JUDGE CARTER **11 CIV 9202**

UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

| | | |
|---|---|---|
| **UNITED STATES SECURITIES AND EXCHANGE COMMISSION,** | : | |
| **Plaintiff,** | : | **Civil Action No. 11-C** |
| -v.- | : | **ECF Case** |
| **DANIEL H. MUDD, ENRICO DALLAVECCHIA, and THOMAS A. LUND,** | : | **Jury Trial Demanded** |
| **Defendants.** | : | |

RECEIVED
DEC 16 2011
U.S.D.C. S.D. N.Y.
CASHIERS

## COMPLAINT

Plaintiff, the United States Securities and Exchange Commission (the "Commission") for its Complaint alleges as follows:

## SUMMARY OF ALLEGATIONS

1. This action arises out of a series of materially false and misleading public disclosures by the Federal National Mortgage Association ("Fannie Mae" or the "Company") and certain of its former senior executives concerning the Company's exposure to subprime mortgage and reduced documentation Alt-A loans. Eager to promote the impression that Fannie Mae had limited exposure to subprime and Alt-A loans during a period of heightened investor interest in the credit risks associated with these loans, Fannie Mae and its executives misled investors into believing that the Company had far less exposure to these riskier mortgages than in fact existed.

2. Between December 6, 2006, and August 8, 2008, (the "Relevant Period"), Daniel H. Mudd ("Mudd"), Enrico Dallavecchia ("Dallavecchia") and Thomas A. Lund ("Lund")

(collectively, "Defendants"), made or substantially assisted others in making materially false and misleading statements regarding Fannie Mae's exposure to subprime and Alt-A loans.

3. For example, in a February 2007 public filing, Fannie Mae described subprime loans as loans "made to borrowers with weaker credit histories" and reported that 0.2%, or approximately $4.8 billion, of its Single Family credit book of business as of December 31, 2006, consisted of subprime mortgage loans or structured Fannie Mae Mortgage Backed Securities ("MBS") backed by subprime mortgage loans.

4. Fannie Mae did not disclose to investors that in calculating the Company's reported exposure to subprime loans, Fannie Mae did not include loan products specifically targeted by the Company towards borrowers with weaker credit histories, including Expanded Approval ("EA") loans. As of December 31, 2006, the amount of EA loans owned or securitized in the Company's single-family credit business was approximately $43.3 billion, yet none of these loans were included in the Company's disclosed subprime exposure.

5. Fannie Mae's exclusion of loans such as EA from its subprime disclosures was particularly misleading because EA loans were exactly the type of loans that investors would reasonably believe Fannie Mae included when calculating its exposure to subprime loans. In fact, the Company identified EA as its "most significant initiative to serve credit impaired borrowers" in response to regulatory requests for information on its subprime loans. In addition, all of the Defendants knew that EA loans had higher average serious delinquency rates, higher credit losses, and lower average credit scores than the loans Fannie Mae included when calculating its disclosed subprime loan exposure.

6. In a November 2007 public filing, Fannie Mae described subprime loans as a loan to a borrower with a "weaker credit profile than that of a prime borrower," classified mortgage

loans as "subprime" if the mortgage loans were originated by a "specialty" subprime lender or a "subprime division of a large lender," and again represented that only 0.2%, or approximately $4.8 billion, of its Single Family credit book of business consisted of subprime mortgage loans or structured Fannie Mae MBS backed by subprime mortgage loans as of both March 31, 2007, and June 30, 2007.

7. Fannie Mae did not tell investors that in calculating the Company's exposure to subprime loans reported in this filing, Fannie Mae again did not include at least $43 billion of EA loans, included loans from only fifteen loan originators of the approximately 210 lenders listed on the HUD Subprime Lender list, and did not even have the capacity to track whether loans were originated by a subprime division of a large lender.

8. Fannie Mae made similarly misleading disclosures concerning its exposure to subprime loans in public filings throughout the Relevant Period. The result of these disclosures was to mislead investors into seriously underestimating Fannie Mae's exposure to subprime loans.

9. Similarly, Fannie Mae misled investors concerning its exposure to Alt-A loans with reduced or alternative documentation requirements. Fannie Mae did not disclose the total percentage of its Single Family mortgage guarantee business consisting of reduced documentation loans as reflected in its own internal reporting, which Defendants routinely received throughout the Relevant Period.

10. Instead, in its public disclosures, Fannie Mae described Alt-A loans as loans with lower or alternative documentation requirements, and then further stated that it classified loans as "Alt-A if the lenders that deliver the mortgage loans to us have classified the loans as Alt-A based on documentation or other product features."

11. Based on this reporting construct, for example, in a May 2007 filing, Fannie Mae publicly reported that approximately 11% of its total Single Family mortgage credit book of business as of March 31, 2007, consisted of Alt-A mortgage loans or Fannie Mae mortgage securities backed by Alt-A mortgage loans. This filing materially underreported the extent of Fannie Mae's total exposure to low documentation loans, which was approximately 17.9% as of March 31, 2007, based on Fannie Mae's own internal records.

12. Fannie Mae also did not disclose to investors that certain reduced documentation loans it received from lenders were not included in the calculation of Fannie Mae's publicly disclosed Alt-A loan exposure if the reduced documentation requirements were internally designated as Lender-Selected. Despite this exclusion, during the Relevant Period, Lender-Selected Reduced Documentation Loans had a serious delinquency rate that was substantially higher than Fannie Mae's full documentation loans with a similar credit risk profile. Further, Fannie Mae did not tell investors that the Company itself provided lenders—in advance—with the coding designations for Alt-A versus Lender-Selected.

13. The result of these disclosures was to mislead investors into materially underestimating Fannie Mae's exposure to reduced documentation loans. Fannie Mae made similarly misleading disclosures concerning its exposure to reduced documentation loans in public filings throughout the Relevant Period.

14. Mudd, Lund and Dallvecchia each knew, based on reports and internal data they received on a regular basis, that the Company's reported exposure to subprime and Alt-A loans was inaccurate. The misleading statements describing subprime and Alt-A loans occurred in periodic and other filings with the Commission, and public settings, including investor and analyst calls and media interviews. Mudd, Lund and Dallavecchia reviewed and approved each

of the false public filings. Mudd and Dallavecchia each made public statements falsely claiming that the Company's exposure to subprime loans was minimal.

15. By engaging in the misconduct described herein, Mudd violated and aided and abetted the violation of the antifraud and reporting provisions of the federal securities laws; Dallavecchia violated the antifraud provisions and aided and abetted the violation of the antifraud and reporting provisions of the federal securities laws; and Lund aided and abetted violations of the antifraud and reporting provisions of the federal securities laws. The Commission seeks injunctive relief, disgorgement of profits, prejudgment interest, civil penalties and other appropriate and necessary equitable relief from both defendants.

## JURISDICTION AND VENUE

16. The Court has jurisdiction over this action pursuant to Sections 20(b) and 22(a) of the Securities Act [15 U.S.C. §§ 77t(b) and 77v(a)] and Sections 21(d), 21(e) and 27 of the Exchange Act [15 U.S.C. §§ 78u(d), 78u(e), and 78aa)], and 28 U.S.C. § 1331.

17. Venue is proper in the Court pursuant to Section 22(a) of the Securities Act, [15 U.S.C. §77v(a)], and Section 27 of the Exchange Act [15 U.S.C. § 78aa] because certain of the acts, practices, transactions and courses of business constituting the violations alleged herein occurred within this judicial district.

18. Defendants Mudd, Dallavecchia and Lund directly or indirectly made use of the means or instrumentalities of interstate commerce, the mails, and the facilities of a national securities exchange in connection with the transactions, acts, practices and courses of business alleged in this Complaint.

## DEFENDANTS

19. **Daniel Mudd**, age 53, was Chief Executive Officer ("CEO") of Fannie Mae from June 2005 until September 2008, interim CEO from December 2004 until June 2005, and Chief Operating Officer ("COO") from February 2000 until November 2004. Ultimately, Mudd was removed as CEO of Fannie Mae after its regulator, the Federal Housing Finance Agency ("FHFA"), placed Fannie Mae into conservatorship in September 2008. Mudd is a resident of Greenwich, Connecticut. Mudd certified Fannie Mae's Forms 10-K and Forms 10-Q during the Relevant Period, including Fannie Mae's 2005 10-K filed May 2, 2007, its 2006 10-K filed August 16, 2007, its 2007 Form 10-Qs filed November 9, 2007, and its 2007 Form 10-K filed February 27, 2008. Mudd reviewed and approved Fannie Mae's Forms 12b-25 filed February 27, 2007, and May 9, 2007.

20. **Enrico Dallavecchia**, age 50, was Chief Risk Officer ("CRO") of Fannie Mae from June 2006 until August 2008 when he was removed by the Board along with two other executives. As CRO, Dallavecchia sub-certified all of Fannie Mae's Annual Forms 10-K and quarterly Forms 10-Q. He also reviewed and approved Fannie Mae's Forms 12b-25 dated February 27, 2007 and May 9, 2007. Dallavecchia is a resident of Potomac, Maryland.

21. **Thomas Lund**, age 53, was a Fannie Mae employee since 1995 who served as Executive Vice-President ("EVP") of Fannie Mae's Single Family Credit Guarantee ("Single Family") business from July 2005 until June 2009. As EVP of the Single Family business, Lund sub-certified all of Fannie Mae's Annual Forms 10-K and quarterly Forms 10-Q. He also reviewed and approved Fannie Mae's Forms 12b-25 dated February 27, 2007, and May 9, 2007. Lund is a resident of Cabin John, Maryland.

## RELEVANT ENTITY

22. **Fannie Mae** was, at all times relevant to this Complaint, a shareholder-owned Government Sponsored Enterprise ("GSE") established by the U.S. Congress in 1938 to support liquidity, stability and affordability in the secondary mortgage market, where existing mortgage-related assets are purchased and sold. Fannie Mae provides market liquidity by securitizing mortgage loans originated by lenders in the primary mortgage market into Fannie Mae MBS, and purchasing mortgage loans and mortgage-related securities in the secondary market for Fannie Mae's mortgage portfolio. By law, securities issued by Fannie Mae are "exempted securities." Accordingly, registration statements with respect to Fannie Mae's offerings are not filed with the Commission.

23. In March 2003, Fannie Mae voluntarily registered its common stock with the SEC under Section 12(g) of the Exchange Act and has, since then, been required to file periodic and current reports with the SEC, including annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K.

24. Throughout the Relevant Period, Fannie Mae's common stock traded publicly on the New York Stock Exchange ("NYSE"). Its principal place of business was and is in Washington, D.C.

25. On July 30, 2008, when the President signed into law the Housing and Economic Recovery Act of 2008 ("HERA"), the Federal Housing Finance Agency ("FHFA") became Fannie Mae's primary regulator.

26. On August 8, 2008, Fannie Mae announced a net loss of $2.3 billion. Fannie Mae stated that it was no longer certain that it would have enough capital to carry it through its losses. At this time, the Company announced that the main cause for its increased credit losses was the

deterioration in the credit performance of a small number of higher risk loan products, including Alt-A loans. As of the third quarter of 2008, more than 70% of Fannie Mae's credit losses were caused by its subprime and Alt-A loans.

27. On September 6, 2008, FHFA placed Fannie Mae into conservatorship and, as conservator, FHFA succeeded to all the rights, titles, powers and privileges of Fannie Mae, its shareholders, and the officers or directors of Fannie Mae with respect to the Company and its assets.

## BACKGROUND

### *Fannie Mae Single Family Mortgage Guarantee Business*

28. Fannie Mae's Single Family mortgage credit book of business was $2.34 trillion in 2006, $2.65 trillion in 2007, and $2.8 trillion in September 2008 when the Company was placed into Conservatorship.

29. During the Relevant Period, Fannie Mae operated three business segments—(i) Single Family; (ii) Multi-Family; and, (iii) Capital Markets.

