

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 8850 / September 27, 2007

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 2729 / September 27, 2007

ADMINISTRATIVE PROCEEDING
File No. 3-12842

In the Matter of

ROBERT C. DEAN

Respondent.

**ORDER INSTITUTING
CEASE-AND-DESIST PROCEEDINGS,
MAKING FINDINGS, AND IMPOSING
REMEDIAL SANCTIONS AND A
CEASE-AND-DESIST ORDER
PURSUANT TO SECTION 8A OF THE
SECURITIES ACT OF 1933**

I.

The Securities and Exchange Commission (“Commission”) deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities of 1933 (“Securities Act”) against Robert C. Dean (“Dean” or “Respondent”).

II.

In anticipation of these proceedings, Respondent has submitted an Offer of Settlement to the Commission (herein “Offer”), which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission’s jurisdiction over him and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Cease-and-Desist Proceedings, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Section 8A of the Securities Act of 1933 (“Order”), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds that:

Summary

This matter concerns Respondent's role in altering the method by which the Federal Home Loan Mortgage Corporation ("Freddie Mac" or "Company") valued certain derivatives known as swaptions at year-end for its fiscal year 2000. As a result of the change in methodology, Freddie Mac issued materially false and misleading financial statements.

Respondent

1. Robert C. Dean, age 42, was a Vice President of Freddie Mac from February 1998 through June 2000 and a Senior Vice President of the Company from June 2000 through October 2003, when he resigned from the Company. His duties included work in Freddie Mac's Market Risk Oversight department.

Other Relevant Entities

2. Freddie Mac, was chartered by Congress in 1970 by the Federal Home Loan Mortgage Corporation Act ("Act"). Its principal place of business is in McLean, Virginia. Congress created Freddie Mac to provide stability in the secondary market for residential mortgages by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing.

Background

3. In June 1998, the Financial Accounting Standards Board ("FASB") released Statement of Financial Accounting Standards No. 133 ("SFAS 133"), which related to accounting for derivative instruments and hedging activities. Derivatives are financial instruments, such as options or futures contracts, whose value depends on the value of another "underlying" security or asset. Financial companies such as Freddie Mac frequently use derivatives to manage interest rate and other risk. SFAS 133 provided generally that, commencing January 1, 2001, holders of derivatives must account for such assets at fair value. SFAS 133 also set out detailed rules concerning when a company could use hedge accounting to account for the changes in the value of a derivative as hedging the change in the fair value or future cash flows of a hedged asset or liability. The requirements of SFAS 133 represented a significant change from the accounting practices required by GAAP before SFAS 133 was issued.

4. For Freddie Mac, a major holder of derivatives subject to SFAS 133, the new standard required the Company to revalue and "mark to market" (i.e., report at actual quoted market prices or estimated market value) its portfolio of derivatives every reporting period. Changes in the fair value of certain derivatives were required by SFAS 133 to be recorded as income or loss on the Company's income statement.

5. Absent action by Freddie Mac, the adoption of SFAS 133 would have resulted in the Company reporting a large one-time gain effective January 1, 2001, because the fair value of its derivatives portfolio greatly exceeded the book value and, thereafter, it would have been required to mark to market certain derivatives, thereby introducing a new component of volatility that complicated the Company's ability to maintain steady and predictable reported earnings.

Changes in the Methodology for Valuing Swaptions

6. Consistent with the Company's general policy of reporting steady and predictable earnings growth, the Company reacted to SFAS 133 by setting a goal to minimize the transitional effects of SFAS 133 – i.e., the transition gain that would be reported effective January 1, 2001. On December 12, 2000, several days after brainstorming alternative ways to reduce the transition gain, Respondent suggested that the Company could record a lower valuation – and thus reduce its transition gain – if it altered the method by which it valued its swaptions. Beginning on or about December 22, 2000, in a series of memoranda written by or in consultation with Respondent, the Company undertook to revise its methodology for valuing its swaptions portfolio, incorporating the unproven premise that prevailing market prices were not indicative of where the Company could conduct transactions in the swaptions market.

