporation's books and

records, contain all the adjustments necessary for a fair presentation of the corporation's financial condition as of December 30, 2001, September 30, 2001, December 31, 2000 . . . Freddie Mac's financial reporting and accounting policies conform to [GAAP.]"

341. On or about March 29, 2002, Freddie Mac made publicly available its Information Statement dated March 29, 2002 which contained its results for the quarter and year ended December 31, 2001 (the "2001 Information Statement"). In the 2001 Information Statement, the Company reported the same or substantially the same financial results described in the January 22 Press Release. Moreover, the Company stated that it "expects operating earnings per share growth in the mid-teens."

342. In addition, the Company reiterated as it had in past disclosures that it had adopted a non-GAAP measurement of its "operating earnings" to exclude the effect of SFAS 133. The Company claimed that "[m]anagement believes that results presented on an operating basis are beneficial in understanding and analyzing Freddie Mac's financial performance because they better reflect the economic impact of Freddie Mac's risk management activities."

343. With respect to its Loan Loss Reserves, Freddie Mac stated that it "maintains reserves for losses on its PCs and retained mortgages at levels management believes to be adequate to absorb estimated losses inherent in the total mortgage portfolio at the balance sheet date."

344. Moreover, in discussing Freddie Mac's "operational risk," Freddie Mac assured investors that it had controls in place to reduce operational risk:

> Operational risk is the risk that financial loss, increased regulatory risk or damage to Freddie Mac's reputation could result from failed internal processes and/or systems, human factors and environmental events. These

> include accounting, operational, reporting, legal and human resource related processes. . . . Management maintains an internal control framework designed to identify measure, monitor and manage all significant operational risk on an ongoing basis. Freddie Mac continuously assesses its operational and financial reporting infrastructure to ensure it is adequate to handle emerging business and financial reporting developments. In 2001, complexities associated with the implementation of SFAS 133 gave risk to increased operating risk resulting from the processing requirements associated with hedge re-designations and the resulting income and expense amortization, as well as derivative and hedged item valuations and effectiveness assessments . . . . In addition, the introduction of Freddie Mac's supplemental operating earnings measure in 2001 also created new accounting and processing requirements. The new processes associated with the implementation of SFAS 133 and the introduction of operating earnings, as well as enhancements to existing processes, involved changes to various automated systems and other internal control mechanisms to manage and control these risks.
>
> The corporation mitigates the risk of human error by adequately training employees, hiring experienced personnel, documenting and adhering to comprehensive policies and procedures as well as by regularly evaluating the effectiveness of its internal control structure. The corporation's Internal Audit Division regularly monitors Freddie Mac's compliance with established policies and procedures, and evaluates Freddie Mac's internal control structure.

345. In the 2001 Information Statement, Freddie Mac also stated that the implementation of SFAS 133 served to increase net income by only $5 million and decrease the AOCI component of "Total stockholders' equity" by approximately $2.5 billion.

346. With respect to its reserves for mortgage losses, the Company stated that it maintained the reserve "at levels it deems adequate to absorb estimated losses inherent in the total mortgage portfolio."

347. The Company also included in the 2001 Information Statement an obscure reference to the Linked Swaps, which were transacted in the third and fourth quarters of 2001. Specifically, Freddie Mac stated: "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."

348. At the end of the 2001 Information Statement, Freddie Mac included a section entitled "Management's Report on Consolidated Financial Statements and Internal Control Structure," which was signed by Brendsel and Clarke. According to this report:

> The management of [Freddie Mac] is responsible for the preparation, integrity and fair presentation of the corporation's annual Consolidated Financial Statements. The annual Consolidated Financial Statements presented have been prepared in accordance with generally accepted accounting principles and, as such, include amounts based on judgments and estimates made by management. Management also has prepared the other information included in this annual report, and is responsible for its accuracy and consistency with the Consolidated Financial Statements.

349. The report also assured investors that Management reviewed the Company's internal controls and found them adequate:

> In addition, management is responsible for establishing and maintaining an internal control structure over financial reporting, including controls over the safeguarding of assets. The objective of the internal control structure is to provide reasonable assurance to management and the Board as to the preparation of the financial statements in accordance with [GAAP.]
>
> Management has made its own assessment of the effectiveness of the corporation's internal control structure over financial reporting, including controls over the safeguarding of assets, as of December 31, 2001 . . . Based on this assessment, management believes that, as of December 31, 2001, the corporation's internal control structure was effective in achieving the objective stated above.

350. Finally, the report commented on the corporate culture at the Company:

> Management also recognizes its responsibility for fostering a strong ethical climate so that Freddie Mac's affairs are conducted according to the highest standards of personal and corporate conduct. This responsibility is characterized and reflected in Freddie Mac's Code of Conduct, which is publicized throughout the corporation. The Code of Conduct address among other things, . . . potential conflicts of interest, . . . acceptable financial activities, . . . ethical business conduct and compliance with the Code of Conduct. Freddie Mac maintains a systematic program to assess compliance with the Code of Conduct.

351. The 2001 Information Statement also reported that: "management's assertion that Freddie Mac maintained effective internal control over financial reporting, as of December 31, 2001, is fairly stated, in all material respects, based upon criteria established in "Internal Controls-Integrated Framework" issued by the Committee of Sponsoring Organizations of the Treadway Commission."

352. Additionally, the 2001 Information Statement indicated that: "the financial statements referred to above present fairly, in all material respects, the financial position of Freddie Mac and subsidiaries as of December 31, 2001 and 2000, and the results of their operations and its cash flows for each of the three years in the period ended December 31, 2001, in conformity with [GAAP]."

353. The Company's Annual Report to shareholders for fiscal year 2001 contained the same or substantially the same false and misleading statements identified in the 2001 Information Statement. In addition, in a letter to shareholders signed by defendants Brendsel and Glenn, the Company stated: "Freddie Mac is a leader in providing timely, comprehensive and transparent financial disclosure. Our disclosures are in the top tier of corporate America. They include complete information on our financial condition, business activities, interest-rate and credit risk management . . . They put us at the vanguard of financial disclosure and transparency."

354. The statements identified in paragraphs 334 through 353 were false and misleading because:

a. As the Company now admits in its Restatement, defendants overstated Freddie Mac's net income and earnings per share for fiscal 2001. For the year, the Company actually earned $3.158 billion in net income and earnings per share of

$4.23, rather than $4.147 billion as originally reported and earnings per share of $5.64. Accordingly, the Company overstated its net income by approximately $989 million. For the year, as restated, net interest income equaled $6.992 billion, rather than $5.480 billion. Defendants failed to disclose that it remained well positioned to produce mid-teens growth because they ensured such growth by engaging in accounting schemes which violated GAAP and Freddie Mac's own internal policies;

b. Defendants failed to disclose that the relatively minor gain caused by the implementation of SFAS 133 resulted because they had devised numerous accounting schemes to minimize the actual transition gain under SFAS 133. In particular, defendants concealed the fact that they inappropriately devised and used CTUGs (described above), J006 and J007 deals, and a different method to value its swaptions so that it could offset the SFAS 133 transition gain and maintain the appearance of steady, stable growth, immune from volatility. At the same time, however, even when it attempted to apply hedge accounting under SFAS 133, it failed to follow the basic GAAP requirements which resulted in the Company having to move previously deferred or unrecognized gains and losses into earnings. In total, the Company's Restatement included a net reduction of $2.257 billion in previously reported pre-tax income in 2001 related to its accounting for derivative instruments;

c. Defendants failed to disclose that, beginning in the third quarter of 2001 and continuing into the fourth quarter of 2001, Freddie Mac effected the Linked Swaps transactions in an effort to push earnings into future periods, in violation of GAAP, and that the Linked Swaps had a significant effect on its operating earnings metric;

d. Defendants failed to disclose that they were manipulating the Company's reserves to manage earnings. Similarly, defendants failed to disclose that it maintained an inappropriate amortization reserve under SFAS 91 and kept other reserves at levels which violated GAAP;

e. Contrary to defendants' claims, management did not foster a strong ethical climate at Freddie Mac. Rather, defendants' encouraged employees to violate GAAP principles or internal policies if and when necessary to meet management's objective of steady mid-teens earnings growth;

f. Moreover, despite defendants' claims, they failed to reduce operating risk and ensure the accuracy of Freddie Mac's financial information. Rather, defendants kept the accounting office understaffed with employees who could not sufficiently deal with the accounting issues affecting Freddie Mac or control the machinations devised by management and F&I;

g. Defendants failed to provide a "fair presentation" (or "present fairly") Freddie Mac's financial results, nor were they prepared in conformity with GAAP; and

h. Defendants failed to disclose the accounting manipulations listed in (a) - (g) above and that the Company's internal controls suffered from material weaknesses.

<u>Year 2002</u>

<u>First Quarter</u>

355. On April 23, 2002, Freddie Mac announced record earnings for the first quarter of 2002. Specifically, the Company reported that operating earnings for the first

quarter totaled $893 million, and that diluted operating earnings per common share were $1.19. Including the effects of SFAS 133, the Company reported net income and diluted earnings per share of $1.413 billion and $1.94, respectively.

356. In the press release, Brendsel once again touted Freddie Mac's results:

> Freddie Mac delivered outstanding first quarter results, with 24 percent operating earnings growth . . . With these exceptional results and our financial strength, we are well positioned to deliver strong, high quality earnings in 2002. . . . Investors can continue to have confidence in the safety, soundness and transparency of Freddie Mac. Our recent disclosure enhancement raise the already high standard of information we provide.

357. In its first quarter 2002 earnings release, Freddie Mac included its outlook for 2002. Specifically, the Company stated that it has "increased its expectation for operating earnings growth in 2002 to be about 16 to 18 percent."

358. On April 23, 2002, Freddie Mac held a conference call to discuss its financial results for the first quarter of 2002. Clarke, Joseph Amato, and a third Freddie Mac officer, hosted the call. Additionally, Clarke or another Freddie Mac officer stated that the Company was "well positioned to deliver 16-18% operating earnings growth in 2002."

359. On or about May 15, 2002, Freddie Mac made publicly available its Information Statement Supplement dated May 15, 2002. This supplement contained the Company's information for the quarterly period ended March 31, 2002 and served to supplement the Information Statement dated March 29, 2002 (the " First Quarter 2002 Supplement"). The First Quarter 2002 Supplement contained the same or substantially the same false and misleading statements as the April 23 Press Release.

360. In the First Quarter 2002 Supplement, the Company again encouraged investors to rely on the Company's non-GAAP measure, "Operating Earnings:"

"Beginning with its first quarter 2001 reporting, Freddie Mac began providing a supplemental performance measure known as 'operating earnings.' Management believes that results presented on an operating basis, while not a defined term within GAAP . . . are beneficial in understanding and analyzing Freddie Mac's financial performance because it better reflects the economic impact of Freddie Mac's risk management activities."

361. The First Quarter 2002 Supplement also reported that: "In the opinion of Freddie Mac, the preceding unaudited Condensed Consolidated Financial Statements, prepared from the corporation's books and records, contain all the adjustments necessary for a fair statement of the corporation's financial condition as of March 31, 2002, December 31, 2001 and March 31, 2001 . . . Freddie Mac's financial reporting and accounting policies conform to [GAAP.]"

