

**UNITED STATES OF AMERICA
OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT**

In the Matter of:)	
)	Judge William B. Moran
LELAND C. BRENDEL,)	HUDALJ 04-056-NA
)	Notice No. 2003-2
Respondent.)	
)	

OFHEO's PREHEARING STATEMENT

INTRODUCTION

Former Freddie Mac Chief Executive Officer (“CEO”) and Board Chairman Leland Brendsel should be held accountable for his unsafe and unsound conduct in this matter pursuant to 12 U.S.C. §§ 4631 and 4636. Throughout the 1990’s until his forced retirement in June 2003, Mr. Brendsel charted a course for Freddie Mac (also “the Enterprise”) to maintain steady, mid-teens earning growth and to hit, or slightly exceed, analysts’ and investors’ yearly earnings per share projections for the Enterprise. That strategy and related actions undertaken at Freddie Mac to maintain and steer this unsustainable course under Mr. Brendsel’s leadership eventually resulted in the loss of hundreds of millions of dollars by Freddie Mac, including the costs of its massive accounting restatement in November 2003, a \$400 million settlement with Freddie Mac’s shareholders, a \$125 million civil money penalty to the United States, and ongoing corporate restructuring costs.¹

¹ The evidence OFHEO introduces at hearing will demonstrate this and the facts summarized below, as well as additional facts alleged in the Second Amended Notice of Charges. Upon application of the

DISCUSSION

Tone for Misconduct Established

Mr. Brendsel established and maintained at Freddie Mac an unsafe and unsound “tone at the top.” The corporate culture fostered by Mr. Brendsel resulted in intense, and often improper, efforts to manage the Enterprise’s reported earnings. Beginning in the early 1990’s, Freddie Mac regularly and persistently promoted analysts’ and investors’ expectations of steady growth in profits. Mr. Brendsel and his senior management fostered a corporate culture that placed a high priority on meeting earnings estimates, while neglecting key elements of the Enterprise’s infrastructure and internal controls needed to support and account for that growth. Mr. Brendsel furthered that culture through, among other tools, his public statements, internal guidance to Freddie Mac employees, and Freddie Mac’s compensation incentives.

Mr. Brendsel oversaw and directed various unsafe and unsound financial manipulations and transactions to achieve his ends, inappropriately shifting earnings to hit earnings targets and achieve steady mid-teens earnings growth. At Mr. Brendsel’s direction, and with his knowledge and encouragement, the Enterprise employed a variety of techniques ranging from improper reserve accounts to complex derivative transactions to shift the recognition of earnings from years with higher than targeted earnings into future years to “smooth” the earnings stream and meet analysts’ expectations.

Mr. Brendsel encouraged Freddie Mac’s “financial engineers” in its Finance and Investment Division (“F&I”) who had little accounting expertise, to devise transactions

preponderance of the evidence standard to these facts, and of the appropriate law, the Court should find that OFHEO has met its burden of proof and demonstrated extensive breaches of the principles of the law of safety and soundness by Mr. Brendsel.

and techniques for moving income that would support his earnings objectives. At the same time, Mr. Brendsel largely ignored the needs of Freddie Mac's accounting function for additional expertise and resources required to control and properly report the financial products and other techniques used to meet his financial objectives. Mr. Brendsel sharply curtailed administrative and personnel expenses in the Corporate Accounting Department, resulting in an insufficient allocation of resources – both dollars and staffing – to the division principally responsible for the critical functions of accounting, financial reporting and internal controls.

Indeed, just as Freddie Mac was facing the complexities of new Financial Accounting Board Standard 133 (“FAS 133”), which required marking its derivatives to market, Mr. Brendsel successfully recommended the appointment of Vaughn Clarke as Freddie Mac's Chief Financial Officer (“CFO”). Mr. Brendsel knew that Mr. Clarke had no accounting expertise, although accounting was a key component of properly controlling the FAS 133 transition.² Equally troubling, as the FAS 133 transition approached and occurred, Mr. Brendsel relied primarily upon his “financial engineers” to minimize the transition gain (“in the neighborhood of \$20 million or so”), rather than the accountants whose task it should have been to implement FAS 133.³

Improper Earnings Management Takes Root

The use of inappropriate accounting strategies by Freddie Mac had begun several years before the central allegations of the Second Amended Notice of Charges matured.