30. Fannie Mae's primary business segment is the Single Family business, which works with lender customers to securitize Single Family mortgage loans (relating to properties with four or fewer residential units) into Fannie Mae MBS and to facilitate the purchase of Single Family mortgage loans for Fannie Mae's portfolio. Revenues in Fannie Mae's Single Family business are derived primarily from fees received as compensation for guaranteeing the timely payment of principal and interest on mortgage loans underlying Fannie Mae's Single Family MBS. During the Relevant Period, the Single Family business comprised approximately 51%, 64% and 54% of Fannie Mae's net revenues in each of 2006, 2007, and 2008, respectively.

31. Fannie Mae's Single Family business principally acquired loans through one of two channels: (i) the Lender (or flow) channel, which obtained loans from lenders on a going-

forward or contractual basis through agreements to purchase loans from lenders before those loans were originated based on certain terms and conditions; and, (ii) the Investor (or bulk) channel, which acquired from lenders loans that had already been originated based on data files for those loans that were provided by lenders to Fannie Mae for review prior to purchase.

32. Fannie Mae's Single Family business had a proprietary automated underwriting system called Desktop Underwriter ("DU"). DU was used by the Single Family business to assess the primary risk factors of a loan in order to measure that loan's default risk. Customers of Fannie Mae also used DU to originate and underwrite loans so those customers would know—in advance—whether any given loan was eligible for sale to Fannie Mae. When DU provided a Fannie Mae customer with an "approve" for a loan application, that customer knew that Fannie Mae would agree to acquire that loan and waive certain warrants and representations so long as the loan is originated in accordance with information originally submitted via DU.

33. At various times during the Relevant Period, Fannie Mae adjusted and recalibrated the risk assessment models within its DU system. For instance, in 2006, in connection with its *Say Yes* strategy to regain market share, Fannie Mae employed a "DU Bump" wherein eligibility parameters were expanded to provide more "approve" messages in DU for larger volumes of loans with lower FICO scores and higher LTVs than previously permitted. By adjusting and recalibrating the risk assessment models within its DU system, Fannie Mae took on increasingly risky loans during the Relevant Period.

34. While many mortgage originators used Fannie Mae's DU system as part of the underwriting process, many large mortgage lenders also had their own automated origination and underwriting platforms. For instance, during the Relevant Period, Countrywide Financial

Corporation's (Countrywide) proprietary underwriting system was called *Clues*, and Freddie Mac had a system similar to DU that was called *Loan Prospector*.

35. Not all loans acquired by Fannie Mae were underwritten using DU. During the Relevant Period, Fannie Mae acquired and securitized mortgage loans that were underwritten through other automated underwriting systems or simply by agreed-upon standards in a manual process. For instance, Fannie Mae acquired loans under Countrywide Financials *Fast and Easy* loan program that were underwritten using Countrywide's *Clues* system. Similarly, most of the My Community Mortgage ("MCM") loans Fannie Mae acquired during the Relevant Period were manually underwritten by loan officers and mortgage brokers at various companies nationwide and not evaluated using DU.

***Mudd's Role at Fannie Mae and his Disclosure Responsibilities***

36. As COO and then CEO from 2000 until September 2008, Mudd oversaw all three Fannie Mae business units, including the Single Family business. Additionally, during the Relevant Period Mudd was a member of the Board of Directors, the Audit Committee, a regular attendee at the Board's Risk Policy and Capital Committee meetings, held regular weekly meetings with his direct reports the business units, and attended quarterly business unit briefings. Mudd regularly read, reviewed and marked-up draft periodic filings and met with individuals who provided sub-certifications prior to certifying Forms 10-K and Forms 10-Q.

37. As CEO, and based on his prior role as COO, Mudd possessed detailed operational knowledge concerning Fannie Mae's subprime and reduced documentation loan exposure. Further, during the Relevant Period, Mudd routinely received acquisition, delinquency and credit loss data concerning subprime and Alt-A loans. Mudd certified filings and made

public statements describing Fannie Mae's subprime and reduced documentation loan exposure knowing that those public statements were false and misleading.

38. With regard to subprime-quality and reduced documentation loans, he received at least quarterly risk briefings on the Single Family business in which data showing Fannie Mae's total subprime and reduced documentation loan exposure was presented. Additionally, Mudd met weekly with his direct reports, who, among other things, informed him about Single Family loan acquisitions, trends and status with respect to market share targets.

39. Mudd was well aware of the Company's increased acquisition of reduced documentation loans—indeed, Mudd himself directed the company to pursue that market. For instance, in an April 26, 2006, Credit Risk meeting following a presentation on reduced documentation loans and their risks by the Single Family credit officer (who noted low documentation loans were riskier), Mudd stated that "the market is moving to low documentation and we need to actively pursue the keys to this market."

40. Mudd oversaw Fannie Mae's 2006 market share increase during which the Single Family business grew its market share from 20% of total mortgage loan originations to 25% by acquiring more subprime and reduced documentation loans. In part as a result of Fannie Mae's successful market share growth and timely filing of the company's periodic reports, Mudd's taxable compensation grew from $6.16 million in 2006 to $10.64 million in 2007.

41. Throughout the Relevant Period, in addition to wages earned, Mudd—like all Fannie Mae executives—received an Annual Incentive Plan ("AIP") bonus that was tied to two things: (i) Company performance, measured by attaining corporate year-end goals; and, (ii) personal performance, measured by attaining individual year-end goals. The AIP program was designed to "put part of the participants' total compensation package at risk, based on the

achievement of one-year goals for both the participant and the corporation" with individual performance driving the AIP payout each year, adjusted for corporate goal performance. The AIP bonus for a given year's performance was paid out in the following fiscal year such that an AIP bonus for performance in 2006 was received in 2007.

42. In his 2006 year-end report to the Board, Mudd noted that the Single Family business increased its market share, in part by entering new markets "especially Alt-A and subprime," that in response to filing the Company's 2004 Form 10-K, "the market and ratings agency reactions generally were positive—there were no big surprises," and that the Company's stock price improved by more than 20%. Mudd's 2006 taxable compensation was more than $6 million with approximately $2.5 million from his AIP bonus. In 2007, Fannie Mae's corporate goals included growing revenue, which the Single Family business set about doing by increasing its book by 5.6% with a plan to acquire more Alt-A and subprime loans. In 2007, Mudd's taxable compensation was more than $10 million—with $3.5 million from his AIP bonus alone. Mudd served as CEO for only eight full months in 2008, but his taxable compensation in 2008 was $7.4 million—with more than $2. 2 million from his AIP bonus based on his personal performance for 2007.

43. Mudd was also well aware that investors were increasingly focused on subprime loans. In a February 6, 2007 memo to the Board of Directors of Fannie Mae, Mudd wrote that investors and analysts were "focused on our market share, subprime risk and our portfolio strategy." As CEO of Fannie Mae, Mudd routinely interacted with investors and the media. During the Relevant Period, as investors and the media increasingly focused their attention on the credit risks associated with subprime and Alt-A mortgage loans, Mudd made numerous false and misleading statements that downplayed the Company's exposure to such loans and provided

false assurance to the market that Fannie Mae was participating in a safer segment of the mortgage market. Indeed, Mudd created the false perception that Fannie Mae's participation in high credit risk loans such as Alt-A and subprime was small and contained, and reinforced this false and misleading impression, telling investors that Fannie Mae was in the prime—not the subprime—market with a different, higher set of standards and underwriting.

44. Mudd was knowledgeable about the mortgage markets. While CEO of Fannie Mae, Mudd made numerous appearances before Congress to testify about the mortgage markets, the role of the GSEs and the subprime market. In that setting, Mudd repeatedly minimized Fannie Mae's reported exposure, falsely claiming it was less than 2% of the Company's book or that Fannie Mae held about zero percent subprime.

45. During the Relevant Period, Mudd received, reviewed and commented on (often in handwritten notes) multiple draft versions of each of Fannie Mae's periodic and other filings with the Commission. Prior to certification, Mudd met—seriatim—with officers of the Company who had provided sub-certifications to discuss issues presented by upcoming public filings. Also, as a member of the Audit Committee at Fannie Mae and the Board of Directors, Mudd participated in final committee and board reviews of Fannie Mae's Forms 10-K and Forms 10-Q during the Relevant Period prior to certifying.

***Lund's Role at Fannie Mae and his Disclosure Responsibilities***

46. Lund served as an officer at Fannie Mae for fourteen years, from 1995 until his retirement in 2009, and was EVP of the Single Family business at Fannie Mae from 2005 forward. Lund was a member of the Executive Committee and was the senior-most executive in charge of the Single Family business. He received and provided regular reports on the actual

volumes of Single Family subprime and reduced documentation loan acquisitions, the associated delinquency rates, and credit losses for all subprime-quality and reduced documentation loans.

47. Lund received Single Family acquisition data on at least a monthly basis detailing acquisitions of reduced documentation and subprime-quality loans. As the senior executive in charge of the Single Family business, Lund was knowledgeable about Fannie Mae's loan acquisitions and the performance of Fannie Mae's high credit risk loan portfolio.

48. At Mudd's weekly direct reports meetings, Lund provided Single Family business overviews to the CEO and others. Lund also held weekly meetings with his direct reports. The SVP for the Western Business Office of Fannie Mae routinely updated Lund on that region's then-most significant customers: Countrywide, IndyMac and WAMU.

49. Lund was also a member of Fannie Mae's Disclosure Committee, which oversaw the preparation of the Company's periodic (and other) filings with the Commission. During the Relevant Period, Lund was the only Single Family business executive that sat on Fannie Mae's Disclosure Committee and was, therefore, uniquely positioned to inform that Committee about the Single Family loan portfolio. Fannie Mae attendance records from the Relevant Period reflect that Lund routinely attended Disclosure Committee meetings where contemplated draft filings with the Commission were reviewed and issues discussed.

50. During the Relevant Period, Lund also received and reviewed draft versions of Fannie Mae's periodic and other filings with the Commission before they were publicly filed. While he knew the difference between the actual and the reported volumes of subprime and reduced documentation loans, Lund did not ensure that investors were likewise informed. Instead, he sub-certified as to the accuracy of the Company's materially false and misleading

disclosures concerning its exposure to subprime and Alt-A loans, which were directly within his area of knowledge and responsibility.

51. During his tenure as EVP of the Single Family business, Lund oversaw Fannie Mae's 2006 market share growth, and, in part as a result of its success and timely filing of the company's periodic reports, Lund's taxable compensation grew from $833,658 in 2006 to $1.9 million in 2007.

52. Throughout the Relevant Period, in addition to wages earned, Lund received an AIP bonus tied to attaining corporate and personal goals. In 2006, Fannie Mae's corporate goals included filing its 2004 Form 10-K, hitting Single Family MBS issuance targets, increasing profitability in the Single Family business, and reintroducing the Company to investors. In 2006, owing to its *Say Yes* business strategy, the Single Family business exceeded its goal of increasing market share from 20% to 25.4%, and on a corporate level, the Company grew its stock price more than 20%—from just under $49 to over $60 per share. Lund's 2006 taxable compensation was $833,658 with $792,960 from his AIP bonus. By contrast, in 2005, Lund's wages totaled $497,285. This represented a 67% increase in compensation between 2005 and 2006.

***Dallavecchia's Role at Fannie Mae and his Disclosure Responsibilities***

53. Enrico Dallavecchia served as Fannie Mae's EVP and Chief Risk Officer from June 2006 through August 2008. In that position, Dallavecchia reported directly to Mudd and was responsible for credit, market, counterparty, and operational risk oversight for all business units within Fannie Mae, which included measuring, reporting, and monitoring Fannie Mae's risk profile and formulating the Company's risk policies. As the senior-most executive in charge of credit risk, Dallavecchia received and provided regular reports on the actual volumes of

subprime and reduced documentation loan acquisitions, the associated delinquency rates, and credit losses for those loans at Fannie Mae.