362. The statements identified in paragraphs 355 through 361 were false and misleading because:

a. As the Company now admits in its Restatement, defendants overstated Freddie Mac's net income and earnings per share for the first quarter of 2002. As restated, the Company actually earned $947 million in net income and earnings per share of $1.27, rather than $1.413 billion and earnings per share of $1.94. Defendants failed to disclose that it remained well positioned to deliver strong, high quality earnings in 2002 because they ensured such growth by engaging in accounting schemes which violated GAAP and Freddie Mac's own internal policies;

b. Defendants failed to disclose that, beginning in the third quarter of 2001 and continuing into the fourth quarter of 2001, Freddie Mac effected nine Linked

Swaps transactions in violation of GAAP to increase earnings, particularly its operating earnings, in 2002 and future periods;

c. The Company failed to disclose it switched its method for calculating amortization rates in violation of SFAS 91, which understated interest income for the first quarter by $132 million; and

d. Defendants failed to provide a "fair presentation" of its financial results and they were not prepared in conformity with GAAP. Defendants failed to disclose the accounting manipulations listed in (a) - (c) above and that the Company's internal controls suffered from material weaknesses.

Second Quarter

363. On July 12, 2002, Freddie Mac issued a press release announcing its agreement with the SEC and OFHEO, to file annual and quarterly reports with the SEC along with material event disclosures on Form 8-K. The Company also agreed to file proxy statements and trading information of its officers and directors. In the press release, Freddie Mac stated:

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

* * *

> Freddie Mac is a leader in disclosure practices. Nearly two years ago, Freddie Mac and Fannie Mae made voluntary risk management and disclosure commitments that are unmatched by any other financial institutions. . . . Today's announcement reinforces Freddie Mac's commitment to maintaining the highest standards of disclosure, transparency and financial strength in fulfilling our statutory mission.

364. On July 23, 2002, Freddie Mac announced its results for the second quarter of 2002. In the press release, the Company reported "record" operating earnings of $968 million and diluted operating earnings per share of $1.30. Including the effects of SFAS 133, the Company reported net income and diluted earnings per share of $1.110 billion and $1.50, respectively.

365. In the press release, Brendsel commented on the Company's disclosure practices, stating: "We also took other steps to demonstrate our leadership in financial disclosure, voluntarily initiating SEC oversight of our disclosures . . . ."

366. In the press release, the Company also disclosed that after consulting with its new auditors, it concluded it needed to decrease the level of its loan loss reserve. Specifically, Freddie Mac reported that: "Freddie Mac has concluded that its continuing strong credit innovations and experience have contributed to a loan loss reserve which has been $250 million in excess of that required by GAAP, and as a result will reduce its reserves by this amount." The Company further stated that: "Freddie Mac maintains loan loss reserves to absorb credit losses on the corporation's existing portfolio." Freddie Mac failed to disclose that it had improperly kept its reserve at a level which had violated GAAP since prior to 1999 or that it used the reserve to manage earnings.

367. In its second quarter 2002 earnings release, Freddie Mac included its outlook for 2002. Specifically, the Company stated that it "expects operating earnings growth of 16 to 18 percent in 2002."

368. On July 23, 2002, Freddie Mac held a conference call to discuss its financial results for the second quarter of 2002. Clarke, Parseghian and Joe Amato hosted the call. During the call, Clarke reiterated that the Company delivered outstanding results with diluted operating earnings per share of $1.30. Clarke added that the Company remained "well positioned to deliver 16 to 18% operating earnings growth in 2002."

369. On or about August 14, 2002, Freddie Mac made publicly available its Information Statement Supplement dated August 14, 2002. This supplement contained the Company's information for the quarterly period ended June 30, 2002 and served to supplement the Information Statement dated March 29, 2002 (the "Second Quarter 2002 Supplement"). The Second Quarter 2002 Supplement contained the same or substantially the same false and misleading statements as the July 23 Press Release.

370. In the Second Quarter 2002 Supplement, Freddie Mac informed investors that Freddie Mac expects operating earnings growth in 2002 to be about 16 to 18 percent.

371. The Second Quarter 2002 Supplement also contained a discussion of the Company's Operating Risk, stating:

> Management maintains an internal control framework designed to identify, measure, monitor and manage significant operational risks on an ongoing basis. Freddie Mac continuously assesses its operational and financial reporting infrastructure to ensure it is adequate to handle emerging business and financial reporting developments. In 2001, complexities associated with the implementation of SFAS 133 gave rise to increased operating risk resulting from the processing requirements associated with hedge re-designations and the resulting income and expense amortization, as well as derivative and hedged item valuations and effectiveness assessments . . . . In addition, the supplemental operating earnings measure introduced during 2001 involves new accounting and processing requirements. The new processes associated with the implementation of SFAS 133 and the introduction of operating earnings, as well as enhancements to existing processes, involved changes to various automated systems, and other internal control mechanisms to manage and control these risks.

372. In the Second Quarter 2002 Supplement, the Company again encouraged investors to rely on the Company's non-GAAP measure, "Operating Earnings:" "Beginning with its first quarter 2001 reporting, Freddie Mac began providing a supplemental performance measure known as 'operating earnings.' Management believes that results presented on an operating basis, while not a defined term within GAAP . . . are beneficial in understanding and analyzing Freddie Mac's financial performance because it better reflects the economic impact of Freddie Mac's risk management activities."

373. The Second Quarter 2002 Supplement also reported that: "In the opinion of Freddie Mac, except as discussed in Note 2, [a note relating to its Loan Loss Reserves] the preceding unaudited Condensed Consolidated Financial Statements, prepared from the corporation's books and records, contain all the adjustments, consisting only of normal recurring adjustments, necessary for a fair statement of the corporation's financial condition as of June 30, 2002, June 30, 2001 and March 31, 2002 . . . Freddie Mac's financial reporting and accounting policies conform to [GAAP.]"

374. In Note 2, entitled "Loan Loss Reserves", Freddie Mac stated that it "maintains its loan loss reserves to absorb credit losses on the corporation's total mortgage portfolio." The Company disclosed that after a review of its loan loss reserves with its new auditor (PwC), it had "concluded" that they were approximately "$250 million more than the level required by GAAP."

375. The statements identified in paragraphs 363 through 374 were false and misleading because:

a. As the Company now admits in its Restatement, defendants understated Freddie Mac's net income and earnings per share for the second quarter of 2002. As restated, the Company actually earned $1.971 billion in net income and earnings per share of $2.74, rather than $1.110 billion and earnings per share of $1.50. Defendants failed to disclose that it remained well positioned to deliver 16% to 18% operating earnings growth in 2002 because they ensured such growth by engaging in accounting schemes which violated GAAP and Freddie Mac's own internal policies;

b. Defendants failed to disclose that, beginning in the third quarter of 2001 and continuing into the fourth quarter of 2001, Freddie Mac effected nine Linked Swaps transactions in violation of GAAP to increase earnings, particularly its operating earnings, in 2002 and future periods;

c. The Company failed to disclose it switched its method for calculating amortization rates in violation of SFAS 91, which understated interest income for the first quarter by $132 million and overstated its income in the second quarter of 2002 by the same amount;

d. Defendants failed to disclose that it had maintained its loan loss reserves at levels which had violated GAAP since prior to 1999 and used the reserves to smooth out earnings per share; and

376. Defendants failed to provide a fair statement of Freddie Mac's financial results nor were they prepared in conformity with GAAP. Defendants failed to disclose the accounting manipulations listed in (a) - (d) above and that the Company's internal controls suffered from material weaknesses. Consequently, contrary to their claims, Freddie Mac was hardly a "vanguard" for financial disclosure. Defendants' accounting

manipulations and accounting errors prevented the Company from providing investors with "transparent" and full disclosures of Freddie Mac's financial condition.

Third Quarter

377. On August 14, 2002, Brendsel and Clarke signed certifications attesting to the accuracy and completeness of Freddie Mac's recent financial disclosures and filed them with the SEC. Specifically, Brendsel and Clarke certified the accuracy of Company's Information Statement for 2001, the Information Statement Supplements for the first and second quarters of 2002, and the definitive proxy materials dated April 2, 2002 stating: "To the best of my knowledge, based upon a review of the covered reports of the Federal Home Loan Mortgage Corporation ("Freddie Mac"), and, as except as corrected or supplemented in a subsequent covered report:"

- no covered report contained an untrue statement of a material fact as of the end of the period covered by such report (or in the case of definitive proxy materials, as of the date on which they were mailed to shareholders); and
- no covered report omitted to state a material fact necessary to make the statements in the covered report, in light of the circumstances under which they were made, not misleading as of the end of the period covered by such report (or in the case of definitive proxy materials, as of the date on which they were mailed to shareholders).

378. On September 26, 2002, defendant Brendsel gave a speech at the Banc of America Securities 32nd Annual Investment Conference. On or about September 24, 2002, Freddie Mac made a transcript of his speech available to investors through its website. Excerpts from his speech include the following:

- "We [Freddie Mac] have a 31 year record of unbroken profitability. . . Our earnings per share have grown close to 20 percent for the last 10 years, despite significant economic and financial volatility."

- "Through the first half of this year, operating earnings grew 18 percent on an annualized basis. We expect another record year of operating earnings for Freddie Mac this year."

- "In achieving these results, Freddie Mac has maintained our rock-solid financial position. Our disciplined and conservative risk management leaves us well protected against financial volatility or any weakness in housing values."

- "We expect to continue to produce strong, durable financial results, taking advantage of the great market that we are in- . . . ."

- "Let me say a word about our use of derivatives. We use them exclusively to reduce risk, to preserve value and to reduce financing costs. We use the most straightforward derivatives, such as swaps and options."

379. On October 23, 2002, Freddie Mac issued a press release announcing its financial results for the third quarter of 2002. In the press release, the Company reported operating earnings of $987 million and diluted operating earnings per common share of $1.34. Including the effect of SFAS 133, the Company reported net income of $1.378 billion and diluted earnings per share of $1.90.

380. In the press release, the Company included its business outlook for 2002, stating: "[g]iven its strong year-to-date performance, Freddie Mac expects operating earnings per share growth of about 20 percent in 2002."

381. On or about November 14, 2002, Freddie Mac publicly made available its Information Statement Supplement for the third quarter of 2002. This supplement contained the Company's information for the quarterly period ended September 30, 2002 and served to supplement the Information Statement dated March 29, 2002 (the "Third Quarter 2002 Supplement"). The Third Quarter 2002 Supplement contained the same or substantially the same false and misleading statements as the October 23 Press Release.

382. With respect to loan losses, the Company stated that it maintains its loan loss reserves to absorb credit losses in the corporation's existing portfolio at the balance sheet date. The Company also disclosed that "Freddie Mac recently conducted a review of its loan loss reserves" and that "[b]ased on this review, management concluded its loan loss reserves have been approximately $246 million more than required since the late 1990s." As a result, the Company lowered the reserve by that amount (on a pre-tax basis).

383. In the Third Quarter 2002 Supplement, the Company again encouraged investors to rely on the Company's non-GAAP measure, "Operating Earnings:" "Beginning with its first quarter 2001 reporting, Freddie Mac began providing a supplemental performance measure known as 'operating earnings' . . . Management believes that results presented on an operating basis, while not a GAAP measurement . . . are beneficial in understanding and analyzing Freddie Mac's financial performance because they provide a more consistent treatment of transactions with similar economic effects."

384. The Third Quarter 2002 Supplement also included a paragraph on the Company's controls and procedures:

> Under the supervision and the participation of Freddie Mac's management, including its Chief Executive Officer and Chief Financial Officer, Freddie Mac carried out an evaluation of the effectiveness of the design and operation of its disclosure controls and procedures within the 90 days prior to the date of this Information Statement Supplement. Based upon and as of the date of that evaluation, the [CEO] and [CFO] concluded that the disclosure controls and procedures are effective in all material respects to ensure that information required to be disclosed in Freddie Mac's disclosure documents is recorded, processed, summarized and disclosed as and when required. There were no significant changes in Freddie Mac's internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation.