² Mr. Brendsel had also allowed the Enterprise Controller (a position also key to proper accounting controls) to spend an inordinate amount of time on business development, rather than at his controller responsibilities, further degrading Freddie Mac's accounting capacity.

³ February 16, 2004 Sworn Interview of Leland C. Brendsel, *In re Special Examination of Federal Home Loan Mortgage Corp.* (“Brendsel Sworn Interview”) at 62.

These early signs of improper earnings management set the stage for Mr. Brendsel's mantra of "mid-teens earnings," which subsequently became an important component of the canon for the Enterprise as it manipulated earnings to meet Mr. Brendsel's earnings objectives.

In 1994, Freddie Mac established a \$200 million FAS 91 account to cushion against fluctuations caused by unpredictable amortization of premiums (or accretion of discounts) resulting from changing mortgage prepayment speeds. While FAS 91 requires amortization, the use of an amortization reserve to accomplish that end does not comply with Generally Accepted Accounting Principles ("GAAP"). This non-compliant reserve account proved a particularly useful tool for improper earnings management by Freddie Mac. In addition, with Mr. Brendsel's knowledge, Freddie Mac maintained its loan loss reserve at unjustifiably high levels relative to its declining credit losses from 1998 through 2000, providing another tool for improper earnings management.⁴

Indeed, Mr. Brendsel was part of a small group of Freddie Mac officials present at a "dry run" for the June 1999 Audit Committee presentation when the admission was made that Freddie Mac had in the past managed earnings using reserves. Mr. Brendsel himself appears to have invoked the use of reserves at a meeting held on November 22, 2000 to discuss lowering the FAS 133 transition gain, where he apparently noted that the "reserve option – may be available to offset earning volatility." In addition to the use of the FAS 91 and loan loss reserves to manipulate earnings from period to period, e-mail and other evidence suggests that Freddie Mac senior management also began to use

⁴ OFHEO does not intend to imply that other reserves, such as the tax reserve, were not also used improperly to manage earnings.

derivative swaps as early as 1996. This device would prove crucial for earnings management purposes by 2000.

Improper Earnings Management Grows

June 4, 1999 boldly marks when improper earnings management became more than an informal policy at Freddie Mac. On that date, the then-Chief Financial Officer (“CFO”) gave his “Financial Review and Outlook” presentation to the Board of Directors, chaired by Mr. Brendsel. The first page of that presentation noted that the financial prospects for Freddie Mac were bright, thanks to strong retained portfolio purchases and favorable credit results: “NII is surging and *we are undertaking transactions to smooth the time pattern over 1999-2000*”(emphasis added). The CFO noted that 1999 net interest income was running substantially above plan and warned that without rebalancing transactions, “1999 net interest income could exceed 2000 net interest income.”⁵

Also on June 4, 1999, the Investment Committee of the Board convened with Mr. Brendsel present. One of the presentations to the Investment Committee on that date recommended implementing various strategies to improve the time pattern of earnings between 1999 and 2000. “[A]nalyzing the adequacy of reserves (amortization and loan loss)” to determine if reserves could be used to manage earnings was among the strategies covered.⁶

Also on June 4, 1999, Freddie Mac’s Controller gave a presentation to the Audit Committee of the Board of Directors, entitled “Management Assessment of Current SEC

⁵ June 4, 1999 “Financial Review & Outlook,” Presentation to the Freddie Mac Board of Directors, FM145287-98.

⁶ June 4, 1999 “Multi-Year Net Interest Income Planning,” Presentation to the Freddie Mac Investment Committee of the Board of Directors, FM-DEAN-014801-04.