54. Dallavecchia was also a member of Fannie Mae's Disclosure Committee, which oversaw the preparation of the Company's periodic (and other) filings with the Commission. During the Relevant Period, Dallavecchia was the only executive from the Chief Risk Office who sat on Fannie Mae's Disclosure Committee. As CRO, Dallavecchia was uniquely positioned to recognize and inform others about the overall credit risks presented by Fannie Mae's loan portfolio.

55. Fannie Mae attendance records from the Relevant Period reflect that Dallavecchia routinely attended Disclosure Committee meetings where contemplated draft filings with the Commission were reviewed and issues discussed. Dallavecchia personally received and reviewed draft versions of Fannie Mae's periodic and other filings with the Commission. Dallavecchia sub-certified as to the accuracy of the Company's materially false and misleading disclosures concerning its exposure to subprime and Alt-A loans, thereby substantially assisting the Company's fraud.

56. Dallavecchia and the Single Family CRO team assisted in drafting the definition of subprime contained in the February 27, 2007, Form 12b-25 in which Fannie Mae first quantified its subprime exposure.

57. Dallavecchia occasionally led the Board's Risk, Policy and Capital Committee meetings and attended Executive Committee meetings. In those roles, Dallavecchia received information and data concerning Fannie Mae's total exposure to reduced documentation and subprime loans.

58. As Fannie Mae's CRO, Dallavecchia had credit risk oversight for Fannie Mae's 2006 market share growth, and, in part as a result of its success and timely filing of the company's periodic reports, Dallavecchia's taxable compensation more than doubled from $617,886 for 7 months of service in 2006 to $2.68 million in 2007.

59. Throughout the Relevant Period, in addition to wages earned, Dallavecchia received an AIP bonus tied to attaining corporate and personal goals. When Dallavecchia began as Fannie Mae's CRO, the then-Chairman of the Board of Directors noted in an address to Senior Management, "We have to think differently and creatively about risk ... Enrico Dallavecchia was not brought on-board to be a business dampener." In 2006, Fannie Mae's corporate goals included filing its 2004 Form 10-K, increasing its earnings per share, profitability, and subprime penetration while building a CRO function and implementing business unit risk officers. In his year-end 2006 self-assessment, Dallavecchia noted that the most significant achievement was his office playing a role "from both a risk perspective and also from a business perspective." Dallavecchia further noted that his office "authored the Risk Section of the 2004 10-K."

60. In 2007, Fannie Mae's corporate goals included growing revenue and timely periodic filings with the Commission. In addition to Fannie Mae meeting most of its 2007 corporate goals with respect to growing revenue, Mudd's year-end 2007 review of Dallavecchia noted that he completed the build out of the CRO structure, developed risk limits and did good work on the Board Risk Policy and Capital Committee. Dallavecchia's 2007 taxable compensation was more than $2.6 million with $1.04 million from his AIP bonus.

61. One month prior to conservatorship, in August 2008, Dallavecchia was terminated as CRO. Accordingly, Dallavecchia served as CRO for only seven full months in 2008; his 2008 taxable compensation was $2.3 million with $923,780 from his AIP bonus.

## OVERVIEW OF FANNIE MAE LOAN PROGRAMS

### *Fannie Mae's Reduced Documentation Loan Programs*

62. During the 1990s, Fannie Mae had limited market presence in Alt-A mortgage loans, which were not a large part of mortgage originations nationwide.

63. In July 1999, Fannie Mae and Countrywide Home Loans entered into an alliance agreement, which included a reduced documentation loan program called the "internet loan," which was soon thereafter re-branded by Countrywide as the *Fast and Easy* loan. This loan program featured a streamlined documentation process, which allowed mortgage-loan applicants with a qualifying FICO credit score to be preapproved for a mortgage loan without providing documentation to verify income or assets.

64. The *Fast and Easy* loan program was popular. Fannie Mae executives referred to it as Countrywide's "signature" or "flagship" mortgage product. By the mid-2000s, other mortgage lenders developed similar reduced documentation loan programs such as Mortgage Express and PaperSaver—many of which Fannie Mae acquired in ever-increasing volumes throughout the Relevant Period.

65. Alt-A loans proliferated in the marketplace, and during the Relevant Period Fannie Mae's Single Family business pushed to increase its acquisitions of those Alt-A loans. By year-end 2006, 35% of Fannie Mae's Single Family loan acquisitions were Alt-A loans. By year-end 2007, that number increased to 37%, and by June 30, 2008, 26% of its Single Family loan acquisitions were Alt-A loans.

### *Fannie Mae's Subprime Loan Programs*

66. Since the late 1990s, Fannie Mae acquired and guaranteed subprime mortgage loans described in Fannie Mae periodic filings during the Relevant Period as loans made to

"borrowers with weaker credit histories" or "weaker credit profile[s]" that "have a higher likelihood of default than prime loans" as part of the Company's two primary programs for borrowers with weaker credit histories: Expanded Approval/Timely Payment Rewards ("EA") and MyCommunityMortgage ("MCM").

67. The credit risks posed by these programs were well understood by senior management at Fannie Mae. Mudd was familiar with the EA and MCM loan programs and the credit risks those loan programs entailed. Throughout the Relevant Period all the Defendants received reports, briefings and presentations containing acquisition volume, Serious Delinquency Rates ("SDQ Rates") and credit loss data with respect to Fannie Mae's EA and MCM loans. Throughout the Relevant Period, Mudd, Lund and Dallavecchia knew that EA loans were—on average—the highest credit risk loans on Fannie Mae's book of business, and knew that EA loans contributed disproportionately to Fannie Mae's credit losses.

68. Indeed, in May 2001, Mudd wrote a memo to the then-CEO noting that EA loans "are the highest default risk loans we have ever done."

69. Traditionally, Fannie Mae treated EA loans as part of its subprime exposure. For example, a March 2002 Report prepared for the U.S. Department of Housing and Urban Development ("HUD") with the participation of Fannie Mae, entitled "Subprime Markets, the Role of GSEs and Risk-Based Pricing," stated under a section entitled 'Agency Subprime Lending Products' that:

> The agencies are increasing their presence in the subprime market by rolling-out new subprime mortgage products through updated versions of their automated underwriting systems. Fannie Mae seller/servicers now offer loan products to three groups of credit-impaired borrowers under two new programs. Fannie Mae's Expanded Approval program allows lenders to approve borrowers who would have been formerly classified as 'Refer with Caution' ... by Fannie Mae's Desktop Underwriter (DU). ... The Expanded Approval products are recent innovations, and, according to Fannie Mae representatives, account for a

> relatively small portion of that GSE's book of business ... At most, according to a Fannie Mae stock analyst, these subprime loan purchases will account for no more than five percent of that GSE's purchase volumes. (Emphasis added).

70. Similarly, in its annual exam process in 2004 and 2005, Fannie Mae's then-primary regulator, the Office of Federal Housing Enterprise Oversight's ("OFHEO") asked for information on Fannie Mae's total Single Family subprime loan exposure, specifically requesting: "[t]he volume of loans purchased in 2004 [and 2005] defined as CE structured subprime ... or sub-prime as otherwise defined." In March of 2005 and April of 2006, respectively, Fannie Mae responded by providing OFHEO with information on mortgage loan purchases and mortgage-backed securities under the EA program, describing the EA program as, "our most significant initiative to serve credit-impaired borrowers."

71. Moreover, before December 2006, various internal Fannie Mae reports, including reports to the Board, identified subprime loans as including: (i) investor channel subprime loans acquired as part of its Subprime NBI; (ii) A- Deal loans that pre-date December 2005; and, (iii) EA loans.

*Fannie Mae Excluded EA and MCM Loans from its Subprime Disclosure*

72. When Fannie Mae first reported its quantitative exposure to subprime loans in a filing with the Commission on February 27, 2007, the Company broadly defined subprime as loans to "borrowers with weaker credit histories." EA and MCM loans fell squarely within this definition, but were not included in the accompanying quantification of Fannie Mae's subprime exposure.

73. Instead, the quantification consisted primarily of private label securities it held that were marketed as being backed by subprime loans, certain "A-" loans that the company acquired prior to 2005, and certain loans that had been acquired through a limited new business

initiative beginning in 2006. Fannie Mae's subprime quantification did not include significant numbers of other loans that fell within its published subprime definition of loans to "borrowers with weaker credit histories."

74. Throughout the Relevant Period, EA loans had, on average, higher SDQ rates than the loans Fannie Mae used in calculating its disclosed subprime exposure. Senior management at Fannie Mae, including the Defendants, were aware of this fact, as SDQ rates were tracked and regularly included in reports and other internal presentations. For example, in a meeting of the Risk Policy and Capital Committee ("RPCC") of Fannie Mae's Board, the CRO reported that as of July 2007 Fannie Mae's SDQ rates for EA were 5.57% (the highest on its book); by contrast, the SDQ rate of its disclosed subprime loans were 4.95 %.

75. Throughout the Relevant Period, the credit risk associated with Fannie Mae's EA and MCM acquisitions was reported to and tracked by senior management, including Defendants, in terms of acquisition volume, delinquencies, and credit losses—alongside those loans that were included when quantifying its disclosed "subprime" exposure in its public filings. EA and MCM loans were routinely included in reports tracking Fannie Mae's high risk loan products (which ranged from three to five or more loan types during the Relevant Period) that were received by the Defendants.

76. Also during the Relevant Period, senior executives, including the Defendants, were provided with credit loss data that showed that the greatest amount of credit losses attributable to any one loan type or product on Fannie Mae's Single Family book were attributable to the EA product. For instance, in an October 26, 2007, Disclosure Committee report, it is noted that EA loans were responsible for $188.9 million in losses and MCM loans

were responsible for $16 million in losses—compared to $5.5 million in losses for the loan population Fannie Mae disclosed as its subprime exposure.

77. As a portion of Fannie Mae's book of business, EA loans increased in volume between 2006 and 2008 from $43.3 billion to $58.3 billion, totaling approximately 2% of the company's book of business during the Relevant Period. MCM loans, which were intended for low-to-moderate income borrowers, accounted for between 0.3% and 1.5% of Fannie Mae's book of business over the same period. None of these loans were included in Fannie Mae's calculation of its publicly disclosed subprime exposure.

## FANNIE MAE'S DISCLOSURES

### *Overview*

78. Since 2003 in its annual Form 10-K filings, Fannie Mae included a table of credit risk characteristics for Single Family loans ("Credit Risk Tables"). Those Credit Risk Tables contain information describing risk characteristics such as original LTV, Product Type, Property Type, Occupancy Type, FICO Credit Score bands, Loan Purpose, Geographic Concentration, and Origination Year. The tables did not include any statement or representation as to whether Fannie Mae held subprime and Alt-A loans.

79. During the Relevant Period, Fannie Mae also provided narrative disclosures in its periodic filings concerning the company's expectation of credit losses, delinquencies, market environment and economic factors that could impact the company's business. These narrative disclosures repeatedly contained materially false and misleading statements and representations regarding Fannie Mae's Alt-A and subprime exposure.

80. During part of the Relevant Period, Fannie Mae also filed supplemental Form 8-Ks filed simultaneously with various Forms 10-K and Forms 10-Q that contained credit characteristic information concerning its Single Family book of business, along with a purported

tabular description of Fannie Mae's subprime and Alt-A holdings. None of the information contained in those supplement Form 8-Ks provided investors with an accurate description of the Company's subprime or Alt-A holdings. Although Fannie Mae claimed to provide additional information to investors, labeling a portion of loans "subprime" and "Alt-A" in a disclosure table, those tables included only a fraction of the loans that met Fannie Mae's own public definition of "subprime" or "Alt-A" in the quantification under each category. These supplemental disclosures deliberately gave investors false comfort that the Company's exposure to subprime and Alt-A loans was dramatically smaller than it, in fact, was.

***Fannie Mae's Initial Quantification of Subprime Exposure Was False and Misleading***

81. By February 2007, following S&P's downgrade of high-profile subprime lender, New Century Financial Corporation, and other indicia of subprime market turmoil—including HSBC Holdings PLC's announcement that the U.S. subprime market was unstable—investors were increasingly focused on subprime loans and the risks associated with these loans.