385. The Third Quarter 2002 Supplement also reported that: "In the opinion of Freddie Mac, the preceding unaudited Condensed Consolidated Financial Statements, prepared from the corporation's books and records, contain all the adjustments, consisting only of normal recurring adjustments, necessary for a fair statement of the corporation's financial condition as of September 30, 2002, September 30, 2001 and June 30, 2002 . . . Freddie Mac's financial reporting and accounting policies conform to [GAAP.]"

386. Brendsel and Clarke certified the accuracy of the Third Quarter 2002 Supplement and attached their signed certifications. In particular, their certifications stated:

- I have reviewed this [Third Quarter 2002 Supplement]
- Based on my knowledge, this [Third Quarter 2002 Supplement] does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statement made, in the light of the circumstances under which such statements were made, not misleading with respect to the period covered by this [Third Quarter 2002 Supplement.]
- Based on my knowledge, the financial statements, and other financial information included in this [Third Quarter 2002 Supplement], fairly present in all material respects the financial condition, results of operations and cash flows of Freddie Mac as of, and for, the periods presented in this [Third Quarter 2002 Supplement].

387. Additionally, in their certifications, Brendsel and Clarke each acknowledged his responsibility for maintaining internal controls:

- Freddie Mac's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for Freddie Mac and we have:

  a. designed such disclosure controls and procedures to ensure that material information relating to Freddie Mac, including its consolidated subsidiaries, is made known to us by other within those entities,

particularly during the period in which this [Third Quarter 2002 Supplement] is being prepared;

b. evaluated the effectiveness of Freddie Mac's disclosure controls and procedures as of a date within 90 days prior to the date of this [Third Quarter 2002 Supplement] (the "Evaluation Date").

388. Finally, Brendsel and Clarke certified that they and the other certifying officers disclosed, based on their most recent evaluation, to Freddie Mac's auditors and the audit committee of Freddie Mac's board of directors "all significant deficiencies in the design or operation of internal controls which could adversely affect Freddie Mac's ability to record, process, summarize and report financial data and have identified for Freddie Mac's auditors any material weakness in internal controls;" and "any fraud, whether or not material, that involves management or other employees who have a significant role in Freddie Mac's internal controls."

389. The statements identified in paragraphs 377 through 388 were false and misleading because:

a. As the Company now admits in its Restatement, defendants understated Freddie Mac's net income and earnings per share for the third quarter of 2002. As restated, the Company actually earned $5.662 billion in net income and earnings per share of $8.06, rather than $1.378 billion and earnings per share of $1.90. Defendants failed to disclose that it expected operating earnings per share growth of about 20 percent in 2002 because they ensured such growth by engaging in accounting schemes which violated GAAP and Freddie Mac's own internal policies;

b. Defendants failed to disclose that, beginning in the third quarter of 2001 and continuing into the fourth quarter of 2001, Freddie Mac effected nine Linked

Swaps transactions in violation of GAAP to increase earnings, particularly its operating earnings, in 2002 and future periods;

c. Defendants failed to disclose that it maintained its loan loss reserves at levels which violated GAAP since prior to 1999 and used the reserves to smooth out earnings per share and that by adding the excess reserves to income in the third quarter of 2002 it had overstated pre-tax income by $246 million;

d. The Company's failure to comply with SFAS 133 in accounting for its derivative instruments had resulted in a $6.887 billion understatement of pre-tax income; and

e. Defendants failed to provide a "fair presentation" of its financial results nor were they prepared in conformity with GAAP. Defendants failed to disclose the accounting manipulations listed in (a) - (d) above and that the Company's internal controls suffered from material weaknesses.

<u>Fourth Quarter/Year End</u>

390. On January 27, 2003, Freddie Mac issued a press release announcing its unaudited financial results for the fiscal year and quarter ended December 31, 2002. In the press release, the Company reported that its net income and diluted earnings per share for the year equaled $5.764 billion and $7.95, respectively. For the year, Freddie Mac reported operating earnings of $3.854 billion and diluted operating earnings per share of $5.20. Freddie Mac also reported $6.777 billion in net interest income for 2002. For the quarter, the Company announced net income of $1.703 billion and earnings per share of $2.38. Operating earnings and diluted operating earnings per share for the quarter equaled $846 million and $1.14, respectively.

391. In the press release, Brendsel assured investors that "Freddie Mac is committed to the highest standards of financial integrity."

392. On January 27, 2003, the Company held a conference call to discuss its financial results for the fourth quarter of 2002. Defendants Clarke, Brendsel, and Parseghian, along with Joseph Amato hosted the call. The Company held the call after the Company's announcement that its 2002 results are being audited and subject to Restatement. During the call, Brendsel stated that "We now believe in some instances that certain accounting practices we previously applied were not consistent with generally accepted accounting principals. At that time --- at the time, we thought they were, and our auditor at that time concurred. But in retrospect, and as I believe now, they are not."

393. On or about January 27, 2003, Freddie Mac publicly made available its Information Statement Supplement for the full year and fourth quarter 2002 earnings. This supplement served to supplement the Information Statement dated March 29, 2002 (the "Fourth Quarter 2002 Supplement"). The Fourth Quarter 2002 Supplement contained the same or substantially the same false and misleading statements as the January 27 Press Release. In describing its operating earnings metric, the Company stated that "[m]anagement . . . believes that it enhances understanding of the corporation's financial performance."

394. The statements identified in paragraphs 390 through 393 were false and misleading because:

a. As the Company now admits in its Restatement, defendants understated Freddie Mac's net income and earnings per share for fiscal 2002. For the year, the Company actually earned $10.090 billion in net income and earnings per share

of $14.18, rather than $5.764 billion and earnings per share of $7.95. As "revised," defendants reported net interest income of 8.886 billion rather than $6.777 billion. For the quarter, as "revised," the Company reported results of $1.510 billion and $2.10 EPS;

b. Defendants failed to disclose that, beginning in the third quarter of 2001 and continuing into the fourth quarter of 2001, Freddie Mac effected the Linked Swaps transactions in violation of GAAP to increase earnings, particularly operating earnings, in 2002 and future periods; and

c. Contrary to defendants' claims, management did not foster a strong ethical climate at Freddie Mac. Rather, defendants' encouraged employees to violate GAAP principles or internal policies if and when necessary to meet management's objective of steady mid-teens earnings growth and either knew or were reckless in not knowing that they acted in violation of GAAP. Defendants failed to disclose that the Company's internal controls suffered from material weaknesses.

VIII. REVELATION OF ACCOUNTING IMPROPRIETIES

395. On December 10, 2002, the Company's Audit Committee engaged Baker Botts LLP to investigate allegations of three separate accounting, public reporting, and internal control irregularities at Freddie Mac, which were raised in an anonymous letter dated October 23, 2002, which Freddie Mac received on December 6, 2002. While investigating the claims made in the letters, Baker Botts met with PwC to share information which they thought may be relevant to PwC's 2002 audit of Freddie Mac.

396. On January 22, 2003, the Company announced its intent to restate its 2000, 2001 and 2002 earnings, and the Company revealed in a January 27, 2003 press release that:

> [I]n some instances the application of certain accounting policies, as used by Freddie Mac and concurred with by Arthur Andersen, were not consistent with generally accepted accounting principles ("GAAP"). These include the application of SFAS 133 (accounting for derivative instruments) and SFAS 115 (classification of mortgage assets between available-for-sale and trading accounts through certain resecuritization transactions).

(Press Release, January 27, 2003). The press release also reported that the Company had notified OFHEO, the SEC and the NYSE about the "developments" connected to the Company's intent to restate its earnings. The Board then hired Baker Botts to investigate the circumstances behind certain transactions identified in the Restatement and related accounting policies.

397. In a March 25, 2003 press release, Freddie Mac reported that it expected to complete the Restatement process by the end of second quarter 2003, with results released shortly afterward. The press release announced that for the quarterly periods covered by the Restatement, "the corporation expects significant volatility in reported quarterly earnings for those periods."

398. Then, on June 9, 2003, Freddie Mac issued a press release, announcing the retirement of Brendsel, the resignation of Clarke, and the termination of Glenn. The Company disclosed that Glenn had been terminated "because of serious questions as to the timeliness and completeness of his cooperation and candor with the Board's Audit Committee counsel, retained in January 2003 to review the facts and circumstances surrounding the principal accounting errors identified during the restatement process." The press release also disclosed that Parseghian would replace Brendsel as CEO and President of Freddie Mac, but that Brendsel would remain Chairman of the Freddie Mac Foundation, a philanthropic organization that grants monies to organizations that serve families and children.

399. In response to the news, the value of the Company's stock fell from a closing price of $59.87 on June 6, 2003 to a closing price of $50.26 on June 9, 2003, a single trading day drop of $9.61 or 16%. In the next three days as the market absorbed this news, Freddie Mac's stock dropped to a low of $47.35.

400. In a June 11, 2003 press release, the Company announced that the SEC had commenced a formal investigation into the Company's accounting practices. On the same day, the U.S. Attorney's Office for the Eastern District of Virginia announced that it had commenced a criminal investigation into possible misconduct at Freddie Mac.

401. On June 11, 2003, Brendsel also announced his resignation as Chairman of the Freddie Mac Foundation.

402. On June 25, 2003 the Company issued a press release that provided a progress report on issues related to the Restatement. The press release quoted Parseghian, who stated "[t]he information we are disclosing today reflects poorly on Freddie Mac's past accounting, control and disclosure practices. Management is aggressively addressing these issues."

403. The June 25, 2003 press release also disclosed that:

> [C]ertain capital market transactions and accounting policies [that] had been implemented with a view to their effect on earnings in the context of Freddie Mac's goal of achieving steady earnings growth, and that the disclosure processes and disclosure in connection with those transactions and policies did not meet standards that would have been required of Freddie Mac had it been an SEC registrant.
>
> * * *
>
> The preliminary findings also note that certain reserve account and other adjustments, that were known departures from GAAP and that were not considered to be material at the time, were made with a view to their effect on earnings.

* * *

> [T]he corporation continues to expect that adjustments affecting its income will relate substantially to changes in the timing of income recognition, and, as a result, ***cumulative increases related to these adjustments will have offsetting effects in future periods. These accounting policy changes will cause greater volatility in Freddie Mac's financial statements for prior periods. Freddie Mac believes there also will be significant volatility in its results in future periods.***

(Emphasis added.)

404. The June 25, 2003 press release quoted Shaun O'Malley, Chairman of Freddie Mac's Board of Directors, who stated "we have every confidence that we have the right management team in place to lead the company and address these serious accounting and control issues." This confidence proved to be misplaced, however, as less than two months later Freddie Mac asked Parseghian to resign as CEO, in response to pressure from the Company's federal regulator, OFHEO.

405. On July 23, 2003, Freddie Mac released the report prepared by Baker Botts in connection with its review of the facts and circumstances relating to the improper transactions and accounting errors at the Company. In a July 23, 2003 press release announcing the release of the Baker Botts Report, Chairman O'Malley commented that "this is a painful day for Freddie Mac." In summarizing the Baker Botts Report, the press release noted that:

> 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.

406. On July 25, 2003, the Freddie Mac Foundation announced that it had replaced Brendsel as its Chairman.

407. In a statement released on August 22, 2003, Armando Falcon Jr., OFHEO's Director, declared that, based on a review of the investigation into the improper transactions and accounting irregularities, Parseghian and General Counsel Maud Mater "should be replaced".

408. On September 30, 2003, SEC Chairman William Donaldson appeared before the U.S. Senate Banking Committee and confirmed that the SEC is continuing to examine evidence of possible fraud at Freddie Mac.