7. On January 2, 2001, the Company formally adopted a revised methodology for valuing swaptions. The new methodology – which the Company used to calculate the fair value that was reported in its year-end financial statements – used volatility values from November 20, 2000, a date six weeks prior to January 1, 2001. This contributed to the Company's swaptions portfolio being valued approximately \$731 million less than it would have been had the Company used current market implied volatilities, i.e., values from December 29, 2000, the last business day of the year. The Company premised its use of November 20 pricing data on (i) the market for swaptions purportedly being illiquid as of December 29, 2000 to a degree seen only during certain historic events, and (ii) the Company purportedly being unable to transact business in swaptions at prices derived through implied volatility reported in the then-current market.

8. Respondent and others developed a test to support the illiquidity premise. The test involved retroactively comparing the daily percentage changes in implied volatility levels of swaptions to their five-year historical standard deviation, or differences from mean values. The stated purpose of this test was to show that the frequency and magnitude of changes in implied volatilities during November and December 2000 were unprecedented versus other prior market liquidity crises. When the critical standard deviation parameter of this test failed to “prove” the requisite historic market illiquidity at three standard deviations, the test was altered until it showed the swaptions market was at historically illiquid levels. The final test used two standard deviations.

9. Respondent initiated the concept and significantly contributed to the development of the Company's revised methodology for calculating the fair value of its swaptions portfolio. It was formally approved by Respondent and others, and it was adopted in the preparation of the Company's year-end financial statements.

10. Respondent negligently approved the use of the methodology that resulted in the swaptions valuation being materially understated, despite his knowledge of certain facts that should have called into question the validity of the methodology and its suitability for determining the fair value of the Company's swaptions. Among other things, Respondent:

- a. knew the Company had not previously deviated from the use of current market implied volatilities, but rather, the Company generally used for its swaptions valuation model current end-of-day market inputs from the Independent Swaptions Pricing Service.
- b. was not aware of any company that had ever used historical data to price a portfolio of swaptions.
- c. knew the methodology was not used in connection with the Company's risk management practices and activities throughout the period whereas the revised methodology was used for accounting purposes.
- d. should have known that the methodology improperly reduced the Company's reported transition gain and therefore did not result in the swaptions being reported at a reasonable estimate of their fair value at year-end as required by GAAP, and that the circumstances surrounding the development of the valuation methodology created substantial risk that the swaptions would not be disclosed at their fair value on the balance sheet date as required by GAAP.

Effect on Reported Results

11. The changed valuation method enabled Freddie Mac to value its swaptions at a value approximately \$731 million lower than would have been if current market implied volatilities (i.e., December 29, 2000 volatilities) had been used, thus offsetting approximately \$731 million of the SFAS 133 transition gain and causing the following reported financial metrics to be materially misstated in Freddie Mac's Information Statement and Annual Report for 2000:

- a. "Futures and Options" in Table 10 were valued at \$2.008 billion; the value using year-end volatilities (the historically utilized method) was \$2.739 billion – a 26.7% understatement.
- b. "Total—Net Fair Value" of derivatives in the same table was negative \$257 million; this figure should have been \$474 million.
- c. "Gross Positive Fair Value" of Futures and Options in Table 9-3 in the notes to the financial statements shows a value of \$2.187 billion; using year-end volatilities, it would have been \$2.918 billion – a 25.1% understatement.

- d. The “Gross Positive Fair Value” of Freddie Mac’s derivatives portfolio in the same table was \$6.312 billion; using year-end volatilities, it would have been \$7.033 billion – a 10.4% understatement.

These misstated financial statements were included in offerings of debt securities by Freddie Mac.

12. As a result of the conduct described above, Respondent violated Sections 17(a)(2) and (3) of the Securities Act.

IV.

In view of the foregoing, the Commission deems it appropriate to accept the Offer submitted by Respondent and to impose the sanctions agreed to in Respondent’s Offer.

Accordingly, it is hereby ORDERED that:

Pursuant to Section 8A of the Securities Act, Respondent Dean shall cease and desist from committing or causing any violations and any future violations of Sections 17(a)(2) and (3) of the Securities Act.

By the Commission.

Nancy M. Morris
Secretary