82. In a February 6, 2007 memo to the Board of Directors of Fannie Mae, Mudd wrote that investors and analysts were "focused on our market share, subprime risk and our portfolio strategy." With this backdrop, Fannie Mae's Disclosure Committee, which included Lund and Dallavecchia as members, decided to include a quantitative disclosure of Fannie Mae's exposure to subprime loans in the Company's public filings.

83. According to an internal e-mail sent to both Lund and Dallavecchia, "Enrico [Dallavechia]'s team has been tasked with developing a definition of 'sub-prime,' as well as providing the numbers for the 12b-25."

84. On February 23, 2007 in a call with investors Mudd stated: "Subprime mortgages are those offered to borrowers with damaged credit" and Fannie Mae's "subprime investment constitutes well below 2 percent of our book."

85. Four days later on February 27, 2007, in a Form 12b-25 filing with the Commission, the Company disclosed the following regarding Fannie Mae's subprime exposure:

> Although there is no uniform definition for sub-prime ... loans across the mortgage industry... sub-prime loans typically are made to borrowers with weaker credit histories ... We estimate that approximately 0.2% of our single-family mortgage credit book of business as of December 31, 2006 consisted of sub-prime mortgage loans or structured Fannie Mae MBS backed by sub-prime mortgage loans ... We estimate that approximately 2% of our single-family mortgage credit book of business as of December 31, 2006 consisted of private-label mortgage-related securities backed by sub-prime mortgage loans and, to a lesser extent, resecuritizations of private-label mortgage-related securities backed by sub-prime mortgage loans. (Emphasis added.)

86. The percentage of subprime loans disclosed by Fannie Mae did not include a material number of subprime-quality loans in the Fannie Mae Single Family mortgage credit book of business as of December 31, 2006, made to "borrowers with weaker credit histories." In particular, the percentage of subprime loans disclosed by Fannie Mae did not include the EA and MCM loans, which were the very types of loans that investors (and analysts) believed were the company's primary subprime exposure.

87. Fannie Mae's exposure to EA loans in its Single Family mortgage credit book of business was approximately $43.3 billion as of December 31, 2006—approximately 10 times greater than the 0.2% ($4.8 billion) disclosed as "sub-prime mortgage loans or structured Fannie Mae MBS back by subprime loans" as of December 31, 2006.

88. The February 27, 2007, disclosure falsely stated that Fannie Mae's total exposure to loans made to borrowers with weaker credit histories (subprime) was 2.2% of its total

mortgage credit book of business, when in fact its exposure was at least 4.64% (as of December 31, 2006).

89. Nothing in Fannie Mae's public disclosures alerted investors that it held a much larger volume of loans that matched the Company's description of subprime loans but were not included in the reported subprime number.

90. Although Fannie Mae excluded EA from its subprime reporting, Fannie Mae's EA loans had, on average throughout the Relevant Period, SDQ rates higher than those loans Fannie Mae actually included in calculating its disclosed exposure to subprime loans. As of January 2007, EA loans had an SDQ rate of 5.69%; disclosed Subprime loans (as-quantified in Fannie Mae's filings) had an SDQ rate of 4.82%.

91. EA and MCM loans accounted for a higher percentage of Single Family credit losses (20.4%) at year-end 2006 than loans Fannie reported as its subprime exposure, which at the time were responsible for no credit losses.

92. Mudd, Lund and Dallavecchia each reviewed and approved the February 27, 2007, Form 12b-25 statement before it was released by the Company, knowing its quantified subprime disclosure excluded EA and MCM loans.

***Dallavecchia's False and Misleading Statement***

93. That same day, February 27, 2007, Dallavecchia spoke directly to investors on a conference call and explained:

> In our filing today, we also indicate that we have increased our participation in subprime product in 2006. Our purchases have been prudent and have been made when we concluded that they would contribute to our mission objectives or they would general a profitable return. Given our view of the subprime market generally, let me offers [sic] some insight into our approach to this segment and the exposure to the risk. <u>The first point, as per our filing, is that our exposure is modest</u>. <u>Approximately 0.2% of our single-family credit book of business consisted of subprime loans or Fannie Mae MBS backed by subprime loans</u> ... to

> conclude my thoughts on credit risk, I anticipate our credit losses will trend upward as a result of the general softening of the housing market ... At the same time, I would advise that you consider our exposure in light of the strength of the risk characteristics I have described <u>and the immaterial size of our participation in the subprime market</u>. (Emphasis added.)

94. Despite knowledge that the Company had exposure to approximately $43.3 billion worth of EA loans and $13.8 billion in MCM loans as of December 31, 2006, which fell squarely within Fannie Mae's publicly stated definition of subprime, Dallavecchia falsely represented that only "0.2% of [Fannie Mae's] Single Family credit book of business consisted of subprime loans,"

95. Moreover, Dallavecchia further misled investors regarding Fannie Mae's subprime exposure by emphasizing that Fannie Mae's subprime was "modest," "prudent" and "immaterial." He gave the public these assurances knowing Fannie Mae's exposure to EA loans was at least ten times greater than "0.2% of [Fannie Mae's] single-family credit book of business." His purpose was clear. As Dallavecchia explained in an internal email on February 23, 2007, in preparing for the investor call, "I am trying to say that if you look at our guarantee book of business we have an insignificant exposure in subprime loans."

***Mudd's False and Misleading Testimony Before Congress***

96. On March 15, 2007, Mudd appeared before the House Financial Services Committee and gave testimony in a hearing on Legislative Proposals on GSE Reform. Mudd was asked: "And you have not engaged in the subprime market. You hadn't gone there to a great extent is that right?" In response, Mudd testified:

> The answer for Fannie Mae on behalf of subprime is that it's important to remember there is subprime and there is predatory. Subprime simply means . . . that you have a credit blemish, and we think those people are part of the market. It's less than 2 percent of our book. It's 80 percent insured. It's highly subordinated. We've been in it very carefully, consistent with some very strong anti-predatory lending guidelines we have.

97. At the time that Mudd gave this testimony, he knew that Fannie Mae EA loans were designed to provide loans to borrowers with weaker credit histories, i.e., "credit blemish[ed]" borrowers, and that the quantification of Fannie Mae's subprime holding as "less than 2 percent of our book" did not include EA or MCM loans. The following month, on April 17, 2007, Mudd again appeared before the Committee on Financial Services to provide testimony in a hearing on solutions to the subprime market turmoil. Mudd again testified: "'Subprime' is, after all, simply the description of a borrower who doesn't have perfect credit." He provided a broad description of Fannie Mae's efforts to reach "borrower[s] who do[n't] have perfect credit":

> We see it as part of our mission and our charter to make safe mortgages available to people who don't have perfect credit. In the past several years, for example, we have designed mortgage options to give borrowers with blemished credit access to high-quality, low-cost, non-predatory loans. We also set conservative underwriting standards for loans we finance to ensure the homebuyers can afford their loans over the long term . . . we continued our careful entry into the subprime market, by and large supporting lenders, products and practices that met our standards, and which helped us meet our HUD affordable housing requirements.

98. Having broadly defined "subprime" and described Fannie Mae's outreach to the market for borrowers without perfect credit, Mudd testified as to the amount of subprime held by Fannie Mae: "Today, our exposure remains relatively minimal – less than 2.5 percent of our book of business can be defined as subprime."

99. Mudd knew EA loans were loans specifically designed for "people who don't have perfect credit" —his own definition for subprime—and that the 2.5 percent figure he used did not include billions of dollars of EA and MCM loans. As such, his statement was knowingly false and misleading when made.

***Fannie Mae's False and Misleading Subprime Disclosures in its 2005 10-K Filing***

100. In May 2007, Fannie Mae filed its 2005 Form 10-K, in which it supplemented its prior public definition of subprime. In addition to asserting that "subprime" generally refers to loans made to borrowers "with a weaker credit profile" and "borrowers [who] have a higher likelihood of default," Fannie Mae now disclosed that it classified loans as subprime if the loans were originated from a specialty subprime lender.

101. On May 2, 2007, Fannie Mae filed its 2005 Form 10-K and stated:

> "*Subprime mortgage*" generally refers to a mortgage loan made to a borrower with a weaker credit profile than that of a prime borrower. As a result of the weaker credit profile, subprime borrowers have a higher likelihood of default than prime borrowers. Subprime mortgage loans are often originated by lenders specializing in this type of business, using processes unique to subprime loans. In reporting our subprime exposure, we have classified mortgage loans as subprime if the mortgage loans are originated by one of these specialty lenders or, for the original or resecuritized private-label, mortgage-related securities that we hold in our portfolio, if the securities were labeled as subprime when sold ...We also estimate that subprime loans represented approximately 2.2% of our single-family mortgage credit book of business as of December 31, 2006, of which approximately 0.2% consisted of subprime mortgage loans or structured Fannie Mae MBS backed by subprime mortgage loans and approximately 2% consisted of private-label mortgage-related securities backed by subprime mortgage loans and, to a lesser extent, resecuritizations of private-label mortgage-related securities backed by subprime mortgage loans.

102. Fannie Mae's reporting of its subprime exposure omitted approximately $43.3 billion worth of EA loans and $13.8 billion in MCM loans in Fannie Mae's Single Family mortgage credit book of business as of December 31, 2006—approximately 12 times greater than the 0.2% ($4.8 billion) disclosed as "subprime mortgage loans or structured Fannie Mae MBS back by subprime loans" as of December 31, 2006.

103. Nothing in Fannie Mae's public disclosures alerted investors that this much larger volume of loans matched the Company's description of subprime loans but were not included in the reported quantitative number.

104. In addition, while Fannie Mae stated that it classified loans as subprime if those loans were originated by specialty subprime lenders, that statement was materially false and misleading as well. Since 1993, the U.S. Department of Housing and Urban Development ("HUD") posted a publicly available HUD Subprime Lender list based on loan data and interviews with lenders themselves. Companies in the mortgage industry rely on the HUD Subprime Lender list as a proxy for identifying subprime lenders. Internal Fannie Mae documents reflect that its personnel, including Lund, were aware of the HUD Subprime Lender list as an accepted source for subprime-lender identification. During the Relevant Period, the HUD Subprime Lender list included approximately 210 lenders.

105. The Company failed to disclose, however, that, when calculating Fannie Mae's subprime exposure, only certain loans that had been originated by 15 lenders were included. Fannie Mae purchased and guaranteed loans from many other lenders on the HUD list, but they were not included when calculating the Company's subprime exposure. Fannie Mae disclosed neither that it was restricting its definition of "specialty lender" to 15 lenders on the HUD list, nor the names of those lenders on the HUD list that it included in its calculations. In fact, Fannie Mae acquired loans from many other specialty lenders on the HUD Subprime Lender list, and EA loans were originated by lenders on the HUD list.

106. Although EA was left out of Fannie Mae's subprime reporting, it was well-known within Fannie Mae that EA was generally considered subprime in the marketplace. For example, on April 5, 2007, the SVP of business and strategic development sent an email to a group of Fannie Mae executives including Lund and Dallavecchia, stating "mcm and ea are much deeper risks that we take and many (if not all) in the market call EA subprime. They are growing very

fast." Within a month, Fannie Mae filed its next public statement concerning its subprime exposure, and again omitted its exposure to EA and MCM loans.

107. On May 9, 2007, Fannie Mae filed a Form 12b-25 with the Commission, which repeated the disclosure contained in the May 2, 2007 filing.

108. As it had previously, Fannie Mae's reporting of its subprime disclosure in this May 9, 2007 filing omitted approximately $43.3 billion worth of EA loans and $13.8 billion in MCM loans in Fannie Mae's Single Family mortgage credit book of business as of December 31, 2006. That undisclosed subprime exposure was approximately 12 times greater than the 0.2% ($4.8 billion) disclosed as "subprime mortgage loans or structured Fannie Mae MBS back by subprime loans" as of December 31, 2006.