409. On October 23, 2003, OFHEO announced that it had entered a into a Consent Order with Glenn (Order No. 2003-01), requiring him to pay a fine of $125,000.00 and to cooperate fully with OFHEO in the on-going special examination and any subsequent supervisory or enforcement proceedings initiated by OFHEO, in what the Consent Order described as "serious and substantial issues regarding the management, operations and business practices of Freddie Mac for a period during which [defendant] Glenn served as an officer and director."

410. Additionally, according to a *Wall Street Journal* article dated October 22, 2003, the Internal Revenue Service also began an examination into tax issues raised by the accounting issues. The article reported that the Company admits it may have to pay as much as $750 million, plus interest, in connection with one set of transactions it employed to manipulate earnings. The Company conceded that a tax liability of that magnitude could have a material adverse impact on its earnings. The IRS began the transactions because as a consequence of Freddie Mac shifting current earnings into

future periods, the Company may have avoided paying the appropriate amount in taxes for particular years.

411. On October 28, 2003, *Bloomberg* reported that four Freddie Mac employees had left the company amid the federal investigation into the Company's Restatement. These employees included: Dean, Senior Vice President of Market Risk Oversight; Chowdhury, Vice President of Asset and Liability (authors of the "Dean-Chowdhury" swaption valuation method which allowed the Company to offset part of the SFAS 133 transition gain); Byron Boston, a Vice President of Investments; and mortgage bond trader, Smriti Popenoe, (both of whom played roles in transacting the "Blaylock trades").

412. In a December 10, 2003 press release, OFHEO announced that, as part of a Consent Order with OFHEO (Order No. 2003-02), Freddie Mac had agreed to implement corrective measures and pay a civil money penalty of $125,000,000, the largest civil money penalty imposed by a safety and soundness regulator. According to the press release, the "[t]he actions came as OFHEO released a report [the OFHEO Report] detailing ***a pattern of inappropriate conduct and improper management of earnings*** that led to the Company's recent restatement." (Emphasis added.) The press release went on to admonish that:

- Freddie Mac ***disregarded accounting rules, internal controls, disclosure standards, and ultimately, the public trust*** in the pursuit of steady earnings growth;
- The ***incentive compensation plans of senior executives contributed to the improper accounting*** and management practices of the enterprise;
- Weaknesses existed in ***every aspect*** of Freddie Mac's accounting process;

- The Board of Directors was ***complacent and failed to exercise adequate oversight***; [and]
- ***Former management exhibited a disdain for appropriate disclosure standards***.

(December 10, 2003, OHFEO press release (Emphasis added.))

413. The December 10, 2003 press release also disclosed that while conducting its investigation, "OFHEO took numerous actions regarding present and former executives at the enterprise. These included: the freezing of compensation packages, removal of the CEO [***Parseghian***] and General Counsel, the levying of a civil money penalty on the former Vice Chairman [***Glenn***], and beginning the process of terminating the former CEO [***Brendsel***] and CFO [***Clarke***] for cause."

414. In a December 18, 2003 press release, OFHEO said that in connection with "the improper management of earnings" it had issued a Notice of Charges against Brendsel and Clarke. According to the press release, "[t]he Charges will result in an enforcement order requiring that they (1) be terminated for cause and thereby forfeit substantial severance awards, (2) pay a civil money penalty, and (3) return bonuses they received for 2000 and 2001. Mr. Brendsel would lose a total of approximately $33.9 million and Mr. Clarke would lose a total of approximately $3.9 million." OFHEO also said that the Notice of Charges begins an administrative process "that will lead to cease and desist orders, the monetary penalties and other remedies, according to OFHEO regulations. The Charges are reviewed by an Administrative Law Judge who makes recommendations to the Director of OFHEO."

IX. THE RESTATEMENT

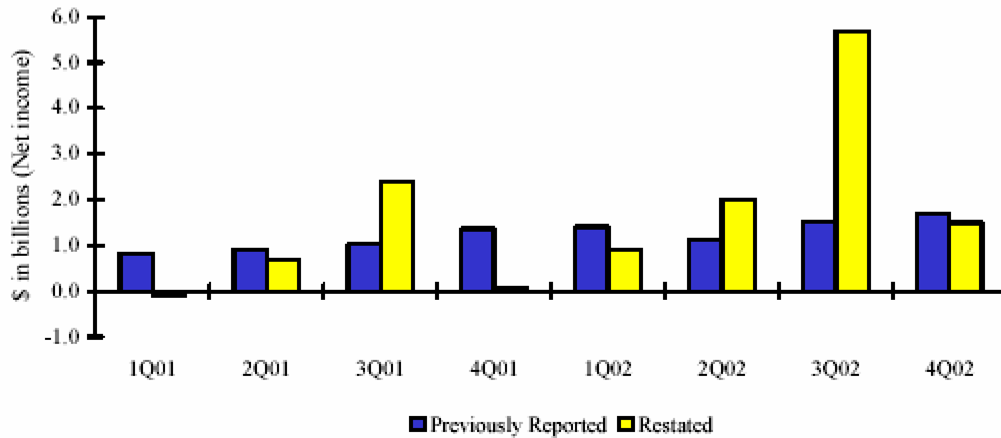
415. On November 21, 2003, Freddie Mac finally issued a press release that announced the Restatement of its previously issued financial statements for 2000, 2001 and 2002.

416. The Restatement reveals that when the effects of the defendants' accounting manipulations are stripped away, Freddie Mac had in fact ***overstated*** its 2001 net income by approximately $1 billion (approximately 25%), or $1.41 earnings per share (diluted). The Restatement also disclosed that Freddie Mac had an actual ***net loss*** of $111 million in the first quarter of 2001, compared to a previously reported net income of $837 million, and that defendants had ***overstated*** net income in the fourth quarter of 2001 by approximately $1.2 billion.

417. As shown in Table 1, the effects of the Restatement reveal that the defendants had ***overstated*** net income in at least three quarters of 2001 and two quarters of 2002. Equally important, Table 1 shows that the previously reported "steady," non-volatile earnings as reported throughout the Class Period was nothing short of pure illusion. Indeed, during the Class Period, actual quarterly earnings, as restated, varied from a net loss of $111 million in the first quarter of 2001, to a $5.7 billion net income in the third quarter of 2002.

Table 1

Net Quarterly Table Effects for 2001 and 2002



418. In the November 21, 2003 press release, the Company stated:

> The net cumulative effect of the restatement through December 31, 2002 was an increase to the Company's net income of $5.0 billion, which includes a net cumulative increase of $4.4 billion for 2000, 2001 and 2002 and $0.6 billion related to periods prior to 2000. While the net cumulative effect of the restatement provided a significant increase in net income, 2001's net income decreased by $1.0 billion compared to previously reported results, primarily due to unrealized losses on derivatives not in hedge accounting relationships.

419. The press release also disclosed that:

> Freddie Mac's restated net income reflects significantly greater volatility than previously reported, and the company anticipates that its net income for periods following the restatement will continue to reflect greater volatility than previously reported from quarter to quarter . . . This volatility results in large part from recording in current period earnings changes in fair values of a significantly higher proportion of Freddie Mac's derivatives portfolio, mortgage-related securities, guarantee assets and guarantee obligations.

420. The Company provided the following summary of the effect of the Restatement on net income, diluted earnings per share, and stockholders' equity:

Restated Financial Results for Three Years Ended December 31, 2002

	Net Income (in millions) [1]			Diluted EPS (in dollars)			Stockholders' Equity (in millions)		
Year Ended	As Previously Reported	As Restated	Change	As Previously Reported	As Restated	Change	As Previously Reported	As Restated	Change
Dec. 31, 2000	$2,547	$3,666	$1,119	$3.40	$5.01	$1.61	$14,837	$17,357	$2,520
Dec. 31, 2001	$4,147	$3,158	($989)	$5.64	$4.23	($1.41)	$15,373	$19,624	$4,251
Dec. 31, 2002	$5,764	$10,090	$4,326	$7.95	$14.18	$6.23	$24,629	$31,330	$6,701

(1)	The net cumulative effect of the restatement through December 31, 2002 also includes $0.6 billion for periods prior to 2000. Included in 2002 results or $82 million of net income related to events occurring in 2003, but affecting 2002. The $82 million of net income is comprised of $155 million of tax benefit attributable to favorable U.S. Tax Court rulings occurring in 2003 offset by $73 million in additional expense, net of tax, related to adjustments in reserves and accruals due to events occurring in 2003.

421. As a way of organizing its Restatement, the Company combined the various accounting errors or manipulative transactions into different categories. For example, the Restatement stemming from the improper use of the loan loss and amortization reserves fell under "All Other Corrections" category. The net cumulative effects of adjustments by category made as a result of the Restatement as of December 31, 2002 were as follows:

Net Cumulative Restatement Effect by Category ($ in millions)

Category	Net Cumulative Impact to Income (Expense) $ in millions	Net Cumulative Impact to Accumulated Other Comprehensive Income (Loss) [1] $ in millions
Security Classification (pre-tax)	$1,700	$2,669
Accounting for Derivative Instruments (pre-tax)	4,980	(163)
Asset Transfers and Securitizations (pre-tax)	181	488
Valuation of Financial Instruments (pre-tax)	214	(268)
All Other Corrections (pre-tax)	383	(86)
Subtotal of Accounting Corrections (pre-tax)	7,458	2,640
Other Accounting Changes (pre-tax)[2]	168	(333)
Total Accounting Corrections and Changes (pre-tax)	7,626	2,307
Tax Impact of Accounting Corrections and Changes[3]	(2,591)	(804)
Total Restatement Effect (including subsequent events) [4]	$5,035	$1,503
Total Restatement Effect (excluding subsequent events)	$4,953	$1,503

[1] Accumulated Other Comprehensive Income (Loss) is a component of stockholders' equity.
[2] Represents the net cumulative impact of (i) accounting changes Freddie Mac elected to make related to stock-based compensation and (ii) enhancements to the methodology used to estimate the lives used in the amortization of certain premiums and discounts.
[3] Includes the Federal income tax effect of total accounting corrections and the impact of certain corrections related to tax expense. See "Tax-Related Adjustments" in this appendix for details.
[4] Included in 2002 results is $82 million of net income related to events occurring in 2003 but affecting 2002. The $82 million of net income is comprised of $155 million of tax benefit attributable to favorable U.S. Tax Court rulings occurring in 2003 offset by $73 million in additional expense, net of tax, related to adjustments in reserves and accruals due to events occurring in 2003.

422. The majority of the increase in net income is attributable to Freddie Mac having to correct its accounting for its derivatives. Specifically, as admitted in the Restatement, a large majority of the Company's derivative portfolio "is not eligible for

hedge accounting treatment, primarily due to (i) errors in security classification that caused hedged items to be ineligible and (ii) documentation or testing requirements that were not met during the Restatement Period . . . ." As a result, "the fair value changes for these derivatives are now reported though current period earnings instead of being deferred and amortized over the life of the hedged item." In addition, a significant amount of the increase in net income was driven by corrections related to securities that the Company previously classified as either HTM or AFS, but should have classified as trading (*e.g.* the improper CTUG and J006/J007 transactions that were intended to avoid future earnings volatility).