Accounting Concerns,” based upon a seminal speech by then-SEC Chairman Arthur Levitt.⁷ Chairman Levitt warned that earnings management by some corporations was adversely affecting the quality of financial reporting, and questioned the effectiveness of the oversight role provided by audit committees relative to earnings management. Several areas of concern were identified by Chairman Levitt as potentially problematic, including issues surrounding materiality of earnings, revenue recognition, and “cookie jar” reserves. Mr. Brendsel, who participated both in the “dry run” in preparation for the Audit Committee meeting, and in the meeting itself, was well aware that Freddie Mac’s financial accounting and reporting were susceptible to the risks inherent in those practices.

Improper Earnings Management Matures with FAS 133’s Arrival

The earnings management culture instituted, developed and cultivated at Freddie Mac by Mr. Brendsel primed the Enterprise to seek ways to circumvent the requirements of FAS 133 when it took effect on January 1, 2001. Moreover, Mr. Brendsel’s instruction that Freddie Mac achieve minimal transition gain in connection with the adoption of FAS 133 brought the culture of earnings management to the fore. This tainted culture profoundly affected the safety and soundness of the Enterprise as Mr. Brendsel oversaw and monitored the achievement of his objective through improper transactions and financial manipulations covering several years.⁸

Mr. Brendsel sought to avoid reporting the more volatile earnings entailed in marking derivatives to market under FAS 133. To that end, he and other senior

⁷ June 4, 1999 “Management Assessment of Current SEC Accounting Concerns,” Presentation to the Freddie Mac Audit Committee, FM-VCO-363905-12.

⁸ “I set an objective of having, achieving a small net gain from the implementation of FAS 133.” Brendsel Sworn Interview at 61-62.

management at Freddie Mac, who felt that they knew how better to account for, report and disclose the Enterprise's financial results than did the Financial Accounting Standards Board ("FASB"), sought out ways to "transact around" this new derivatives accounting standard.

Accounting for income without the transactions and manipulations employed by Freddie Mac during the FAS 133 transition period would have derailed Mr. Brendsel's objectives of steadily increasing EPS and mid-teens earnings in 2000 by significantly exceeding Freddie Mac's earnings targets. Conversely, it would have laid the groundwork for falling below the targets in 2001. Mr. Brendsel thus successfully directed his management to minimize the increased income volatility that would come with the adoption of FAS 133's mark-to-market standards.

Mr. Brendsel employed various vehicles to achieve low earnings volatility by minimizing the income gain in connection with the FAS 133 transition gain. The complex CTUG transactions, which were both improperly accounted for and had no legitimate business purpose, were entered into to reduce earnings that would have been reportable. The four problematic J-deals were entered into improperly to manage earnings and were not accounted for improperly.

To ensure that Freddie Mac met Mr. Brendsel's objective of minimal, non-volatile FAS 133 transition gain, Freddie Mac also revalued its swaption portfolio for a short, but coincidentally convenient, period (late 2000 through early 2001) in such a way that resulted in only \$5 million in transition gain appearing on Freddie Mac's year 2000 income statement.⁹ The swaptions revaluation accounting was fleshed out within Market Risk

⁹ Had the swaptions not been revalued the transition gain would have been approximately \$700 million. Had the CTUG and J-deals not been entered into the gain would have been double that, around \$1.4 billion.

Oversight and the F&I Division by Mr. Brendsel's "financial engineers" with no official approval from Freddie Mac's Corporate Accounting Division. Mr. Brendsel, who ordained the objective fulfilled by this minimal transition gain, monitored its accomplishment through regular visits to the F&I trading floor.

Not surprisingly, the FAS 133 transition eventually turned into an accounting problem for Mr. Brendsel and Freddie Mac, requiring an accounting restatement of over \$5 billion, and costing Freddie Mac, by its calculations, close to \$1 billion, costs that continue to rise to this day. The transition to FAS 133, which would have required significant and complex accounting expertise to manage effectively, occurred at a time when Mr. Brendsel had knowingly allowed Freddie Mac's Corporate Accounting Department to weaken significantly.

