

UNITED STATES DISTRICT COURT
DISTRICT OF DISTRICT OF COLUMBIA

In Re Fannie Mae Securities Litigation

Consolidated Civil Action No. 1:04-cv-01639

Judge Richard Leon

**DEFENDANT FANNIE MAE'S MEMORANDUM OF LAW IN SUPPORT OF ITS
MOTION TO DISMISS THE CONSOLIDATED CLASS ACTION COMPLAINT**

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I.
INTRODUCTION

Although the Consolidated Class Action Complaint (the “Complaint”) is over 250 pages long, it is largely copied from a September 17, 2004, report issued by the Office of Federal Housing Enterprise Oversight (“OFHEO”) and, to increase its bulk, includes *over 140 pages* of verbatim reprints of certain of Fannie Mae’s public disclosures. Beyond that, it contains little more than the conclusions by OFHEO that Fannie Mae misinterpreted and misapplied two extraordinarily complex Financial Accounting Standards Board (“FASB”) provisions—FAS 91 (as defined herein) and FAS 133 (as defined herein) — resulting in misapplication of Generally Accepted Accounting Principles (“GAAP”) and ultimately requiring Fannie Mae to restate its 2001 through mid-2004 financial results.

The Complaint should be dismissed for the following reasons:

- (1) the mere fact that Fannie Mae has agreed to restate its financials—without more—is insufficient to state a claim for securities fraud;
- (2) plaintiffs fail to plead any specific facts supporting an inference that Fannie Mae’s alleged misapplication of FAS 133 was made with scienter, the requisite mental state for any claim for securities fraud;
- (3) plaintiffs’ FAS 91 allegations are (a) barred by the statute of limitations, (b) otherwise so vague and conclusory as to render them inactionable as a matter of law, and (c) lack facts sufficient to support a strong inference of scienter;
- (4) plaintiffs’ allegations concerning Fannie Mae’s internal controls are insufficient to support a strong inference of scienter;
- (5) plaintiffs fail to plead “loss causation” in accordance with recent Supreme Court authority.

We summarize each of these grounds for dismissal below.

First, it is well-settled that the mere existence of an accounting restatement is insufficient to state a claim for securities fraud. A restatement of earnings, most often, is the result of an accounting *error*. It cannot be overemphasized that plaintiffs must show that the misapplication

of GAAP and upcoming restatement were the result of *fraud*, and not simply the product of *mistake*. Mistakes are not securities fraud. This is especially so here as FAS 133 “is notorious for being the most complex of any of the FASB’s pronouncements.” (Ira G. Kawaller, *What Analysts Need to Know about Accounting for Derivatives*, Financial Analysts Journal, Mar. 1, 2004, at 24; Stern Decl. ¶ 21.)

Second, plaintiffs’ allegations regarding Fannie Mae’s implementation of FAS 133, without more, are simply insufficient to establish a strong inference of scienter. The potential for error in applying FAS 133 was extraordinary. Many commentators voiced the widely held view that FAS 133 is a complicated, lengthy and difficult accounting provision to implement. *See id.*; *see also* (See Office of Thrift Supervision, *FAS No. 133 and Its Impact on Risk Management*, The Q. Rev. of Interest Rate Risk (Fourth Quarter, 2004), at 5 (“FAS 133 is a complex accounting standard (which spans nearly 900 pages, including appendixes and Derivative Implementation Group issues), and even the most well intentioned firm may not meet the requirements to avail itself the *privilege* to use hedge accounting.”); Stern Decl. ¶ 30.)

Given the complexity of interpreting and applying FAS 133, Fannie Mae sought guidance from its independent auditors, KPMG, who possessed specialized expertise in FAS 133, who approved Fannie Mae’s complex policy manual for applying FAS 133 to its derivative accounting, and who provided Fannie Mae with clean audit opinions throughout the class period. In fact, Fannie Mae’s application of FAS 133, and its financial results as a whole, were reviewed by KPMG throughout the class period. The Complaint contains no allegations that even remotely suggest that KPMG was misled by Fannie Mae, that Fannie Mae failed to provide any relevant information to KPMG, or that KPMG itself was engaged in a fraud with Fannie Mae to misstate Fannie Mae’s financial results. These facts affirmatively negate any suggestion that Fannie Mae acted with intent to deceive.