423. In addition, Freddie Mac provided restated quarterly information for each quarter of 2002 and 2001, and full-year results for 2000, by category, as follows:

FREDDIE MAC QUARTERLY AND ANNUAL RECONCILIATION OF PREVIOUSLY REPORTED TO RESTATED RESULTS 2002 (unaudited) (dollars in millions)					
Line:	1Q 2002	2Q 2002	3Q 2002	4Q 2002	Full-Year 2002
1 Income before cumulative effect of change in accounting principle, net of taxes, as previously reported Impact of accounting errors and corrections:	$ 1,413	$ 1,110	$ 1,538	$ 1,703	$ 5,764
2 Security classification	(180)	723	416	(49)	910
3 Accounting for derivative instruments	(804)	1,118	6,887	(665)	6,536
4 Asset transfers and securitizations	128	(262)	(858)	141	(851)
5 Valuation of financial instruments	89	(170)	31	(37)	(87)
6 All other corrections	133	(57)	(272)	(175)	(371)
7 Other accounting changes(1)	(8)	(6)	(4)	301	283
8 Tax impact of accounting corrections and changes	176	(485)	(2,076)	291	(2,094)
9 Income before cumulative effect of change in accounting principle, net of taxes, as revised/restated	947	1,971	5,662	1,510	10,090
10 Cumulative effect of change in accounting principle, net of taxes	-	-	-	-	-
11 Net income as revised/restated	$ 947	$ 1,971	$ 5,662	$ 1,510	$ 10,090
12 Diluted earnings per common share after cumulative effect of change in accounting principle, net of taxes, as previously reported (2)	$ 1.94	$ 1.50	$ 2.13	$ 2.38	$ 7.95
13 Effect of adjustments	(0.67)	1.24	5.93	(0.28)	6.23
14 Diluted earnings per common share after cumulative effect of change in accounting principle, net of taxes, as revised/restated (2)	$ 1.27	$ 2.74	$ 8.06	$ 2.10	$ 14.18

(1) Represents the net impact of (i) accounting changes Freddie Mac made related to stock-based compensation and (ii) enhancements to the methodology used to estimate the lives used in the amortization of certain premiums and discounts.
(2) Earnings per share is computed independently for each of the quarters presented. Due to the use of weighted-average common shares outstanding when calculating earnings per share, the sum of the four quarters may not equal the full-year amount. Earnings per share amounts may not recalculate due to rounding.

FREDDIE MAC QUARTERLY AND ANNUAL RECONCILIATION OF PREVIOUSLY REPORTED TO RESTATED RESULTS 2001 and 2000 (unaudited) (dollars in millions)						
Line:	1Q 2001	2Q 2001	3Q 2001	4Q 2001	Full-Year 2001	Full-Year 2000
1 Income before cumulative effect of change in accounting principle, net of taxes, as previously reported Impact of accounting errors and corrections:	$ 832	$ 914	$ 1,032	$ 1,364	$ 4,142	$ 2,547
2 Security classification	284	(455)	1,420	(770)	479	640
3 Accounting for derivative instruments	(928)	(441)	839	(1,241)	(1,771)	875
4 Asset transfers and securitizations	(153)	363	184	(152)	242	(488)
5 Valuation of financial instruments	(555)	230	(440)	280	(485)	626
6 All other corrections	(93)	91	(26)	103	75	(11)
7 Other accounting changes(1)	(1)	(9)	(10)	(11)	(31)	(18)
8 Tax impact of accounting corrections and changes	425	63	(585)	561	464	(505)
9 Income (loss) before cumulative effect of change in accounting principle, net of taxes, as restated	(189)	756	2,414	134	3,115	3,666
10 Cumulative effect of change in accounting principle, net of taxes, as previously reported Impact of accounting errors and corrections:	5	-	-	-	5	-
11 Security classification	445	-	-	-	445	-
12 Accounting for derivative instruments	(486)	-	-	-	(486)	-
13 Asset transfers and securitizations	-	(53)	-	-	(53)	-
14 Valuation of financial instruments	160	-	-	-	160	-

15 All other corrections	(7)	-	-	-	(7)	-
16 Other accounting changes	-	-	-	-	-	-
17 Tax impact of cumulative effect of change in accounting principle	(39)	18	-	-	(21)	-
18 Cumulative effect of change in accounting principle, net of taxes, as restated	78	(35)	-	-	43	-
19 Net income (loss), as restated	$ (111)	$ 721	$ 2,414	$ 134	$ 3,158	$ 3,666
20 Diluted earnings per common share after cumulative effect of change in accounting principle, net of taxes, as previously reported(2)	$ 1.13	$ 1.24	$ 1.40	$ 1.87	$ 5.64	$ 3.40
21 Effect of adjustments	(1.36)	(0.28)	1.98	(1.76)	(1.41)	1.61
22 Diluted earnings (loss) per common share after cumulative effect of change in accounting principle, net of taxes, as restated(2)	$ (0.23)	$ 0.96	$ 3.38	$ 0.11	$ 4.23	$ 5.01

(1) Represents the impact of accounting changes Freddie Mac made related to stock-based compensation.

(2) Earnings per share is computed independently for each of the quarters presented. Due to the use of weighted-average common shares outstanding when calculating earnings per share, the sum of the four quarters may not equal the full-year amount. Earnings per share amounts may not recalculate due to rounding.

X. DEFENDANTS' SCIENTER

424. Defendants acted with scienter throughout the Class Period, in that they either had actual knowledge of the misrepresentations and/or omissions of the material facts set forth herein, or acted with reckless disregard for the truth in that they failed to ascertain and to disclose the true facts, even though such facts were readily available to them. In addition to the facts demonstrating that defendants orchestrated or encouraged the various fraudulent and improper transactions, defendants' scienter is evidenced by the following: (i) defendants' admissions that they sought to portray the Company as stable, profitable and immune to earnings volatility; (ii) defendants' efforts to conceal the fraud; (iii) defendants' deliberate or reckless efforts to weaken accounting and internal controls; (iv) the close tie between defendants' and other Freddie Mac employees' bonus

compensation scheme and performance reviews and their ability to manage earnings; and (v) certain defendants' unusual and suspicious stock sales.

A. Defendants' Admissions

425. In connection with its Restatement and during the investigations by Baker Botts and OFHEO, defendants have made a number of damaging admissions. Additionally, defendants have evidenced their scienter by engaging in transactions which lacked any true business purpose, but were only transacted because they served management's goal of reporting steady earnings. Their statements and conduct reveal that during the Class Period they wanted to conceal the true volatile nature of Freddie Mac's business so that they could portray the Company as a stable, profitable, and immune from swings in earning volatility. These statements and conduct include the following:

(a) Parseghian, and others within the Company, have disclosed to investigators that the Company's clear goal was to manage interest income and that defendants would propose transactions and strategies that would attempt to meet those goals. See ¶¶35,36, 40-44, 46-50 above;

(b) Company also admitted that it maintained reserves and made adjustments to those reserves "which were known departures of GAAP" with a view to their effect on earnings. See ¶¶53-87 above;

(c) The Company engaged in certain transactions (CTUG, J006 and J007) to avoid having to report a substantial transition gain from the adoption of SFAS 133. See ¶¶112-141 above;

(d) The Company changed its methodology in valuing its swaption portfolio to further offset the transition gain under SFAS 133, but changed it back once it had accomplished its objective. See ¶¶142-159;

(e) Defendants devised and had the Company enter into nine Linked Swap transactions, which lacked any true business purpose, so that they could push earnings into future periods. See ¶¶160-177

(f) Defendants judged employees' performance on how well they managed earnings and contributed to meeting the goal of avoiding earnings volatility. See ¶¶481-493 below;

(g) Defendants devised transactions to avoid the effect of another new GAAP rule (J8 and J9) which would have caused volatility in earnings. See ¶¶178-183 above; and

(h) Defendants expended a substantial amount of time and effort to conceal their accounting manipulations. See ¶¶426-469 below.

B. Defendants' Efforts To Conceal The Fraud

426. Defendants went to great lengths to withhold disclosure about the size of the SFAS 133 transition gain and accounting improprieties to offset that gain and manage earnings. During its investigation, OFHEO found the Freddie Mac fostered a company-wide culture of "minimal disclosure." The Company favored withholding information from investors, rather than provide the market with full and complete disclosures, as set forth below:

1. Concealment Of Efforts To Transact Around SFAS 133

427. At no time did defendants disclose the gross amount of the SFAS 133 transition gain or that the Company had executed the CTUG and J006/J007 transactions

to offset that gain, and to avoid future earnings volatility by reclassifying those securities from trading to AFS. Additionally, the defendants did not disclose the key role that changing the valuation of the swaptions portfolio had on reducing the SFAS 133 transition gain that could not be offset by the CTUG and J006/J007 transactions. Indeed, the Company never expressed any exceptions to its swaption valuation disclosure, which stated that the Company used ***market estimates*** of volatility to value its swaptions.

428. In fact, as evidenced below, defendants went to great lengths to withhold this information from the investing public. In early February 2001, a meeting was held among key personnel in External Reporting, Shareholder Relations and Corporate Accounting. Following this meeting, Josephine Umana, the Director of Reporting, prepared an e-mail, dated February 6, 2001, that stated:

> During the meeting last week on SFAS 133, I believe it was decided that the 2000 MD&A [Management Discussion and Analysis] would include some of "components" of the net SFAS 133 transition gain. We will provide some information about the components during the 1Q01 Earnings Conference Call.

429. Pursuant to this e-mail, Tracy Abruzzo, a manager in Corporate Accounting, commenced to prepare for the 2000 year-end Information Statement the following draft disclosure related to the SFAS 133 transition gain and various transactions that were executed to offset the gain:

> 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.

430. Abruzzo's draft was heavily edited to remove any discussion of the components of the transactions entered to offset the SFAS 133 transition gain. In fact, the 2000 Information Statement disclosed only that:

> 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 ACOI component of "Total stockholders' equity" by approximately $2.5 billion.

431. That defendants knew, or were reckless in not knowing, that the Company purposefully sought to avoid any disclosure about the CTUG, J006/J007 transactions or the temporary revaluation of the Company's swaption portfolio to achieve a reduction of the SFAS 133 transition gain as further evidenced in Clarke's talking points for the earnings conference call that Umana referenced in her February 6, 2001 e-mail. Clarke's talking points stated:

> 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.

432. Indeed, with respect to the change in its swaption valuation methodology, Freddie Mac never documented the policy change as normal and failed to seek Board approval. The Company never amended or supplemented its public disclosure of its valuation policy to reflect the adoption of the Dean-Chowdhury policy.

433. To carry out the CTUG transactions, defendants violated a Company Board resolution. Specifically, the Company's Board required that any PC transaction between $5 billion and $11 billion must be reported to the Board's Securitization Committee and that approval must be obtained for any PC transaction involving more

than $11 billion. (Bd. Res. No. FHLMC 98-13) Defendants reported only one of the transactions to the Securitization Committee, even though three of the transactions exceeded $5 billion. Furthermore, by dividing the CTUG into four separate transactions, that were each less than $11 billion apiece, defendants purposefully avoided having to obtain Board approval for any of the transactions.

434. It was not until the Information Statement dated March 29, 2002, that the Company made any specific disclosure about the size of the transactions that had been executed to offset the SFAS 133 transition gain. This information statement stated that:

> 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).

435. This disclosure was still plainly inadequate because it failed to disclose the gross amount of the SFAS 133 transition gain, the fact that the PCs classified as trading were subsequently – and improperly – moved to AFS through the sham CTUG transaction with Salomon to avoid future earnings volatility, or the temporary change in the swaption portfolio valuation, in violation of GAAP, that reduced the SFAS 133 transition gain by at least another $700 million.

2. <u>Concealment Of The Linked Swaps Transactions</u>

436. During its investigation, OFHEO found no documentary evidence suggesting that F&I disclosed the purpose and structure of the linked swaps to Freddie Mac's corporate accounting office prior to their execution. After the last trade, however, on September 7, 2001, F&I sent an email to Corporate Accounting that disclosed the nature and purpose of the Linked Swaps. Specifically, the email from Eric Reiser

informed Jamie Amico, Assistant Controller Director, and Lisa Roberts, in Corporate Accounting, that: "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." The email outlined the unique leverage feature with respect to the ninth linked swap and solicited the guidance of Corporate Accounting on how the transaction should be disclosed - in the notional amount of $10 billion or the leveraged amount of $50 billion. In reply to Reiser's email for advice, Lynn Abell, Accounting Manager in Corporate Accounting Policy, provided Reiser with the requested guidance regarding the disclosure of notional amounts.