Mr. Brendsel's Continued Neglect of Corporate Accounting

Corporate Accounting had long-standing resource and expertise problems known by Mr. Brendsel to be a critically weak part of the Enterprise's internal controls and infrastructure. Nonetheless, Mr. Brendsel routinely declined, despite repeated warnings of the problems in Corporate Accounting, to allocate adequate funding to the accounting function. From 1993 through 1996, the first four years of rapid retained portfolio growth at Freddie Mac, management actually reduced accounting and reporting personnel by 20%. Thereafter, despite various warnings to Mr. Brendsel from Freddie Mac's Controller and others within the Corporate Accounting Division, and from Freddie Mac's internal auditor, Corporate Accounting continued to suffer from too few qualified personnel, resource shortages, deficient accounting policies, fragile accounting controls, and over reliance on manual systems.

Mr. Brendsel's failure to take adequate measures to correct the accounting and accounting-related deficiencies, even prior to the FAS 133 transition, inevitably resulted in a fiasco. Given Mr. Brendsel's instructions to minimize the transition gain and oversight by an unqualified CFO chosen by him, Freddie Mac subsequently found itself restating much of the accounting applied in connection with the FAS 133 transition, ultimately costing the Enterprise hundreds of millions of dollars.

Mr. Brendsel Managed and Minimized Disclosures

Claims to the contrary notwithstanding, Freddie Mac had a corporate culture that encouraged minimizing, or even certain curtailing, financial disclosures, both internally and publicly, a policy supported and fostered by Mr. Brendsel. While throughout 2000 Mr. Brendsel and other members of senior management made the Board of Directors aware of the challenges posed by implementation of FAS 133, they assiduously avoided providing the Board with full and complete information about the measures that would be used to lessen its impact. Rather, Mr. Brendsel and other knowledgeable officers released significant FAS 133 information to the Board and public only in carefully controlled slivers designed to obfuscate rather than inform.

Mr. Brendsel actively denied the Board of Directors full and accurate information as to the nature of the transactions being undertaken during the course of Freddie Mac's FAS 133 transition. With respect to its public disclosures of the FAS 133 transition, Freddie Mac, under Mr. Brendsel's direction, crafted and relied upon general statements that failed to convey the size of the gross transition gain and the substantial and complex transactions and manipulations used to offset that possible gain.

Mr. Brendsel Allowed Earnings Management to Taint Operating Earnings

Because of its distaste for the requirements of FAS 133, Freddie Mac, under Mr. Brendsel's leadership, developed its own "operating earnings" metric to report its version of income along with the GAAP requirements. As 2001 progressed, the culture of improper earnings management instituted at Freddie Mac by Mr. Brendsel again appeared front and center. Operating earnings increased that year at a pace faster than anticipated due to interest rates favorable to Freddie Mac, which greatly increased net interest income ("NII"), the primary component of operating earnings. By late spring, management was reviewing ways to dampen the rapidly increasing operating earnings produced by these favorable conditions. Indeed, Mr. Brendsel knew that Corporate Accounting and the F&I Division were already considering, among other things, increasing reserve levels and contributing an extraordinary multi-year amount to the Freddie Mac Foundation as possible ways to reduce operating earnings to be reported at year's end.

These measures would not have accomplished sufficient income-dampening. So in the second half of 2001, Freddie Mac entered into a series of nine transactions known as the "linked swaps," which had the effect of transferring approximately \$420 million in operating earnings from 2001 into later years. Mr. Brendsel became aware of the linked swap transactions at least as early as August 23, 2001, when he insisted that the Investment Committee receive much less information about them than the head of the F&I Division had intended to provide to the Committee. What the eventual Investment Committee presentation failed to disclose, but what Mr. Brendsel had learned at the "dry run" for the presentation, is that without the linked swaps, and the resulting \$420 million

shift in operating earnings, the anticipated NII would have been \$0.57 per share above analysts' expectations for Freddie Mac's yearly earnings.

The Investment Committee also was not informed as to the overall magnitude of the linked swaps or that the swaps served little, if any, business purpose. Neither the Committee nor the full Board was ever informed that the total income-shifting impact of all nine linked swaps was approximately \$420 million. Despite the lead audit partner for Arthur Andersen strongly recommending immediate termination of the swaps (once he belatedly learned of them), Mr. Brendsel allowed them to continue unabated until December 2001, shortly before they were scheduled to terminate anyway. By allowing the linked swaps thus to remain in existence, Mr. Brendsel achieved his goal of shifting the \$420 million in operating earnings into later reporting periods.