In addition to KPMG’s extensive involvement, OFHEO, the agency charged by Congress

with overseeing the safety and soundness of Fannie Mae, monitored Fannie Mae's operations, including the FAS 133 issues here. Every year, OFHEO conducts an examination of Fannie Mae's business, evaluating a variety of metrics, specifically including its use of and accounting for derivatives. In 2002, as part of its annual audit, OFHEO reviewed Fannie Mae's: (1) compliance with GAAP, and FAS 133 in particular, (2) internal and external audit program (involving, among other things, an audit of Fannie Mae's internal controls), and (3) board governance issues. (*See generally* OFHEO Report to Congress, June 15, 2002 ("2002 OFHEO Report") at 21-42 (detailing OFHEO's examination of Fannie Mae's operations); Stern Decl. ¶ 2). OFHEO concluded that Fannie Mae's "FAS 133 implementation has been deliberate and well-documented with the necessary investments made to provide systems needed to ensure ongoing compliance." (*Id.* at 29.) Simply put, Fannie Mae's accounting and implementation of FAS 91 and FAS 133 was open and transparent to its auditors and regulator—facts wholly inconsistent with fraud.

Further negating any inference of fraud concerning Fannie Mae's application of FAS 133 is the fact that during each financial reporting period, Fannie Mae disclosed to the market not only its GAAP results, but pro forma "core business earnings," which presented the Company's financial condition without the application of FAS 133. As Fannie Mae repeatedly and consistently disclosed throughout the class period—and the Complaint nowhere refutes—the "core business earnings" presentation provided investors with a more accurate picture of Fannie Mae's financial status and was the exclusive measure that the Company used internally to run its operations. Leading Wall Street analysts relied on Fannie Mae's "core business earnings" as opposed to GAAP results in presenting financial data and analysis to the investing public. It defies logic to suggest that Fannie Mae intentionally misstated GAAP earnings while simultaneously issuing core earnings and promoting them as a better measure of its financial performance. Put differently, if Fannie Mae were attempting to mislead investors by overstating

GAAP earnings through a misapplication of FAS 133, it never would have published core earnings. Fannie Mae doggedly insisted on it.

Third, the bulk of plaintiffs' FAS 91 allegations involve events that occurred in 1998, and are therefore barred by the 5-year statute for repose for claims under Section 10(b) of the Securities Exchange Act of 1934. The remainder of plaintiffs' allegations concerning FAS 91 are too vague and conclusory to support a claim for securities fraud. In particular, plaintiffs fail to tie any of these remaining FAS 91 allegations to any specific misstatements or omissions. Plaintiffs simply fail to plead how these alleged misapplications of FAS 91 had *any* impact on Fannie Mae's financial statements, much less that such an impact was material. Moreover, plaintiffs have not alleged facts sufficient to support a strong inference of scienter concerning Fannie Mae's application of FAS 91. As with FAS 133, Fannie Mae's treatment of FAS 91 was transparent to its auditors and regulator. Perhaps in recognition that these facts are inconsistent with intent to commit securities fraud, plaintiffs resort to the testimony of Roger Barnes, a disgruntled former Fannie Mae employee who purportedly raised "red flags" that Fannie Mae allegedly ignored about its GAAP accounting. These allegations are flatly contradicted by judicially noticeable facts and establish.

Fourth, plaintiffs' attempts to bolster their scienter allegations through allegations of weak internal controls are insufficient to support a strong inference of scienter as a matter of law. Such allegations—even if true—are the stuff of negligence, not fraud. Here, Fannie Mae's regulator routinely reviewed their internal controls and continually found them to be adequate until September of 2004. Any notion that Fannie Mae recklessly disregarded the possibility that its internal controls were inadequate is belied by judicially noticeable facts.

Finally, plaintiffs fail to plead loss causation—the causal connection between the alleged misrepresentation or omissions and the investors' alleged economic loss—that is an essential element of a claim for securities fraud. Under the standards recently announced by the U.S.

Supreme Court in *Dura Pharms. Inc. v. Broudo*, 125 S.Ct. 1627 (2005), a plaintiff must establish that the alleged misrepresentation, not other factors, actually caused the loss. Here, plaintiffs cannot allege that the stock drop that terminates the class period is related to the purported “fraud” alleged in the Complaint. Fannie Mae’s stock price did not react to its reported GAAP financial results, but rather reacted to several other unrelated factors. Without specific credible allegations that the decline in Fannie Mae’s stock price was the result of the Company having allegedly misapplied GAAP, plaintiffs cannot state a claim for securities fraud under the Private Securities Litigation Reform Act (“PSLRA”) as a matter of law.