437. On September 7, 2001, the day of the last Linked Swap, F&I personnel raised the propriety of the Linked Swaps with Freddie Mac's Legal Department. In particular, Federico approached Kevin MacKenzie, an attorney in Legal, and questioned him as to how to disclose the notional amounts. Robert Dean, Senior Vice President of Market Risk Oversight, also discussed the transactions with Freddie Mac's attorneys while they engaged in their research. After several weeks, Steve Dinces, Vice President and Deputy General Counsel, concluded the transactions were permissible provided that: i) they had a legitimate business purpose or risk management effect; and ii) they met with the requirements of GAAP.

438. In response to the Legal Department's request, Dean prepared a matrix which illustrated that the Linked Swaps had a minimal impact on the Company's risk management strategies. Upon receiving this matrix, the Legal Department terminated its inquiry into the Linked Swaps.

439. On September 26, 2001, Dean emailed Clarke and Federico. In the email, Dean describes the guidelines for evaluating the consistency of Asset Liability Management's ("ALM") derivatives strategies or significant individual trades with Freddie Mac's financial reporting standards. The email warns that "[e]ach derivatives strategy or significant individual trades must be supported by sufficient risk and return characteristics, and [t]he accounting applied must be consistent with GAAP."

440. The email provided examples of strategies and/or trades that would generally be inappropriate, including:

> "Entering into pay-fixed and receive-fixed swaps with identical terms and the same counterparty and treating both swaps as a fair value hedge in Freddie Mac's embedded options strategy."

441. Upon learning of the trades, Amico and Lou Betancourt, an accountant who reported to Amico, worried that the Linked Swaps could be viewed as "earnings management." They brought their concerns to Clarke, Andersen, and others at the Company.

442. The first time Andersen learned of the swaps was through Amico sometime after the last trade occurred on September 7, 2001. The audit engagement partner for Freddie Mac, Arnall, met with Dossani and Federico and advised them to terminate the swaps. In late September or early October, Arnall expressed his concerns over the linked swaps with Clarke. He had another meeting with Clarke in late October.

443. On September 27, 2001, Arnall and his advisory partner, C.E. Andrews, met with Glenn. Arnall again expressed his concerns over the Linked Swaps and their lack of a true business purpose.

444. According to handwritten notes by Usha Chaudhary ("Chaudhary"), then assistant to Glenn, Freddie Mac resisted following Andersen's advice to unwind or

terminate the swaps. Chaudhary's notes from a senior staff meeting on October 15, 2001 indicate that "Rob A[rnall] and Vaughn [Clarke] discussions re: swap transactions for LT earnings mgt.- Rob does not want it to go on – Vaughn pushing back."

445. Chaudhary's notes from a meeting between Arnall and presumably Glenn, her boss, on November 19, 2001, confirm the fact that Andersen and Corporate Accounting did not have knowledge of the Linked Swaps before Freddie Mac implemented them:

> "Early Sept. 7th transaction, hedging transaction executed before AA&C [Arthur Andersen & Co.] was made aware. CA [presumably Corporate Accounting] was hoodwinked – limited info. Expected 3rd Qtr. Notional derive. To go down but the notional doubled. Market value impact of trade was due to NIM management. (2) levered swap transactions. Plan was to get out of the trans[actions] soon pre-Dec. 7th but we want to wait 2 weeks putting documentation together. Pay fix swaps."

446. Notwithstanding the grave concerns raised by Freddie Mac's internal corporate accounting office and its external auditor, Freddie Mac allowed the swaps to continue until December 2001, over two more months. By that time, however, the swaps were already scheduled to terminate and Freddie Mac had succeeded in shifting $420 million in operating earnings from 2001 to later periods.

447. Freddie Mac failed to advise at least one trading partner of the serious concerns its external and internal accountants had with respect to the Linked Swaps. Instead, the Company assured them that it had both groups' approval. In particular, on September 10, 2001, Parseghian spoke with "Phil," a representative from Goldman Sachs, about the Linked Swaps. Seeking to allay any concerns "Phil" had over the swaps, Parseghian assured him: "I think that both our internal and external auditors . . . – they are aware of the impact that it has. It's not-we haven't been secretive of that. The guidance we have been given is that it is consistent with GAAP."

448. Defendants also took steps to conceal the various Linked Swap transactions from the Board. Specifically, on August 23, 2001, senior management conducted "Dry Run" review of information to be presented to the Investment Committee. The "Dry Run" review made clear to senior management that the linked swaps shifted $420 million in earnings. The September 7, 2001 report to the Investment Committee, however, contains no information about the magnitude of the swaps or their relative minimal justification in terms of the company's standard risk-management objectives. 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

The presentation also stated: "F&I NII per share of $5.23 is in line with expected analysts' estimates of $4.17 for 2001 EPS. Without action to stabilize the time pattern of NII, F&I NII per share could be as high as $5.80."

449. In preparation for a conference call with Audit Committee Chairman Tom Jones on October 16, 2001, Lisa Roberts, then Deputy Corporate Controller, drafted the following detailed description of the Linked Swap transactions:

> 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.

450. Between the completion of that draft, dated October 11, 2001, and the conference call package prepared and sent to Jones, the draft was edited to remove the key details regarding the nature, size and effect of the Linked Swaps. The disclosure to Jones only stated:

> There was significant increase in the derivative balance this quarter. This increase resulted from strategies for managing the volatility of interest rate risk with 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.

The disclosure omitted any reference to the magnitude of the operating earnings effects and contained no discussion of the effect the Linked Swaps transactions would have on interest rate risk, the purported justification for the transactions.

451. Finally, as part of the Audit Committee's quarterly review of significant 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 was misleading because the $135 million figure represented the impact of only the ninth swap on fourth quarter operating earnings. Management never informed the Audit Committee that the impact of all nine Linked Swaps was approximately $420 million.

452. Additionally, on or about October 9, 2001, Jamie Amico, the Director of Accounting Policy, prepared a draft disclosure. The date of Amico's draft suggests that it was intended for the Company's 2001 third quarter Information Statement Supplement. Amico's draft discloses the effect the Linked Swaps have had and are expected to have on transferring earnings from 2001 to subsequent reporting periods:

> 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. . . . 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.

453. The Company chose not to include either Amico's draft or any other general or specific description of the Linked Swaps in the third quarter disclosures.

454. When engaging in the Linked Swaps, Freddie Mac employees also impressed upon its counterparties the need for secrecy. Specifically, as noted above, according to taped recordings between Flanagan, one F&I trader, and a counterparty, Flanagan told the counterparty to keep the linked swaps "under your hat." Flanagan also stated: "I don't want to see any [expletive deleted] Bloombergs about this trade either (laughs)." (The "Bloomberg" he referred to are electronic messages sent over the Bloomberg terminal. Traders often use messages sent over the Bloomberg terminal as a way of communicating with each other, since many traders have a Bloomberg on or near their desk. Flanagan apparently did not want any "Bloombergs" to be sent about the trades because that would leave a written record of the rationale for the transactions.)

455. In December 2002, Freddie Mac's new auditor, PwC, began asking Glenn questions about the Linked Swaps. Consequently, Glenn, who maintained diaries of various meetings at Freddie Mac, ripped out pages of the spiral bound book relating to his late September 2001 meeting with Arnall about the Linked Swaps and took them home to review. According to Glenn, in an interview with Baker Botts on June 4, 2003, those pages subsequently became "lost" and remain missing.

456. The facts and circumstances surrounding the failure to disclose the Linked Swaps to the Investment Committee, the Chair of the Audit Committee, the full Audit Committee, its Corporate Accounting Office, its external auditor, its Legal Department, and, most importantly, to investors, gives rise to a strong inference that the defendants

acted knowingly or recklessly in disseminating false and misleading information regarding the Linked Swaps and their effect on operating earnings.

3. Alteration And Destruction Of Business Records

457. During the course of the Company's investigation into the improper transactions and accounting machinations, Glenn altered entries in his business diaries that related to his duties as COO of the Company, before he surrendered those business diaries to the Company's outside attorneys.

458. Specifically, on October 2, 2000, Glenn and Peter Federico of F&I had a business dinner during which Federico told Glenn about the expected SFAS 133 transition gain of $350 million, which subsequently increased to $1.4 billion, as discussed above. Glenn made a notation in his notebook diary that read "we need to decide how to spread that over several years." Just prior to turning his diary over to Baker Botts attorneys, Glenn altered the words "we need" to read "we're trying."

459. Additionally, on March 15, 2001, Glenn altered a notation in his business diary possibly related to the swaption portfolio revaluation. Glenn told the Baker Botts attorneys that he intentionally scratched out the words "in Dec." because he was concerned over how PwC would view it. When he finally confessed to this alteration, Glenn indicated to the Baker Botts attorneys that after the alteration he later concluded that the altered language had nothing to do with the swaption portfolio valuation change that took place in December 2000 through February 2001, and therefore the alteration did not serve its intended purpose.

460. On February 7, 2001, Glenn attended a senior staff meeting. During the meeting he wrote the word "smoothing" and "allows smoothing" on the margins of his business diary adjacent to entries related to net interest income. Before surrendering the

diary to Baker Botts attorneys, Glenn erased the words "smoothing" and "allows smoothing," and added the words "controls" and "forecasts assumptions."

461. Finally, in or around December 2002, PwC began to question Glenn about the Linked Swaps. In response to this inquiry, Glenn ripped pages out of his spiral bound business diary relating to a late September 2001 meeting that Glenn had with Rob Arnall from Andersen when they discussed the propriety of the Linked Swaps. Glenn told Baker Botts attorneys that he ripped out the pages so he could take them home to review them, but subsequently "lost them." Glenn claims he clipped a small piece of paper to the business diary indicating that the pages were lost, but admitted that he removed the piece of paper before surrendering the business diary to Baker Botts attorneys, and that he did not reveal this alteration.

4. Defendants Agonize Over Hiring New Auditors Who Could Discover The Fraud

462. In 2001, Andersen's role in the scandal confronting Enron, the once highly regarded energy company in Houston, Texas, began to emerge. At the time, stories were published about how Enron engaged in transactions to create nonexistent profits and enrich themselves. Andersen was also Enron's auditor.

463. At a January 2002 meeting, Freddie Mac's Audit Committee decided to replace Andersen and told Brendsel to begin the process of finding a suitable replacement.

464. Glenn's diary indicates that he suffered considerable angst over having to hire a new auditor. For example, on January 27, 2002, Glenn wrote Andersen "signs off on mk [mark] to mkt [market], FAS 133, operating earnings. Andersen people play key role in getting work done."

465. In a memo dated January 30, 2002 to Brendsel, Glenn expressed other concerns about replacing Andersen, stating: "I find it difficult to understand how such an important issue could have been made without my knowledge or involvement."

466. In an effort to retain Andersen, Glenn formed a "Management Selection Committee" to interview candidate firms for the position of external auditor. In a presentation document entitled "Auditor Selection: Process and Recommendation," this Management committee recommended that the Audit Committee meet and interview PwC and Andersen.

467. One of the selection criteria in the document was labeled "Transition Risk." The Management Selection Committee gave Andersen good marks under this category, noting: "No transition risk if [Andersen] is retained for 2002 audit. Due to lack of tenure of key [Freddie Mac] financial managers, [Andersen] knowledge, of policy and process is critical to [Freddie Mac's] financial reporting process."