Mr. Brendsel Was Responsible For This Unsafe And Unsound Conduct

Mr. Brendsel "was responsible for formulating the plans and policies of Freddie Mac..."¹⁰ He also was responsible for "[e]nsur[ing] that appropriate controls, policies, and procedures ... [were] established to protect corporate assets, and promote operational efficiency and that controls, policies and procedures ... [were] regularly evaluated for adequacy." Mr. Brendsel also was responsible for providing "supervision to the President and other senior executives."¹¹ He was responsible for various statutory certifications, which he certified improperly or not at all. Any attempts by him to place blame for his unsafe and unsound conduct on others, or claim that Arthur Andersen's audits shield him from culpability and liability should be summarily rejected.

¹⁰ Brendsel Sworn Interview at 16.

¹¹ Position description for Freddie Mac CEO/Board Chairman.

Mr. Brendsel set the tone for improper earnings management at Freddie Mac through his insistence on mid-teens earnings and steadily rising EPS that met analysts' and investors' expectations. He directed, was aware of, and participated in the unsafe and unsound financial transactions and manipulations in connection with Freddie Mac's improper earnings management. Further, Mr. Brendsel failed to take the steps necessary to improve Freddie Mac's internal accounting controls and reporting processes. Indeed, he often worked against the Enterprise's best interests by actions such as promoting an unqualified CFO and limiting financial disclosures to the Board and to the public.

Mr. Brendsel Is Liable for His Unsafe And Unsound Conduct

Mr. Brendsel's conduct summarized above was unsafe and unsound, and in violation of the Federal Housing Enterprises Safety and Soundness Act of 1992. His conduct was "knowing," "involved recklessness," and was "part of a pattern of misconduct." It "caused or would be likely to cause a substantial loss" to Freddie Mac. *See* 12 U.S.C. § 4636 (2),(3).

Such conduct thus merits a cease and desist order pursuant to 12 U.S.C. § 4631(d), to include: (1) restitution of the enormous financial loss already suffered by Freddie Mac, including reimbursement of that part of the loss that Mr. Brendsel should not have received in salary, bonuses and other benefits,¹² (2) indemnification of Freddie Mac for costs and payments it has incurred or made (or may be required to make) on account of Mr. Brendsel's unsafe and unsound conduct, and (3) guarantee against any

¹² This amount is the unjust enrichment obtained by Mr. Brendsel due to his misconduct, and should be ordered paid over to Freddie Mac under 12 U.S.C. § 4631(d)(1)(A) if OFHEO does not meet the elements for the award of a third tier civil money penalty against Mr. Brendsel. *See* 12 U.S.C. § 4631(d)(2), § 4636(b)(2),(3).

future loss to Freddie Mac resulting from Mr. Brendsel's unsafe and unsound conduct. It further merits a third tier civil money penalty.

CONCLUSION

OFHEO therefore requests that upon consideration of the evidence it will introduce demonstrating Mr. Brendsel's conduct discussed above, that he be found in violation of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, and that the remedies as set out above be levied against him.

Respectfully submitted,



David W. Roderer
Stephen E. Hart
Office of Federal Housing Enterprise Oversight
1700 G Street, NW
Washington, DC 20552
(202) 414-8960

Dated: September 14, 2007

CERTIFICATE OF SERVICE

I hereby certify that on this 14th day of September 2007, I caused a copy of the foregoing OFHEO'S PREHEARING STATEMENT to be served by facsimile and first class mail on the persons identified below:

Stephen D. Andrews, Esq.
Williams & Connolly LLP
725 Twelfth St., N.W.
Washington, DC 20005
(202) 434-5029

Steven M. Salky, Esq.
Zuckerman Spaeder LLP
1800 M Street, N.W., Suite 1000
Washington, D.C. 20036
(202) 822-8106



David W. Roderer
Office of Federal Housing Enterprise Oversight