II. STATEMENT OF FACTS

A. Fannie Mae’s Mission

Fannie Mae was established in 1938 as a United States government-owned entity to provide liquidity in the secondary mortgage market and make mortgages more accessible for low- and middle-income Americans. (*See* Fannie Mae, Form 10-K filed for the period ending December 31, 2002, March 31, 2003 (“2002 10-K”) at 1; Stern Decl. ¶ 9.) In 1968, Congress amended Fannie Mae’s charter to make it a shareholder-owned company. (*Id.*) To this day, the Company remains one of two (the other being Freddie Mac) federally-chartered government-sponsored enterprises (“GSEs”) that serve the important public policy of expanding homeownership to moderate- and low-income families. (*Id.*)

Among other things, Fannie Mae meets its mission by supplying capital and liquidity for residential mortgages. (*See* Fannie Mae 2001 Annual Report (“2001 Annual Report”) at 5; Stern Decl. ¶ 6.) The additional capital and liquidity provided by Fannie Mae, in turn, increases the market for 30-year fixed-rate mortgages and frees up banks’ limited capital, allowing them to make more loans. (Compl. ¶ 32.) In this way, Fannie Mae increases the availability of mortgages to working-class Americans and, at the same time, reduces the interest rates paid by

homeowners.

B. Extensive Legislative And Executive Branch Regulation And Oversight Of Fannie Mae

To safeguard Fannie Mae's ability to achieve its civic mission, Congress has implemented a variety of procedural safeguards. First, Fannie Mae remains subject to Congressional legislation and oversight. (*See* 2002 10-K at 17; Stern Decl. ¶ 9.) Second, Fannie Mae is regulated for various purposes by the United States Department of Housing and Urban Development ("HUD"), the United States Department of the Treasury ("Treasury Department"), and the General Accounting Office ("GAO"). Finally, in 1992 Congress created a new agency, OFHEO, whose sole purpose is to ensure the capital adequacy and financial safety and soundness of the two GSEs. (*See* Federal Housing Enterprises Financial Safety and Soundness Act of 1992, tit. 13, Pub. L. No. 102-550; *OFHEO Mission Statement*, at <http://www.ofheo.gov/Mission.asp> (last visited May 3, 2005); Stern Decl. ¶ 19.)

In many respects, OFHEO has regulatory oversight similar to other federal financial regulators such as the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Office of Thrift Supervision and the Board of Governors of the Federal Reserve System. *See OFHEO Mission Statement*, at <http://www.ofheo.gov/Mission.asp> (last visited May 3, 2005); Stern Decl. ¶ 19.) Like the examination process used by other financial regulators, OFHEO conducts annual risk-based examinations of Fannie Mae. (*See* OFHEO Report to Congress, June 15, 2001 ("2001 OFHEO Report") at 4; Stern Decl. ¶ 3.)

Between Congress, OFHEO, HUD, the Treasury Department and the GAO, Fannie Mae is one of the most heavily regulated companies in the United States, if not the world. Moreover, unlike most federal regulators, who oversee the operations of thousands of businesses, OFHEO's sole charge is to regulate two GSEs. (*See OFHEO Mission Statement*, at <http://www.ofheo.gov/Mission.asp> (last visited May 3, 2005); Stern Decl. ¶ 19.)

C. The Business Of Residential Mortgage Funding

Fannie Mae provides liquidity to the secondary mortgage market through two primary lines of business: (1) its portfolio business; and (2) its credit guaranty business. (See Compl. ¶¶ 33-34; see also Fannie Mae, Form 10-K for the period ending December 31, 2003, filed Mar. 15, 2004 (“2003 10-K”) at 2; Stern Decl. ¶ 10.)

Fannie Mae’s mortgage portfolio business purchases mortgages (or other mortgage-related securities) from lenders and mortgage brokers and funds them through the issuance of debt in the global capital markets. (Fannie Mae 1999 Annual Report (“1999 Annual Report”) at 14; Stern Decl. ¶ 5.) Fannie Mae does not loan money directly to homebuyers; rather, Fannie Mae purchases mortgages from lenders and mortgage brokers and earns a spread between the yield on the mortgages (e.g. 6%) and the cost of the debt that the Company issues to buy them (e.g. 5%). Under this example, Fannie Mae earns the spread of 1%. (See *id.*)

In its credit guaranty business, Fannie Mae issues mortgage-backed securities (“MBS”). MBS are securities that are backed or collateralized by a pool of one or more mortgages.¹ Fannie Mae earns a fee for guaranteeing the timely payment of principal and interest on the underlying mortgages. (2003 10-K at 10; Stern Decl. ¶ 10.)