468. An early draft of this presentation recommended the reappointment of Andersen and noted that a transition of auditors "presents significant risks" including the "possibility of restatements."

469. The Audit Committee chose to disagree with management's choice and replaced Andersen with PwC. As management feared, PwC began asking questions and raising issues soon after it started its engagement in March 2002.

C. Inadequate Internal Accounting And Auditing Functions Support A Strong Inference Of Scienter

470. Throughout the Class Period, defendants knew, or were reckless in not knowing, that the Company's internal controls suffered from material weaknesses. Defendants deliberately or recklessly undermined the Company's accounting and

oversight functions. The weak controls permitted defendants to engage in transactions that violated GAAP and provided investors with a false portrayal of the Company as stable and immune to earnings volatility.

471. Indeed, defendants, as the Company's most senior management, were responsible for ensuring that Freddie Mac had adequate and capable internal accounting and auditing systems and skilled personnel in place to detect and prevent the fraudulent transactions and improper accounting methods that were implemented to manipulate earnings, as particularized above. Instead, defendants viewed the back offices such as Corporate Accounting as second class citizens. According to former Controller Gregory Reynolds:

> To get money allocated to back office and infrastructure was a serious uphill battle. It wasn't appreciated, the importance of it was not recognized and, therefore, the resources were not allocated. . . . [T]he leadership of the company was far more visible in their support, encouragement and endorsement of people in, if you will, the first class citizen departments. You would see Leland [Brendsel] and David [Glenn] wander into the trading room and ask the traders how it's going. In my 12 years at the company, I never once saw Leland or David wander into the area of the company that my team worked in. It was that kind of a thing.

472. In particular, the staffing level and experience of the employees in the Corporate Accounting Department and Internal Audit Department were insufficient to detect and prevent improper transactions and accounting errors that resulted in the Restatement. In fact, the Company now admits that:

> [T]he principal factors contributing to the Restatement were lack of sufficient accounting expertise and internal control and management weaknesses as a consequence of which Freddie Mac Personnel made numerous errors in applying generally accepted accounting principles ("GAAP").

(Restatement at Appendix II, p. 1)

473. According to Maryann Murphy, the Engagement Partner from PwC, who replaced Andersen, and who was responsible for preparing the Restatement, there had been "warning signs" about problems in Corporate Accounting that were recorded in internal Company reports and circulated to senior management throughout the Class Period. These internal documents that provided such warnings, included:

a. A Market Risk Oversight report in 1999 discussing issues related to the implementation of SFAS 133 and stated that "[a]ccounting resources are strapped with few full-time people with questionably the right skills.";

b. An April 2000 memorandum to Clarke from Jeff Harris, Vice President of Corporate Accounting, stating that "[o]ur primary risks relate to the significant amount of change occurring within the company generally and resource issues relative to turnover and recruitment.";

c. A June 2000 memorandum from Jeff Harris to then-Controller Gregory Reynolds stating that "[t]he FAS 133 project had a critical dependence on external resources due to strategy development delays, team turnover and a lack of available skilled, knowledgeable resources . . . [which] presents challenges in transferring knowledge to internal resources.";

d. An August 11, 2000 Internal Audit Report on Derivatives & Hedging Instruments stating that: "Staffing levels and experience in the financial accounting and reporting functions have been insufficient and this causes key person dependencies. The lack of trained and knowledgeable staff in the derivatives group has contributed to the delays in processing journal entries and to a number of adjusting journal entries for errors in prior periods." The report further stated that "[Corporate

Accounting's] derivative accounting group has three vacant positions out of a total of nine staff level positions. Additionally, the six current employees have all been in the group for less than a year and most are relatively inexperienced in their new positions.";

e. On the same date, Internal Audit released a Financial Reporting Audit which stated that "key person dependencies exist in the entire financial reporting process, both inside and outside of Corporate Accounting." The audit also confirmed that management had initially identified this weakness through the Management Assessment, Risk, and Controls ("MARC") process as early as 1998.

f. A proposed presentation for a Board meeting on December 1, 2000, prior to the "dry run" process, suggested telling the Board that "Corporate Accounting systems are already under a severe strain. It's not clear how well they will respond to FAS 133 additional demands." Freddie Mac had known of the requirements of SFAS 133 for two and one-half years prior to its required implementation.

474. As indicated by these internal Company reports, the defendants knew or were reckless in not knowing that Corporate Accounting was understaffed and that the derivatives group in particular – who were responsible for many of the transactions related to SFAS 133 – lacked sufficient skills and abilities necessary to carryout their responsibilities. Nevertheless, defendants chose to undertake a response to SFAS 133 that was particularly complicated involving tremendous volume of transactions as securities and derivatives were reclassified, and reclassified yet again, and chose to undertake some very complicated re-securitizations without proper accounting guidance.

475. A Financial Reporting Improvement Plan was developed, in part, to address issues regarding the level of staffing in Corporate Accounting by April 2001.

However, on January 31, 2002, and again on June 6, 2002, the General Auditor who leads the Internal Audit department reported to the Audit Committee of the Board that staffing deficiencies were still a problem, ***a weakness that had now persisted for over five years.***

476. In fact, on January 29, 2003, PwC reported to management that: "There were only six people in Accounting Policy, 2 of which should be there. We don't know what the other people do."

477. Weaknesses in accounting personnel extended to the Company's CFO and its Controller. In fact, despite being the Company's CFO, Clarke was not a certified public accountant and, on May 8, 2003, PwC informed certain Board members that, in connection with PwC's certification of the financial results, PwC would not accept representations from Glenn and Clarke in connection with the 2000, 2001 and 2002 audits. According to Maryann Murphy, the PwC Engagement Partner, Clarke had little knowledge of GAAP, financial accounting or disclosure rules.

478. Furthermore, Brian Green was named Deputy Controller in August 2000 and became the Acting Controller on February 5, 2001. At the time he became Acting Controller, Green had never read SFAS 133 and did not know what was being done at the Company to respond to it.

479. Moreover, according to Gregory Reynolds, who had been the Company's Controller prior to being replaced by Green, he complained to Clarke that the Company did not have sufficient internal auditing resources and that Green lacked the training and skills necessary to serve as Controller:

> I told [Clarke] point blank . . . I am concerned from a corporate standpoint that you're moving me over without a qualified successor in place. You're in the middle of a transition of FAS 133, a very complicated accounting requirement both technically and operationally; you are in the

> middle of an annual report preparation season . . . you've got process issues within the financial reporting process . . . I seriously question whether the financial reporting process can afford to give up one more leadership person, and I expressed my reservations . . . I called Vaughn [Clarke] later that afternoon, and I said, 'I really am concerned that the financial reporting process needs a qualified leader with strong financial skills that truly understands the Company . . . .' He didn't respond very favorably to that, so I got more specific, I said 'Who's going to make the difficult decisions that need to be made over the next several months, such as our disclosure obligations now that FAS 133 is in place, some remaining issues in our FAS 133 adoption? Who is going to make these decisions?' And Vaughn [Clarke] said, 'I'll make them myself'.

480. The failure to implement proper internal controls, which could have detected and prevented the improper activities, particularly in the face of numerous "warning signs," gives rise to a strong inference that the defendants acted with scienter. Had senior management taken steps to adequately staff its corporate accounting department with experienced personnel knowledgeable in accounting for securities and derivations, such personnel might have "pushed back" on some of senior management's schemes to manipulate earnings.

D. Defendants Tied Compensation To Freddie Mac's Ability To Manage Earnings

481. The Individual Defendants, who created a "tone at the top" at Freddie Mac that strongly emphasized hitting EPS targets, possessed an additional motive for improperly managing earnings to reach those targets and thus remain in favor with analysts and investors – their compensation was tied to Freddie Mac's EPS targets for the current year. In particular, the Individual Defendants tied their bonuses to meeting Freddie Mac's EPS targets.

482. The direct compensation of Freddie Mac executive officers includes three key components: base salary, an annual cash bonus, and long term stock incentives- for example, stock options and restricted stock.

483. Glenn and Brendsel maintained substantial discretion over the final outcome and amount of money funding the bonus "pool" from which bonuses were distributed.

484. As found by OFHEO during its special examination of Freddie Mac, at the end of the performance year, Glenn applied a scoring range to each metric on a "corporate scorecard." The score range was discretionary in nature, reflected current performance, unusual influences on performance for the current year, and the historical performance of certain metrics. Glenn reviewed the performance of a scorecard component and then assigned a score within a scoring range that produced a weighted average performance result. This process ultimately determined the overall portion of the funded bonus pool.

485. Glenn would submit his bonus recommendations to Brendsel who had discretion to change them.

486. In its special examination of Freddie Mac, OFHEO determined that whether or not Freddie Mac met its earning targets significantly affected the compensation of key individuals, including the Individual Defendants. For years 1998-2002, the EPS score was a substantial part, in some cases over half, of the amount funding the bonus pool:

Earnings Per Share in the Informal Scoring Process

	1998	1999	2000	2001
EPS Score	5	2.13	Unknown	1.2
Total Score	8.53	3.5	Unknown	1.9
EPS as a Share of Total Score (%)	59	61	40	63
Bonus Funding (%)	170	50	125	185

487. In 2001, when the total funding depended heavily on meeting the EPS range on the corporate scorecard (63%), OFHEO found that both Brendsel's and Glenn's bonuses were closely tied to the scorecard results. For example, Brendsel received a bonus of $2,618,906 in 2001, of which an estimated $1,649,911 was directly attributable to Freddie Mac meeting the operating EPS target. Similarly, Glenn received a bonus of $1,572,500 in 2001, of which $990,675 was attributed to meeting the EPS target.

488. According to the OFHEO, for other senior officers, Freddie Mac determined 40% of the bonus in that manner and then based the rest on the performance of the division led by the officer and on that officer's individual performance. Therefore, for most senior officers, 25% (63% of 40%) of their bonuses were directly tied to the corporate EPS performance.

1. Freddie Mac Judged Officers On Their Ability To Manage Earnings And The SFAS 133 Transition Adjustment

489. An officer's division and individual performance were in key cases based in part on such factors as meeting earnings expectations of analysts or managing the SFAS 133 transition adjustment. Specifically, through its review of the annual Employee Performance Management forms, OFHEO determined that "management of earnings was a major factor in judging executive performance."

490. For example, Glenn reviewed the evaluation performance form of then CFO John Gibbons for 1998 and noted on it "achievement of EPS results within an acceptable range of consensus." Similarly, Gibbons' 1999 assessment cited his "achieving EPS results within an acceptable range of consensus."

491. In the 2000 performance review of Dean, conducted by Clarke, Dean explicitly maintained that one of his accomplishments in 2000 involved SFAS 133 and

the transition gain related to swaptions valuation: "Reduced size of transition gain from $1 [billion] to .02 [billion] by recognizing that swaptions valuation was not indicative of where options could be traded, due to a large imbalance in the market." For 2000, Freddie Mac awarded Dean a bonus of $111,175. In 2001, Dean received an even larger bonus of $145,833. In response to OFHEO's request for a copy of Dean's 2001 evaluation, however, Freddie Mac claimed it is "missing."

492. The 2001 evaluation for Peter Federico of F&I, who was reviewed by Nasir Dossani, states in reference to SFAS 133 that Federico "managed transition adjustment to income from $1.75 billion to 6 million." Further, the evaluation noted "managed hedge ineffectiveness to 2 cents per share (1Q-3Q)."