109. Mudd, Lund and Dallavecchia had each reviewed and approved the Form 12b-25 dated May 9 2007 that was released by the Company.

*Fannie Mae's False and Misleading Subprime Disclosures for Year-End 2006*

110. In early August 2007, as Fannie Mae prepared a draft Form 8-K Credit Supplement to be filed simultaneous with its upcoming 2006 Form 10-K, Mudd personally requested additional basic data concerning the Company's credit book in a draft version of the Form 8-K. The additional data Mudd received from the CRO office on August 5, 2007, included details on the total volume of EA, MCM, disclosed subprime, and Alt-A loans Fannie Mae had on its book of business. This draft included SDQ data that clearly showed EA loans had a higher rate of delinquency (5.38%) than the Company's disclosed subprime loans (4.8%).

111. The data provided to Mudd also included data on FICO scores that demonstrated that the credit quality of EA loans was worse than the credit quality of the loans that Fannie Mae disclosed as its subprime exposure. Specifically, the document disclosed that 53% of EA loans

had FICO scores below 620; whereas 47% of Fannie Mae's disclosed subprime had FICO scores below 620. Further, 26% of EA had FICO scores below 580 while 23% of disclosed subprime loans had FICO scores that low.

112. On August 3, 2007, as members of the Disclosure Committee, Dallavecchia and Lund both received the same draft credit supplement sent to Mudd. This information concerning EA and MCM was not ultimately made public.

113. Fannie Mae issued its 2006 Form 10-K less than two weeks after each of the defendants received the draft 8-K disclosure comparing EA and disclosed subprime, and documenting that EA loans had a higher serious delinquency rate than disclosed subprime and that EA loans had a weaker credit profile than disclosed subprime.. The public filing again defined "subprime" as "loans to borrowers with riskier credit profiles." Nevertheless, EA and MCM loans were not included when quantifying Fannie Mae's subprime exposure; nor was it disclosed that there were "loans to borrowers with riskier credit profiles" that were excluded from Fannie Mae's subprime reporting.

114. On August 16, 2007 Fannie Mae filed its 2006 Form 10-K and stated:

> In recent years, we have increased our acquisitions of loans to borrowers with riskier credit profiles, referred to as subprime loans by the industry. Subprime mortgage loans that we acquire are generally originated by lenders specializing in this type of business, using processes unique to subprime loans. Based on data published by National Mortgage News and our internal economic analysis of the mortgage market, subprime mortgage loan originations have increased sharply in recent years, rising to a record high of approximately 24% of single-family mortgage loan originations in the first quarter of 2006 ... Our acquisitions of subprime mortgage loans have been significantly less than the overall market's share. We estimate that approximately 0.2% of our total single-family mortgage credit book of business as of December 31, 2006 consisted of subprime mortgage loans or structured Fannie Mae MBS backed by subprime mortgage loans. We have also invested in highly rated private-label mortgage-related securities that are backed by ... subprime mortgage loans ... We estimate that ... private-label mortgage-related securities backed by subprime mortgage loans, including

> resecuritizations, accounted for approximately ... 2% ... of our single-family mortgage credit book of business as of June 30, 2007.

115. Fannie Mae's Single Family mortgage credit book of business consisted of approximately $43.3 billion worth of EA loans and $13.8 billion worth of MCM loans as of December 31, 2006 — more than 12 times greater than the 0.2% ($4.8 billion) disclosed as "subprime mortgage loans or structured Fannie Mae MBS back by subprime loans" as of December 31, 2006.

116. Nothing in Fannie Mae's public disclosures alerted investors that this much larger volume of loans matched the Company's description of subprime loans but were not included in the reported quantitative number.

117. Mudd certified and Lund and Dallavecchia each sub-certified the 2006 Form 10-K even though they knew that the statements regarding the Company's subprime exposure were materially misleading.

***Fannie Mae's False and Misleading Subprime Disclosures for First, Second and Third Quarters of 2007***

118. In preparing to review the upcoming Fannie Mae filing, a Disclosure Committee Analytical Report was sent on October 26, 2007, to several individuals, including Mudd, Dallavecchia and Lund. The report presented data on Single Family's "[h]igher risk products," including EA, MCM, and disclosed subprime. The data documented that, in the two periods addressed in the document, year-to-date as of September 2006 and year-to-date as of September 2007, Fannie Mae's credit losses from EA and MCM far outweighed losses compared to the loans reported as the company's subprime exposure. As of September 2006, Fannie Mae had $80.6 million in losses from EA and $1.7 million in losses from MCM, compared to no losses from loans disclosed as subprime. As of September 2007, Fannie Mae had $188.9 million in

losses from EA, and $16 million in losses from MCM, compared to $5.5 million in losses from loans disclosed as subprime. Fannie Mae's credit losses from EA in 2006 and 2007 were overwhelmingly greater than any losses it experienced related to its disclosed subprime holdings during the same period. A key observation in the Report showed that the Company's highest risk products (which included EA and MCM loans) "comprise less than 15% of the S[ingle] F[amily] book but accounted for 57% of the $440MM" increase in credit losses.

119. Within two weeks, on November 9, 2007, Fannie Mae filed its Forms 10-Q for the first, second and third quarters of 2007. Even though each of the Defendants knew that EA and MCM loans fit Fannie Mae's public definition of subprime loans and were a source of credit losses far greater than losses triggered by the loans that were disclosed as subprime, EA or MCM loans were not included in the quantification of subprime. The Company stated in its first quarter Form 10-Q:

> A subprime mortgage loan generally refers to a mortgage loan made to a borrower with a weaker credit profile than that of a prime borrower. As a result of the weaker credit profile, subprime borrowers have a higher likelihood of default than prime borrowers. Subprime mortgage loans are typically originated by lenders specializing in this type of business <u>or by subprime divisions of large lenders,</u> using processes unique to subprime loans. In reporting our subprime exposure, we have classified mortgage loans as subprime if the mortgage loans are originated by one of these specialty lenders <u>or a subprime division of a large lender</u>. ... Approximately 0.2% of our total single-family mortgage credit book of business as of March 31, 2007 consisted of subprime mortgage loans or Fannie Mae MBS backed by subprime mortgage loans. This percentage increased to approximately 0.3% as of September 30, 2007. Less than 1% of our single-family business volume for the nine months ended September 30, 2007 consisted of subprime mortgage loans or Fannie Mae MBS backed by subprime mortgage loans. (Emphasis added.)

120. The Company's subprime disclosures in its second and third quarter Forms 10-Q were comparable.

121. The quantified subprime exposure omitted at least $43 billion worth of EA loans that were part of Fannie Mae's Single Family mortgage credit book of business and $17.6 billion in MCM loans as of March 31, 2007—approximately 12 times greater than the 0.2% ($4.8 billion) disclosed as "subprime mortgage loans or structured Fannie Mae MBS back by subprime loans" as of March 31, 2007.

122. Nothing in Fannie Mae's public disclosures alerted investors to this much larger volume of loans that matched the Company's description of subprime loans but were not included in the reported subprime exposure.

123. The November 9, 2007, Form 10-Q filings supplemented its prior public definition of subprime. In addition to stating that it classified "mortgage loans as subprime if the mortgage loans are originated by one of these specialty lenders," it also stated that it classified loans as subprime if the loans are originated by "a subprime division of a large lender."

124. This statement in the November 9, 2007 Form 10-Q was false. In reality, Fannie Mae never tracked loans from the subprime divisions of large lenders and, accordingly, the Company never included any of those subprime loans in its reported subprime exposure—despite its explicit claim that it did so.

125. Since at least 2003, Mudd was aware that subprime divisions of major lenders were originating and selling EA loans to Fannie Mae. Nevertheless, the Company never included any EA loans in its subprime reporting.

126. In February 2007, Mudd traveled to meet with Fannie Mae's then-largest customer, Countrywide. At the meeting, Mudd was briefed by the President and COO of Countrywide Home Loans about the volume of loans Fannie Mae acquired from that customer's subprime lending division (Full Spectrum Lending), which between 2004 and 2006 totaled

$14.23 billion worth of loans. The presentation explicitly referred to Countrywide's subprime lending division customers as subprime "Fallen Angels."

127. In the Relevant Period alone, Fannie Mae acquired loans totaling approximately $28.5 billion from Countrywide's subprime division—the subprime division of a large lender. That number is far greater than the amount of "sub-prime mortgage loans or structured Fannie Mae MBS back by subprime mortgage loans" that Fannie Mae publicly disclosed to investors at any point during the Relevant Period.

128. Disclosing loans acquired from Countrywide's subprime division alone would have more than doubled the disclosed subprime exposure in Fannie Mae's Single Family guarantee portfolio. However, those loans were not included in the Company's reported subprime exposure.

129. During the Relevant Period, Fannie Mae purchased or securitized loans from subprime divisions of other large lenders including Citigroup, JPMorgan and GMAC.

130. Lund's direct reports knew and informed him that subprime divisions of large lenders sold loans to Fannie Mae—including Citi's Argent/Ameriquest, Countrywide's Full Spectrum Lending, and First Franklin's Flagstar bank.

131. On November 9, 2007, for the quarter ended September 30, 2007, Fannie Mae also filed a "credit supplement" on Form 8-K with the Commission. The document contained a summary description of certain credit risk characteristics of its Single Family book of business in chart form. Included in this chart were separate columns identifying Fannie Mae's subprime holdings and designating that 0.3% of its Single Family holdings were subprime loans. This supplemental disclosure did not inform investors of the additional subprime exposure from EA and MCM loans, or loans originated by the subprime divisions of large lenders. Fannie Mae

continued to issue credit supplements that were similarly false and misleading throughout the Relevant Period.

### *Mudd's False and Misleading Subprime Statements to the Media*

132. On December 2, 2007, Mudd spoke about Fannie Mae's subprime holdings in a newspaper interview published in the San Francisco Gate.

> Q: We know you very well for the fact that you have well-underwritten loans, fully amortizing, and that you either keep these loans in portfolio or guarantee them. So how are you having involvement with these subprime loans at all?
>
> A: I'll give you two pieces to understand it. The notion that there is a delineation between a lower prime loan and a high subprime loan are incorrect. There's a FICO score, there's an LTV (loan to value) and a bunch of other factors. We have about 2 percent of our broker's business in total that meets our definition of what would be a subprime loan, not a predatory loan, but typically a loan to an individual that has had a credit blemish in the past. We made a decision a few years ago that there were lots of creditworthy individuals who had a credit blemish which would have previously either disqualified them from a prime loan, or condemn them to a subprime lender. They were probably eligible for what we call affordability product. So we have about 2 percent of that business on our books, and that is how our involvement happened.

133. Mudd made these claims when he knew they were false and misleading. At the time that he made this statement, Mudd knew that the "2 percent" figure did not include billions of dollars in EA or MCM loans held by Fannie Mae. Mudd also knew that those undisclosed loans were specifically designed for "credit blemish[ed]" borrowers and that the figure could not reflect loans originated by the subprime division of large lenders, which by then the Company claimed to include in its reported subprime exposure.

### *Fannie Mae's False and Misleading Subprime Disclosures for Year-End 2007*

134. In February 27, 2008, Fannie Mae issued its 2007 Form 10-K, which was identical to prior disclosures but further included the following statement:

> Subprime mortgage loans, whether held in our portfolio or backing Fannie Mae MBS, represented less than 1% of our single-family business volume in each of 2007, 2006 and 2005. We estimate that subprime mortgage loans held in our

portfolio or subprime mortgage loans backing Fannie Mae MBS, excluding resecuritized private-label mortgage-related securities backed by subprime mortgage loans, represented approximately 0.3% of our total single-family mortgage credit book of business as of December 31, 2007, compared with 0.2% and 0.1% as of December 31, 2006 and 2005, respectively.