493. The 2000 evaluation for Dossani, who was reviewed by Parseghian, notes: "The scope of [Dossani's] responsibilities in the corporation's SFAS 133 efforts was systematically expanded during the course of the year; his group has taken on this challenge and developed and implemented an approach that is both innovative and exceeds any reasonable expectations of earnings volatility (e.g. if we had adopted Fannie Mae's approach we would expose ourselves to higher earnings volatility by a factor of 10)." Additionally, in his 2000 Employee Performance Management Form, Dossani listed as an accomplishment "Transition adjustment (which could have affected income by $1.75 billion) had close to zero impact on EPS as a result of ALM strategies that included large, complex but effective asset restructuring and other actions."

2. Defendants' Actions In Pushing Gains Into Future Periods Helped Ensure Bonuses In Later Years

494. The actions by defendants to move gains from a current period to a future period helped ensure that EPS compensation goals would be easily met in future quarters,

and possibly bolster the value of the stock on which options would be presumably exercised in the future quarters.

495. Notably, while OFHEO was conducting its special investigation of Freddie Mac, John McCoy, the Company's Human Resources Committee Chair, informed the agency that EPS would *not* be a factor in the corporate scorecard in 2003.

3. The Individual Defendants Garnered Substantial Bonuses Under Freddie Mac's Compensation System

496. During the Class Period, the Individual Defendants succeeded in garnering substantial bonuses under Freddie Mac's compensation scheme:

a. Defendant Brendsel

497. According to the Company's proxy for 2002, in 2001, Brendsel earned a salary of $1,132,500 and a bonus of $2,123,438. In 2000, Brendsel earned $1,092,667 for a salary and was awarded a bonus of $1,710,000. In 1999, Brendsel earned $1,016,667 for a salary and received a bonus of $380,000.

498. On December 17, 2003, OFHEO filed charges against Brendsel and seeks to recover the bonuses he received in 2000 and 2001.

b. Defendant Clarke

499. Clarke's responsibilities as CFO included duties related to "Earnings Performance Management." Glenn rated the performance of Clarke based in part on his abilities to manage shareholder and investor EPS expectations. As found by OFHEO, in the course of the 2001 review of the evaluation component-"*Ability to manage shareholder and EPS expectations: Analyst consensus with forecast*," (Emphasis added.) Glenn noted: "I have questions about our role here due to the tendency to use accounting to meet shareholder expectations."

500. In 2001, Clarke received a bonus of $333,000. The year before in 2000, Clarke received a bonus of $203,723. In 1999, he was awarded a bonus of $56,100.

501. On December 17, 2003, OFHEO filed charges against Clarke and seeks to recover the bonuses he received in 2000 and 2001.

c. Defendant Glenn

502. According to the Company's proxy for 2001, Glenn earned $850,000 a year and received a bonus of $1,275,000 in 2001. The year before in 2000, Glenn earned $806,667 a year and was awarded a bonus of $1,009,000. In 1999, Glenn earned $693,333 a year and was awarded a bonus of $210,000.

503. Under his agreement with OFHEO, Glenn must give up $13 million in severance, bonuses, and options.

d. Defendant Parseghian

504. In 2001, Parseghian received a bonus of $750,000. He did not participate in the bonus program for the years 1998 through 2000.

E. Individual Defendants' Insider Trading

505. In addition to their substantial bonuses, Brendsel, Clarke and Parseghian succeeded in selling thousands of their Freddie Mac shares during the Class Period for proceeds totaling over $2.48 million:

BRENDSEL

Transaction Date	Shares Sold	Sale Price	Gross Sales Proceeds
11/27/2002	3,500	$58.24	$203,840.00
11/27/2002	4,652	$58.26	$271,025.52
Total	8,152		$474,865.52

CLARKE

Transaction Date	Shares Sold	Sale Price	Gross Sales Proceeds
5/20/2002	3,337	$67.30	$224,580.10
Total	3,337		$224,580.10

PARSEGHIAN

Transaction Date	Shares Sold	Sale Price	Gross Sales Proceeds
6/3/2002	5,000	$63.70	$318,500.00
6/5/2002	5,000	$64.35	$321,750.00
6/5/2002	2,200	$64.50	$141,900.00
6/5/2002	7,800	$64.25	$501,150.00
6/5/2002	7,853	$64.10	$503,377.30
Total	27,853		$1,786,677.30

506. The timing of these sales is unusual and suspicious in nature. Clarke and Parseghian sold 31,190 shares of stock during the second quarter of 2002 for proceeds totaling over $2 million. These sales were made only weeks before the Company revealed (after a review by PwC, Freddie Mac's new auditor) that it had maintained its loan loss reserves at levels in excess of the amount permitted under GAAP. In particular, Parseghian sold 6% of the shares he beneficially owned, while Clarke sold 17% of the shares of his direct holdings in only a matter of days. According to a statement issued by Parseghian, the last time he sold stock in Freddie Mac was back on February 1, 2001.

507. Brendsel sold 8,152 shares of Freddie Mac stock after PwC began questioning the Company's financials and approximately two months before the Company announced the need to restate its financial results.

XI. CLAIMS FOR RELIEF

COUNT ONE

Against All Defendants for Violations of § 10(b) of the Exchange Act and Rule 10b-5 Promulgated Thereunder

508. Plaintiffs repeat and reallege each of the allegations set forth in the foregoing paragraphs.

509. Throughout the Class Period, defendants, directly and indirectly, by the use of means and instrumentalities of interstate commerce, the United States mails and a national securities exchange, employed a device, scheme and artifice to defraud, made untrue statements of material fact and omitted to state material facts necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, and engaged in acts, practices and a course of business which operated as a fraud and deceit upon Plaintiffs and the members of the Class.

510. The Company and the Individual Defendants, as the most senior officers of Freddie Mac during the Class Period, are liable as direct participants in all of the wrongs complained of herein. Through their positions of control and authority, the Individual Defendants were in a position to and did control all of the Company's false and misleading statements and omissions, including the contents of all of its public information statements and reports and press releases as more particularly set forth above. In addition, certain of these false and misleading statements constitute "group published information," which the Individual Defendants were responsible for creating.

The Company is liable for each of the statements of the Individual Defendants through the principles of respondeat superior.

511. As detailed above, the defendants had actual knowledge of the misrepresentations and omissions of material facts set forth herein, or acted with reckless disregard for the truth in that they failed to ascertain and to disclose such facts, even though such facts were available to them. Such material misrepresentations and/or omissions were made knowingly or recklessly and for the purpose and effect of concealing Freddie Mac's operating condition and future business prospects from the investing public and supporting the artificially inflated price of its securities.

512. Plaintiffs and the other members of the Class relied upon the defendants' statements and/or on the integrity of the market in purchasing shares of Freddie Mac's common stock at artificially inflated prices.

513. In bringing these claims, Plaintiffs and the members of the Class are entitled to the presumption of reliance established by the fraud-on-the-market doctrine. At all times relevant to this Complaint, the market for Freddie Mac's common stock was an efficient market for the following reason, among others:

a. Freddie Mac common stock traded on the NYSE and the PCX in a highly efficient market. The average weekly trading volume throughout the Class Period was 15.18 million shares;

b. Freddie Mac published periodic annual and quarterly reports that it made available to its investors on its website, www.freddiemac.com;

c. Freddie Mac's common stock was followed by numerous securities analysts employed by major brokerage firms, such as Merrill Lynch, Lehman Brothers,

Salomon Smith Barney, and Goldman Sachs, who wrote reports that were distributed to the sales force and certain customers of their respective brokerage firms. Each of these reports was publicly available and entered the public marketplace;

d. Freddie Mac regularly issued press releases, which were carried by national and international news wires. Each of these releases was publicly available and entered into the public marketplace; and

e. The market price of Freddie Mac's common stock reflected the effect of news disseminated in the market.

514. As a direct and proximate cause of the wrongful conduct described herein, Plaintiffs and the other members of the Class suffered damages in connection with their purchases of Freddie Mac common stock. Had Plaintiffs and the other members of the Class known of the material adverse information not disclosed by the defendants, or been aware of the truth behind the defendants' material misstatements, they would not have purchased Freddie Mac stock at artificially inflated prices.

515. By virtue of the foregoing, defendants violated § 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder and are liable to Plaintiffs and the members of the Class, each of whom has been damaged as a result of such violations.

COUNT TWO

Against The Individual Defendants
for Violation of § 20(a) of the Exchange Act

516. Plaintiffs repeat and reallege each of the allegations set forth in the foregoing paragraphs. This Count is brought pursuant to § 20(a) of the Exchange Act, 15 U.S.C. § 78t(a), on behalf of all members of the Class against Brendsel, Clarke, Glenn and Parseghian.

517. For all the reasons set forth in Count One above, Freddie Mac is liable to Plaintiffs and the members of the Class who purchased Freddie Mac common stock based on the materially false and misleading statements and omissions set forth above, pursuant to § 10(b) of the Exchange Act, 15 U.S.C. §78j(b), and Rule 10b-5, 17 C.F.R. § 240.10b-5, promulgated thereunder.

518. Throughout the Class Period, Brendsel, Clarke, Glenn and Parseghian, by virtue of their positions, stock ownership and/or specific acts described above, were controlling persons of Freddie Mac within the meaning of § 20(a) of the Exchange Act.

519. Brendsel, Clarke, Glenn and Parseghian, had the power to, and did, directly and indirectly, exercise control over Freddie Mac, including the content and dissemination of statements which the Plaintiffs allege are false and misleading. Brendsel, Clarke, Glenn and Parseghian were each provided with and had access to reports, financial statements, press releases and other statements alleged to be misleading prior to and/or shortly after they were issued and had the ability to prevent the issuance or correct the statements. Brendsel, Clarke, Glenn and Parseghian, had direct and supervisory involvement in the day-to-day operations of the Company and induced Freddie Mac to engage in the acts constituting violations of the federal securities laws, as set forth in Count One above.

520. As a result of Freddie Mac's false and misleading statements and omissions alleged herein, the market price of Freddie Mac common stock was artificially inflated. Under such circumstances, the presumption of reliance available under the "fraud on the market" theory applies, as more particularly set forth in Count One above. The members of the Class relied upon either the integrity of the market or upon the

statements and reports of the defendants in purchasing Freddie Mac stock at artificially inflated prices.

521. As a direct and proximate result of the wrongful conduct by Freddie Mac, Plaintiffs and the other members of the Class suffered damages in connection with their purchases of Freddie Mac common stock. Had Plaintiffs and the other members of the Class known of the material adverse information not disclosed by Freddie Mac, or been aware of the truth behind its material misstatements, they would not have purchased Freddie Mac common stock at artificially inflated prices.

522. By virtue of the foregoing, Brendsel, Clarke, Glenn and Parseghian are liable pursuant to § 20(a) of the Exchange Act to Plaintiffs and the members of the Class, each of whom has been damaged as a result of Freddie Mac's underlying violations.

PRAYER FOR RELIEF

WHEREFORE, Plaintiffs pray for relief and judgment, as follows:

1. Declaring this action to be a proper class action pursuant to Rule 23(a) and (b)(3) of the Federal Rules of Civil Procedure on behalf of the Class defined herein;

2. Awarding Plaintiffs and the Class compensatory damages;

3. Awarding Plaintiffs and the Class pre-judgment and post-judgment interest, as well as reasonable attorneys' fees, expert witness fees and other costs; and

4. Awarding such other relief as this Court may deem just and proper.

JURY TRIAL DEMAND

523. Pursuant to Rule 38(b) of the Federal Rules of Civil Procedure, Plaintiffs hereby demand a trial by jury in this action of all issues so triable.

Dated: January 15, 2004

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that I electronically filed the foregoing with the Clerk of the Court using the CM/ECF system this 15th day of January 2004. Notice of this filing will be sent to all parties by operation of the Court's electronic filing system. Parties may access this filing through the Court's system. Service was accomplished on the following counsel who are not CM/ECF participants by mailing the foregoing via regular U.S. mail:

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