135. Approximately $55.6 billion worth of Fannie Mae's Single Family mortgage credit book of business consisted of EA loans as of December 31, 2007, and $38.8 billion in MCM loans—approximately 11 times greater than the 0.3% ($8.3 billion) disclosed as "sub-prime mortgage loans held in our portfolio or subprime mortgage loans backing Fannie Mae MBS" as of December 31, 2007.

136. Nothing in Fannie Mae's public disclosures alerted investors that this much larger volume of loans matched the Company's description of subprime loans but were not included in the reported quantitative number.

137. As of January 31, 2008, the serious delinquency rate of EA was 7.14%—performance that was worse than the disclosed subprime serious delinquency rate of 6.21% for the same period. By February 2008, it was clear from reports provided to all three defendants that credit losses from EA loans were "disproportionate to the amount of the book they constitute."

***Fannie Mae's False and Misleading first and second quarter 2008 filings***

138. On May 6, 2008, Fannie Mae filed its Form 10-Q first quarter 2008 and stated:

> Subprime mortgage loans, whether held in our portfolio or backing Fannie Mae MBS represented less than 1% of our single-family business volume for the first quarter of 2008 and 2007. We estimate that subprime mortgage loans held in our portfolio or subprime mortgage loans backing Fannie Mae MBS, excluding private-label mortgage-related securities backed by subprime mortgage loans, represented approximately 0.3% of our total single-family mortgage credit book of business as of both March 31, 2008 and December 31, 2007. (Emphasis added.)

139. Approximately $101 billion worth of Fannie Mae's Single Family mortgage credit book of business of March 31, 2008, consisted of undisclosed loans that fell within the company's description of subprime, and approximately $94.4 billion worth of Fannie Mae's Single Family mortgage credit book of business consisted of undisclosed loans as of December 31, 2007—approximately 12 times greater than the 0.3% ($8 billion as of March 31, 2008 and $8.3 billion as of December 31, 2007) disclosed as "subprime mortgage loans held in our portfolio or subprime mortgage loans backing Fannie Mae MBS" as of December 31, 2007.

140. Nothing in Fannie Mae's public disclosures alerted investors that this much larger volume of loans matched the Company's description of subprime loans, but were not included in the reported quantitative number.

141. By July 2008, Dallavecchia was emailing Mudd directly to highlight that EA and MCM were generating approximately 20% of the Company's credit losses.

142. As of the beginning of August 2008, EA and MCM were classified in internal Fannie Mae documents as two of Fannie Mae's top three highest-risk loan products and Fannie Mae made plans to eliminate the EA loan program as part of an attempt to improve the overall credit quality of its Single Family book of business.

143. This was not disclosed. Instead, on August 8, 2008, Fannie Mae filed its Form 10-Q for the second quarter 2008 and explained:

> Subprime mortgage loans, whether held in our portfolio or backing Fannie Mae MBS represented less than 1% of our single-family business volume for the first six months of 2008 and 2007. We estimate that subprime mortgage loans held in our portfolio or subprime mortgage loans backing Fannie Mae MBS, excluding resecuritized private-label mortgage-related securities backed by subprime mortgage loans, represented approximately 0.3% of our total single-family mortgage credit book of business as of both June 30, 2008 and December 31, 2007.

144. Approximately $60 billion worth of Fannie Mae's Single Family mortgage credit book of business consisted of EA loans and $41.7 billion in MCM loans as of June 30, 2008—approximately 12 times greater than the 0.3% ($8 billion) disclosed as "subprime mortgage loans held in our portfolio or subprime mortgage loans backing Fannie Mae MBS" as of both June 30, 2008 and December 31, 2007.

145. Nothing in Fannie Mae's public disclosures alerted investors to the fact this much larger volume of loans matched the Company's description of subprime loans but were not included in the reported quantitative number.

***Mudd Publicly Declares that Fannie Mae has Zero Subprime***

146. On August 20, 2008, Mudd falsely stated in a radio interview: Fannie Mae has "about zero percent" exposure to subprime loans, and "[s]ubprime to Fannie Mae means a loan to a borrower that has had a credit problem in the past." When Mudd made this statement, he knew that Fannie Mae had substantial exposure to loans made to borrowers who have had a credit problem in the past.

***Post-conservatorship Fannie Mae Acknowledges Additional Subprime Holdings***

147. After Fannie Mae had been placed into conservatorship on September 6, 2008, the Company made a disclosure that highlights the misleading nature of the Company's prior subprime reports. At the time this disclosure was made, neither Mudd nor Dallavecchia were at Fannie Mae and Lund, who remained EVP of the Single Family business until June 2009, was no longer a member of the Disclosure Committee.

148. On November 10, 2008, Fannie Mae filed its Form 10-Q for the third quarter and stated:

> We have classified mortgage loans as subprime if the mortgage loan is originated by a lender specializing in subprime business or by subprime divisions of large lenders. We apply these classification criteria in order to determine our ... subprime loan exposures; <u>however, we have other loans with some features that are similar to ... subprime loans that we have not classified as ... subprime because they do not meet our classification criteria.</u> (Emphasis added).

149. In this statement, for the first time the Company publicly acknowledged what Mudd, Lund and Dallavecchia had known throughout the Relevant Period; namely, that Fannie Mae held loans squarely within the public definition of subprime that it had not included in calculating its publicly disclosed exposure to subprime loans.

150. Based on the facts alleged above, Mudd, Lund and Dallavecchia, knew or were reckless in not knowing that Fannie Mae's statements disclosing its subprime holdings, and as to Mudd and Dallavecchia, their respective statements regarding Fannie Mae's subprime holdings, were false and misleading.

## FANNIE MAE'S ALT-A DISCLOSURE FRAUD

### *Fannie Mae Increases Market Share By Acquiring Reduced Documentation Alt-A Loans*

151. Fannie Mae acquired increasing amounts of reduced documentation loans. Prior to 2000, Fannie Mae had a limited market presence in purchasing reduced documentation loans, and those loans were not a large part of mortgage originations nationwide. This changed during the 2000s, and by 2007, reduced documentation loans were surging in popularity, representing approximately 40% of mortgage loan originations nationwide.

152. Traditionally, Fannie Mae's MBS dominated the nationwide mortgage-related securities market. However, by 2005, private label competition for mortgage-backed securities overtook Fannie Mae's MBS market dominance; as a result, Fannie Mae's nationwide share of mortgage loan originations fell from 40% in 2004 to 20% in 2005.

153. In response, at the end of 2005, Fannie Mae's board of directors instructed the Single Family business to adjust its business plan to gain back market share. The goal was to increase Single Family's purchases from 20% of total mortgage loan originations to at least 25% by the end of 2006. In an April 2006 meeting, Mudd directed the Single Family business to acquire more reduced documentation loans specifically, saying: "the market is moving to low documentation and we need to actively pursue the keys to this market."

154. Fannie Mae's push to increase its reduced documentation loans was dramatic. At the end of 2004, reduced documentation loans constituted 17.8% of Fannie Mae's Single Family loan acquisitions: by year-end 2005 that number was 20.2%, and by year-end 2006, 27.8% of Fannie Mae's Single Family loan acquisitions were reduced documentation loans. This represented a nearly 40% increase from 2005 and a greater than 50% increase from 2004.

***Fannie Mae Internally Tracked Its Loans With Low Or Alternative Documentation Requirements As Reduced Documentation Loans***

155. As described in internal Company records, documentation level is a key credit risk characteristic of a loan. Because Alt-A loans do not require that a borrower fully document their income, assets and/or employment, Alt-A loans have a greater risk of default than fully documented loans. Fannie Mae executives—including Mudd, Lund and Dallavecchia—regularly monitored the total reduced documentation loan acquisition trends at the Company and the attendant credit risk those loans presented via internal reports.

156. Mudd, for example, was well aware of the Company's increased acquisition of reduced documentation loans. An April 26, 2006 CEO credit risk briefing stated that of all loans acquired by Fannie Mae's Single Family business, 20.2% were reduced documentation loans at year-end 2005, and this number increased to 23.5% of acquisitions by February 2006. That same report noted that credit risks (such as reduced documentation) are a strong predictor of serious

delinquency within the first year of a loan's acquisition and therefore present significant credit risk.

157. Similarly, at the beginning of his tenure as CRO of Fannie Mae in June 2006, Dallavecchia was briefed on Fannie Mae's increasing stake in reduced documentation loans. Dallavecchia received a credit risk briefing that explained: Fannie Mae's Single Family business has seen an increase in "potentially riskier products like ... low documentation loans ... [and] Alt-A loans as a percent of total acquisitions increased from 11.5% in 2002 to 20.2% in 2005." That same presentation described this increase as an acquisition "trend" and noted Fannie Mae's Single Family plan for an "Alt-A push. Goal of $60B in 2006."

158. As a member of the Disclosure Committee, throughout the fall of 2006, Dallavecchia received draft versions of Fannie Mae's 2004 Form 10-K, which contained detailed acquisition data concerning reduced documentation mortgages, including quantitative exposure data that showed reduced documentation mortgages "represented approximately 18%, 20% and 24% of our single-family acquisitions in 2004, 2005, and the first half of 2006."

159. Likewise, throughout the Relevant Period, as EVP of the Single Family business, Lund was aware of Fannie Mae's increasing exposure to Alt-A loans. He received monthly reports that presented Fannie Mae's total reduced documentation loan exposure, which between 2006 and 2008 ranged from 13% to 21% of the Single Family mortgage book of business. Those loan acquisition reports were sometimes called the "Tom Lund Report."

160. During the Relevant Period, Lund's Single Family officers—from his Single Family Credit Risk officers to Product Management and Development executives—routinely prepared presentations and reports concerning not only Fannie Mae's increasing acquisitions of reduced documentation loans, but also the credit risks associated with those loans, including their

expected and actual SDQ rates. As the head of the Single-Family business, Lund had access to data and information prepared by his officers, as well as Early Warning reports—all of which conveyed, as described by his staff: "Low doc is more likely to default than full doc."

***Fannie Mae Failed to Report All The Reduced Documentation Loans That It Tracked Internally for Credit Risk Monitoring Purposes***

161. In its public filings, when it publicly disclosed the amount of reduced or alternative documentation loans it held, the Company did not report all of the reduced documentation loans that it tracked internally as one of seven key credit risks.

162. Each of the Defendants knew that approximately half of the reduced documentation loans in the Single Family book were not included when the Company reported its Alt- A loans.

163. When the Company internally tracked its reduced documentation loans it included loans that it referred to as "Special Lender Programs" or Lender-Selected loans. These were loans in which the lender ostensibly initiated the reduced documentation option for processing the loan. The Company also tracked "Other Low/No Doc loans," which are Borrower-Selected loans, or loans in which borrowers specifically requested loans for which minimal documentation was required.

164. When the Company reported its Alt-A holdings it failed to disclose all its reduced documentation loans: it disclosed Borrower-Selected loans but did not report its Lender-Selected loans. This limited disclosure misrepresented the extent of Fannie Mae's total exposure to reduced documentation loans.

165. On average throughout the Relevant Period, Lender-Selected Reduced Documentation Loans—the undisclosed Alt-A loans—had SDQ rates that were 1.4 times higher than full documentation loans with otherwise similar credit risks. Moreover, during the Relevant Period, certain types of Lender-Selected Reduced Documentation Loans that Fannie Mae acquired, such as Countrywide's *Fast and Easy* loans, had SDQ rates that were 2 times higher than full documentation loans with otherwise similar credit risks.

166. Fannie Mae's Alt-A disclosure misrepresented the extent of its reduced documentation high risk holdings as evidenced by the undisclosed loans from a single source of Lender-Selected reduced documentation loans. At year-end 2006, Fannie Mae had $102.5 billion worth of *Fast and Easy* loans alone on its Single Family book of business, which grew to $129.2 billion by year-end 2007, and by the end of the third quarter of 2008, Fannie Mae had $133.4 billion worth of *Fast and Easy* loans on its Single Family book of business. None of these loans, or other similar Lender-Selected reduced documentation loans, were ever disclosed to investors when the Company quantified its Alt-A exposure.

167. This single unreported Alt-A product from one customer—Countrywide—accounted for 4.63% of Fannie Mae's 2006 Single Family business, 5.10% in 2007 and 4.94% as of September 2008. As one of Lund's officers stated in a presentation: "CHL [Countrywide] sells whatever it can through Fast & Easy."

***Fannie Mae Failed To Disclose That The Company Directed Lenders When To Classify Loans as Alt-A***

168. Fannie Mae stated that it classified loans as "Alt-A if the lender that delivers the mortgage loans to us has classified the loans as Alt-A based on documentation or other product features." This reporting materially understated the extent of Fannie Mae's total exposure to reduced documentation loans.

169. Fannie Mae did not disclose that the Company directed lenders that delivered the mortgage loans to Fannie Mae's lender channel whether to label reduced documentation loans as Alt-A or not. The Alt-A classification, in practice, came from Fannie Mae and was executed by the originating lenders; the lenders did not make the coding determination.

170. Fannie Mae had contractual agreements with lenders that included instructions on when to code reduced documentation loans for delivery through its Lender Channel as Alt-A.

Occasionally, when a customer delivered loans to Fannie Mae's Lender channel with an Alt-A code that Fannie Mae had not prescribed for delivery for that loan type, Fannie Mae would instruct the customer to re-code its loans to remove the Alt-A code prior to accepting delivery.

171. Fannie Mae determined whether the lender classified the loan as Alt-A rather than accepting an Alt-A classification as designated by a lender

***Fannie Mae Issues a Series of False and Misleading Disclosures on Alt-A***

172. In its 2004 Form 10-K, which was filed on December 6, 2006, the Company disclosed that it had increased its holdings of reduced documentation loans, but did not quantify those holdings:

> We also have increased the proportion of reduced documentation loans that we purchase . . . we began to increase our participation in these product types where we concluded that it would be economically advantageous or that it would contribute to our mission objectives ... In addition, there has been an increasing industry trend towards streamlining the mortgage loan underwriting process by reducing the documentation requirements for borrowers. Reduced documentation loans in some cases present higher credit risk than loans underwritten with full standard documentation.

173. In its discussion of Alt-A, Fannie Mae did not disclose that the amount of "loans that are underwritten with lower or alternative documentation" in the Single Family mortgage credit book of business was $390 billion as of September 30, 2006, or the fact that by June 30, 2006, approximately 24% of Fannie Mae's Single Family loan acquisitions were reduced documentation loans.

174. As Fannie Mae prepared to file its 2005 Form 10-K in February 2007, Single Family officers working on the credit risk disclosures voiced concern: "Given Alt-A is an increasing as part of our business [*sic*] strategy and volume and this is the 2005 disclosure it seems to warrant more than a fairly benign reference, as is the case in the 2004 disclosure ... The decision now may very well be not to include numbers for this segment and just disclose an

increasing trend in words, but by the time we are done with 2006 we need to reflect the reality of the business."

175. During this time period, senior management at Fannie Mae recognized that investors wanted to know the Company's Alt-A exposure. In April 2007, the director of Investor Relations at Fannie Mae wrote an email acknowledging, "In anticipation of IR's 2005 10-K briefing with Dan and Bob tomorrow, we would like to get your direction on how management should address questions related to FNMs exposure to Alt-A product ... we expect the question to be asked and need to plan for it." (Emphasis added).

### *Fannie Mae's False and Misleading Alt-Disclosures in its May 9, 2007 Form 12b-25 Filing*

176. On May 9, 2007, for the first time, Fannie Mae disclosed a quantification of its Alt-A holdings in its Form 12b-25 filing. The Company defined Alt-A as loans with "lower or alternative documentation" and disclosed that it held 11% of Alt-A in its Single Family mortgage credit book of business. Fannie Mae stated:

> Although there is no uniform definition of Alt-A ... [Alt-A] loans generally are loans that are underwritten with lower or alternative documentation than a full documentation mortgage loan and that also may include other alternative features ... In reporting our Alt-A exposure, we have classified mortgage loans as Alt-A if the lenders that deliver the mortgage loans to us have classified the loans as Alt-A based on documentation or other product features, or, for the original or resecuritized private-label, mortgage-related securities that we hold in our portfolio, if the securities were labeled as Alt-A when sold. We estimate that approximately 11% of our total single-family mortgage credit book of business as of both March 31, 2007 and December 31, 2006 consisted of Alt-A mortgage loans or structured Fannie Mae MBS backed by Alt-A mortgage loans ... As described below in the discussion of our Capital Markets group, we also have invested in highly rated private-label mortgage-related securities backed by Alt-A loans. We estimate that approximately 1% of our total single-family mortgage credit book of business consisted of private-label mortgage-related securities backed by Alt-A mortgage loans as of both March 31, 2007 and December 31, 2006. (Emphasis added.)

177. The amount of Alt-A Fannie Mae publicly disclosed did not include the "lower or alternative documentation loans" that were internally referred to as Lender-Selected reduced document loans. Yet nothing in Fannie Mae's public disclosures alerted investors to the fact that a much larger volume of loans that matched the Company's description of its Alt-A holdings were excluded from the amount of Alt-A that the Company disclosed.

178. Fannie Mae's total exposure to loans with "lower or alternative documentation" (Alt-A) was actually 20.7% and 20.1% of its total Single Family mortgage credit book of business at March 31, 2007, and December 31, 2006, respectively, not 11% as disclosed. Fannie Mae's reporting of its Alt-A mortgage loans omitted approximately $219 billion and $201 billion worth of Fannie Mae's Single Family mortgage credit book of business which consisted of reduced documentation loans as of March 31, 2007, and December 31, 2006, almost equal to the volume of Single Family loans ($263 billion and $257 billion) that were disclosed as Alt-A.

***Fannie Mae's False and Misleading Alt-A Disclosures in its 2006 Form 10-K***

179. In June 2007, Lund's Single Family personnel prepared Single Family Credit Committee presentation materials, which acknowledged that, for internal Fannie Mae calculations, Fannie Mae's undisclosed Alt-A loan programs were treated as reduced documentation loans, not full document loans.

180. Even though senior management, including Mudd, Lund and Dallavecchia, recognized that Fannie Mae had an increasing volume of reduced documentation loans that performed as poorly as some loans disclosed as Alt-A, none of these loans were disclosed. On August 16, 2007, in its 2006 Form 10-K, the Company stated:

> *"Alt-A mortgage"* generally refers to a loan that can be underwritten with lower or alternative documentation than a full documentation mortgage loan but may also include other alternative product features. As a result, Alt-A mortgage loans generally have a higher risk of default than non-Alt-A mortgage loans. In

> reporting our Alt-A exposure, we have classified mortgage loans as Alt-A if the lenders that deliver the mortgage loans to us have classified the loans as Alt-A based on documentation or other product features, or, for the original or resecuritized private-label, mortgage-related securities that we hold in our portfolio, if the securities were labeled as Alt-A when sold ...We estimate that approximately 11% of our total single-family mortgage credit book of business as of December 31, 2006 consisted of Alt-A mortgage loans or structured Fannie Mae MBS backed by Alt-A mortgage loans. This percentage increased to approximately 12% as of June 30, 2007 ... We estimate that private label mortgage-related securities backed by Alt-A loans ... accounted for approximately 1% (and 2% respectively) ... of our single-family mortgage credit book of business as of June 30, 2007. (Emphasis added.)

181. At the time of this disclosure, Fannie Mae's total exposure to loans with "lower or alternative documentation" (Alt-A) was actually 22% of its total Single Family mortgage credit book of business, not 12% as disclosed. Fannie Mae's reporting of its Alt-A omitted approximately $238 billion worth of Fannie Mae's Single Family mortgage credit book of business, which consisted of reduced document loans as of June 30, 2007— almost equal to the $296 billion that was disclosed as Alt-A.

***Fannie Mae's False and Misleading Alt-A Disclosures in its first, second and third quarter 2007 10-Qs***

182. By October 2007, reduced documentation loans comprised 29.1% of Fannie Mae's Single Family loan acquisition volume and 22% of the Single Family mortgage credit book of business.

183. Nevertheless, on November 9, 2007, in its 2007 Forms 10-Q for the first quarter, the Company disclosed:

> As of March 31, 2007, we estimate that approximately 11% of our total single-family mortgage credit book of business consisted of Alt-A mortgage loans or Fannie Mae MBS backed by Alt-A mortgage loans. This percentage increased to approximately 12% as of September 30, 2007 ... As of March 31, 2007, we held in our investment portfolio approximately $34.5 billion in private-label mortgage-related securities backed by Alt-A mortgage loans.

184. On that same day, November 9, 2007, Fannie Mae also filed its 2007 Forms 10-Q for the second and third quarter, the Alt-A disclosures for which were comparable to the 2007 Form 10-Q for the first quarter.

185. Fannie Mae's total exposure to loans with "lower or alternative documentation" (Alt-A) was actually 22% of its total Single Family mortgage credit book of business, not 12% as disclosed. Fannie Mae's reporting of its Alt-A omitted approximately $267 billion worth of Fannie Mae's Single Family mortgage credit book of business which consisted of reduced document loans as of September 30, 2007— almost equal to the $306 billion that was disclosed as Alt-A.

186. On November 9, 2007, for the quarter ended September 30, 2007, Fannie Mae also filed a Form 8-K credit supplement with the Commission. The document contained a summary description of certain credit risk characteristics of its Single Family book of business in chart form. Included in this chart was a separate column identifying Fannie Mae's Alt-A holdings, and designating that 12.5% of its Single Family mortgage credit book of business were Alt-A loans. Nowhere in this supplemental disclosure was there any statement to suggest that Single Family holdings included billions of dollars of additional reduced documentation loans that were not reflected in the 12.5% figure. Fannie Mae continued to issue credit supplements that were similarly misleading throughout the Relevant Period.

***Fannie Mae's False and Misleading Disclosure in its Year-End 2007 10-K Filing***

187. On February 27, 2008, in its 2007 Form 10-K, the Company repeated its prior statement on Alt-A and updated its reporting as follows:

> Alt-A mortgage loans, whether held in our portfolio or backing Fannie Mae MBS, represented approximately 16% of our single-family business volume in 2007, compared with approximately 22% and 16% in 2006 and 2005, respectively.

188. Fannie Mae's total volume of loans with "lower or alternative documentation" (Alt-A) was actually 37% of its Single Family acquisitions, not 16% as disclosed.

189. On May 6, 2008, in its 2008 Form 10-Q for the first quarter, the Company stated:

> Alt-A mortgage loans, whether held in our portfolio or backing Fannie Mae MBS represented approximately 4% of our single-family business volume for the first quarter of 2008, compared with approximately 23% for the first quarter of 2007. Alt-A mortgage loans held in our portfolio or Alt-A mortgage loans backing Fannie Mae MBS, excluding resecuritized private-label mortgage-related securities backed by Alt-A mortgage loans, represented approximately 11% of our total single-family mortgage credit book of business as of March 31, 2008, compared with approximately 12% as of December 31, 2007.

190. Fannie Mae's total exposure to loans with "lower or alternative documentation" (Alt-A) was actually 22% of its total Single Family mortgage credit book of business, not 11% as disclosed. Fannie Mae's reporting of its Alt-A loans omitted approximately $323 billion worth of mortgage loans in Fannie Mae's Single Family mortgage credit book of business that consisted of reduced document loans as of March 31, 2008— more than the $300 billion that was disclosed as Alt-A.

191. As of December 2007, 23% of Fannie Mae's Single Family mortgage credit book of business consisted of reduced documentation loans, not the 11% reported in the public filing.

192. Approximately two and a half months after the 2008 Form 10-Q filing, in July 29, 2008, Lund held a staff meeting which addressed issues related to reduced documentation loans. Countrywide's *Fast and Easy* program—a Lender-Selected loan program whose loans were tracked as a reduced document high risk loan internally but excluded from Fannie Mae's public disclosure of its Alt-A exposure— was specifically discussed in the presentation. The briefing addressed that these loans performed as poorly as some loans that were disclosed as Alt-A.

Despite this knowledge, *Fast and Easy* loans were not disclosed as part of Fannie Mae's Alt-A exposure, and Lund continued to sub-certify Fannie Mae's public statements.

193. By August 2008, and before the filing of its 2008 Form 10-Q for the second quarter, Fannie Mae was planning to eliminate its high risk products, including Alt-A. The Company still did not disclose its total Alt-A loans.

194. On August 8, 2008, in its 2008 Form 10-Q for the second quarter, its final filing before conservatorship, the Company stated:

> Alt-A mortgage loans, whether held in our portfolio or backing Fannie Mae MBS represented approximately 4% of our single-family business volume for the first six months of 2008, compared with approximately 22% for the first six months of 2007 ... Alt-A mortgage loans held in our portfolio or Alt-A mortgage loans backing Fannie Mae MBS, excluding resecuritized private-label mortgage-related securities backed by Alt-A mortgage loans, represented approximately 11% of our total single-family mortgage credit book of business as of June 30, 2008, compared with approximately 12% as of December 31, 2007.

195. Fannie Mae's total exposure to loans with "lower or alternative documentation" (Alt-A) was actually 23% of its total Single Family mortgage credit book of business, not 11% as disclosed. Fannie Mae's reporting of its Alt-A omitted approximately $341 billion worth of Fannie Mae's Single Family mortgage credit book of business which consisted of reduced documentation loans as of June 30, 2008—more than the $306 billion that was disclosed as Alt-A to investors on August 8, 2008.

***Post-conservatorship Fannie Mae Acknowledges Additional Alt-A Holdings***

196. In its first periodic filing post-conservatorship, Fannie Mae made a disclosure that highlights the misleading nature of the Company's prior Alt-A disclosures. At the time this disclosure was made neither Mudd nor Dallavecchia were at Fannie Mae, and Lund, who remained EVP of the Single Family business, was no longer a member of the Disclosure Committee. The Company explained:

We have classified mortgage loans as Alt-A if the lender that delivers the mortgage to us has classified the loans as Alt-A based on documentation or other features ... We apply these classification criteria in order to determine our Alt-A ... loan exposure[ ]; however, we have other loans with some features that are similar to Alt-A ... that we have not classified as Alt-A ... because they do not meet our classification criteria. (Emphasis added.)

197. In this statement for the first time the Company publicly acknowledged what Mudd, Lund and Dallavecchia had known throughout the Relevant Period, that it held loans that matched its public definition of Alt-A, but had not included them when reporting its Alt-A exposure:

198. Based on the facts alleged above, Mudd, Lund and Dallavecchia, knew or were reckless in not knowing that Fannie Mae's statements reporting Alt-A were false and misleading.

**FIRST CLAIM FOR RELIEF**
**VIOLATION OF SECTION 10(b) OF THE EXCHANGE ACT AND RULE 10b-5(b)**
**(MUDD)**

1. Paragraphs 1 through 198 are realleged and incorporated by reference as if set forth fully herein.

2. Mudd directly or indirectly, by use of the means or instrumentalities of interstate commerce, or by use of the mails, or of the facilities of a national securities exchange, in connection with the purchase or sale of Fannie Mae securities, knowingly or recklessly, has made untrue statements of material facts or omitted to state material facts necessary in order to make statement made, in the light of the circumstances under which they were made, not misleading.

3. By reason of the foregoing, Mudd directly or indirectly has violated, and unless enjoined will again violate, Section 10(b) of the Exchange Act (15 U.S.C. § 78j(b)) and Rules 10b-5(b) thereunder (17 C.F.R. § 240.10b-5(b)).

**SECOND CLAIM FOR RELIEF**

**VIOLATION OF SECTION17(A)(2) OF THE SECURITIES ACT**

**(MUDD AND DALLAVECCHIA)**

4. Paragraphs 1 through 198 are realleged and incorporated by reference as if set forth fully herein.

5. Mudd and Dallavecchia, directly or indirectly, in the offer and sale of Fannie Mae securities, by use of the means and instruments of transportation and communication in interstate commerce and by use of the mails, knowingly, recklessly or negligently have obtained money or property by means of untrue statements of material fact or omissions to state material facts necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading.

6. By reason the foregoing, Mudd and Dallavecchia have violated, and unless enjoined will again violate, Sections 17(a)(2) of the Securities Act (15 U.S.C. § 77q(a)(2)).

**THIRD CLAIM FOR RELIEF**

**AIDING AND ABETTING VIOLATIONS OF SECTION 10(b) OF THE EXCHANGE ACT AND RULE10b-5(b)**

**(MUDD, DALLAVECCHIA AND LUND)**

7. Paragraphs 1 through 198 are realleged and incorporated by reference as if set forth fully herein.

8. Fannie Mae and Mudd, directly or indirectly, by use of the means or instrumentalities of interstate commerce, or by use of the mails, or of the facilities of a national securities exchange, in connection with the purchase or sale of Fannie Mae securities, knowingly or recklessly, has made untrue statements of material facts or omitted to state material facts necessary in order to make statement made, in the light of the circumstances under which they were made, not misleading.

9. Mudd, Dallavecchia and Lund acted knowingly or recklessly and provided substantial assistance to and thereby aided and abetted Fannie Mae in its violations of Exchange Act Section 10(b) and Rule 10b-5(b); [17 C.F.R. § 240.10b-5(b)]; therefore, each is liable pursuant to Exchange Act Section 20(e) [15 U.S.C. § 78t(e)].

10. Dallavecchia and Lund acted knowingly or recklessly and provided substantial assistance to and thereby aided and abetted Mudd in his violations of Exchange Act Section 10(b) and Rule 10b-5(b); [17 C.F.R. § 240.10b-5(b)]; therefore, each is liable pursuant to Exchange Act Section 20(e) [15 U.S.C. § 78t(e)].

11. Unless restrained and enjoined, Mudd, Dallavecchia and Lund will continue to aid and abet violations of Section 10(b) of the Exchange Act (15 U.S.C. § 78j(b)) and Rules 10b-5(b) thereunder (17 C.F.R. § 240.10b-5(b)).

**FOURTH CLAIM FOR RELIEF**
**VIOLATION OF EXCHANGE ACT RULE 13A-14(A)**
**(MUDD)**

12. Paragraphs 1 through 198 are realleged and incorporated by reference as if set forth fully herein.

13. On December 6, 2006, May 2, 2007, August 16, 2007, and February 27, 2008, Mudd signed false certifications of Fannie Mae Forms 10-K, and on November 9, 2007, May 6, 2008, and August 8, 2008, Mudd signed false certifications of Fannie Mae Forms 10-Q. Each of those Forms 10-K and Forms 10-Q certifications Mudd made were pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 and Rule 13a-14(a) promulgated thereunder. His certifications falsely stated that: he had reviewed each report; based upon his knowledge, the reports did not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not

misleading; and based upon his knowledge, the financial statements and information contained in each report fairly present in all material respects the financial condition, results of operations and cash flows of the registrant.

14. By reason of the foregoing, Mudd violated, and unless restrained and enjoined will continue to violate, Exchange Act Rule 13a-14(a) (17 C.F.R. § 240.13a-14) promulgated under Section 302 of the Sarbanes-Oxley Act of 2002.

**FIFTH CLAIM FOR RELIEF**
**AIDING AND ABETTING VIOLATIONS OF SECTION 13(A) OF THE EXCHANGE ACT AND RULES 12B-20, 13A-1 AND 13A-13**
**(MUDD, DALLAVECCHIA AND LUND)**

15. Paragraphs 1 through 198 are realleged and incorporated by reference as if set forth fully herein.

16. Section 13(a) of the Exchange Act and Rule 13a-1 and Rule 13a-13 thereunder requires issuers of registered securities to file with the Commission factually accurate current and quarterly reports. Exchange Act Rule 12b-20 provides that in addition to the information expressly required to be included in a statement or report, there shall be added such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made, not misleading.

17. Fannie Mae violated Exchange Act § 13(a) [15 U.S.C. § 78m(a)] and Exchange Act Rules 12b-20, 13a-1 and 13a-13 (17 C.F.R. §§ 240.12b-20, 240.13a-1, and 240.13a-13).

18. By reason of the foregoing, Mudd, Dallavecchia and Lund acted knowingly or recklessly and provided substantial assistance to and thereby aided and abetted Fannie Mae's violations of Section 13(a) of the Exchange Act (15 U.S.C. § 78m(a)) and Exchange Act Rules 12b-20, 13a-1 and 13a-13 (17 C.F.R. §§ 240.12b-20, 240.13a-1, and 240.13a-13); therefore, each is liable pursuant to Exchange Act Section 20(e) [15 U.S.C. § 78t(e)].

## PRAYER FOR RELIEF

WHEREFORE, the Commission respectfully requests that this Court:

(a) Permanently restrain and enjoin defendant Mudd from violating Section 17(a)(2) of the Securities Act of 1933, 15 U.S.C. §77q(a) ("the Securities Act"), Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b) ("the Exchange Act") and Exchange Act Rule 10b-5, 17 C.F.R. §240.10b-5, Section 13(a) of the Exchange Act, 15 U.S.C. § 78m(a), and Exchange Act Rules 12b-20 and 13a-13,17 C.F.R. §§ 240.12b-20, 240.13a-13 and Exchange Act Rule 13a-14(a) (17 C.F.R. § 240.13a-14), and aiding and abetting Fannie Mae's violation of Section 10(b) of the Exchange Act and Exchange Act Rule 10b-5.

(b) Permanently restrain and enjoin defendant Dallavecchia from violating Section 17(a)(2) of the Securities Act, aiding and abetting Fannie Mae's and Mudd's violations of Section 10(b) of the Exchange Act and Exchange Act Rule 10b-5, and aiding and abetting Fannie Mae's violation of Section 13(a) of the Exchange Act and Exchange Act Rules 12b-20, 13a-1 and 13a-13.

(c) Permanently restrain and enjoin defendant Lund from aiding and abetting Fannie Mae's and Mudd's violations of Section 10(b) and Rule 10b-5, aiding and abetting Fannie Mae's violation of Section 13(a) of the Exchange Act and Exchange Act Rules 12b-20, 13a-1 and 13a-13.

(d) Order defendants Mudd, Dallavecchia and Lund to pay disgorgement, together with prejudgment interest;

(e) Order defendants Mudd, Dallavecchia and Lund to pay penalties pursuant to Section 20(d) of the Securities Act [15 U.S.C. § 77t(d)] and Section 21(d)(3) of the Exchange Act [15 U.S.C. § 78u(d)(3)];

(f) Permanently bar defendants Mudd, Dallavecchia and Lund, pursuant to Section 20(e) of the Securities Act [15 U.S.C. §77t(e)] and Section 21(d)(2) of the Exchange Act (15 U.S.C. § 78u(d)(2)), from acting as an officer or director of any issuer that has a class of securities registered under Section 12 of the Exchange Act (15 U.S.C. § 78l) or that is required to file reports pursuant to Section 15(d) of the Exchange Act (15 U.S.C. § 78o(d)); and

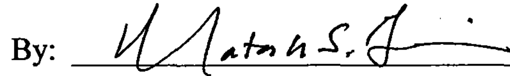
(g) Grant such other relief as this Court may deem necessary and proper.

Dated: December 16, 2011

Washington, D.C.

Respectfully Submitted,

UNITED STATES SECURITIES AND
EXCHANGE COMMISSION

By: 

Natasha S. Guinan (4320636)
Sarah L. Levine
James A. Kidney
Stephen L. Cohen
Charles E. Cain

100 F Street, N.W.
Washington, D.C. 20549
Tel.: (202) 551-4572 (Guinan)
Fax: (202) 772-9236 (Guinan)
E-mail: GuinanN@sec.gov