1. **Risks Associated With Residential Mortgage Funding**

Fannie Mae’s business model exposes the Company to two main types of risk: credit risk and interest rate risk. *Credit risk*, here, is the risk that a homeowner will fail to pay interest or principal on a mortgage, with the primary credit risk being that the borrower will default on his or her mortgage. *Interest rate risk* is “the risk of loss to future earnings or long-term value that may result from changes in interest rates.” (Fannie Mae 2002 Annual Report (“2002 Annual

¹ Mortgage-backed securities are liquid tradable securities that represent a beneficial interest in a pool of mortgage loans or in other mortgage-backed securities. (See *Understanding Fannie Mae Mortgage-Backed Securities*, available at <http://www.fanniemae.com/mbs/tools/fanniemaembs.jhtml?p=Mortgage-Backed+Securities&s=Search+Tools+%26+Resources&t=Understanding+Fannie+Mae+Mortgage-Backed+Securities> (last visited May 3, 2005); Stern Decl. ¶ 26.)

Report’) at 55; Stern Decl. ¶ 7.) For example, if interest rates decline, borrowers are more likely to refinance their mortgages to take advantage of the lower interest rates. This could reduce the yield on Fannie Mae’s portfolio because the newer mortgages would provide Fannie Mae with a lower rate of return. (*Id.*)

2. Fannie Mae’s Use Of Derivatives To Manage Risk

Between 1998 and 2004, Fannie Mae was one of the world’s largest users of derivatives (Compl. ¶ 105), using those derivatives to manage the interest rate risk inherent in the Company’s \$2.25 trillion dollar mortgage portfolio business. (*See* Compl. ¶ 37; Fannie Mae, Form 10-Q for the period ending June 30, 2004, filed Aug. 9, 2004, (“2004 Q2 10-Q”) at 2; Stern Decl. ¶ 15.)² However, unlike many derivatives investors, “*Fannie Mae does not trade or speculate in derivatives to make money.*” (Fannie Mae 2003 Annual Report (“2003 Annual Report”) at 6 (emphasis added); Stern Decl. ¶ 8.) Rather, Fannie Mae uses these derivatives as a conservative and prudent risk management tool that “disperse[s] the risk of interest rate changes so that Fannie Mae can fund long-term, fixed-rate mortgages that give the consumer the right to refinance at any time.” (*Id.*) OFHEO routinely examined Fannie Mae’s use of derivatives as part of its annual review of the Company, and concluded that “[d]erivative instruments are used prudently for hedging risks and in accordance with the standards used by other large financial intermediaries.” (2002 OFHEO Report at 30, 51; Stern Decl. ¶ 2.)³

Generally, Fannie Mae employs three forms of derivatives to protect itself against risks to its mortgage portfolio business resulting from changes in interest rates: interest rate swaps,⁴

² Derivatives are financial contracts that derive their value from underlying market-determined variables like interest rates. (Christopher L. Culp, Ph.D., *Demystifying Derivatives in Mortgage Markets and at Fannie Mae*, Fannie Mae Papers, (vol. II, issue 4, Oct. 2003) at 1, *available at*, <http://www.fanniemae.com/commentary/pdf/fmpv2i4.pdf>, last visited May 3, 2005; Stern Decl. ¶ 27.)

³ OFHEO also concluded that: (1) “the derivatives being used [by Fannie Mae] are limited to those instruments that are common in the financial markets to conduct risk management activities,” (2002 OFHEO Report at 30; Stern Decl. ¶ 2), and (2) “the derivatives used [by Fannie Mae] are not exotic instruments.” (*Id.*)

⁴ A swap is an agreement between two parties to make several periodic exchanges of an asset or cash flow on specified terms.

options, and “swaptions.” In an interest rate swap, two parties agree to exchange payments tied to different interest rates—typically, one party will pay a fixed rate and the other will pay a floating rate tied to some reference interest rate. (2003 Annual Report at 30; Stern Decl. ¶ 8.) An option is a contract that gives its holder the right, but not the obligation, to buy or sell an asset on or before some date. A swaption is an option on an interest rate swap. Fannie Mae’s use of these derivatives is to protect itself from risk resulting from fluctuations in interest rates that could result in its cost of capital to fund home mortgages exceeding the rate of return it receives from mortgages it holds in portfolio.

For example, Fannie Mae will often fund its purchase of long-term (*i.e.* 30-year) fixed-rate mortgages by issuing various, successive short term (*i.e.* 90-day) debt instruments. Fannie Mae regularly issues 90-day debt instruments. As a result, over time, Fannie Mae pays a variable rate on its debt as interest rates fluctuate. To hedge against the volatility inherent in its shorter term debt, the Company will often enter into longer term derivative instruments with a willing third party, such as a bank or other financial institution. Fannie Mae’s use of derivatives enables it to hedge the interest rate risk inherent in its mortgage portfolio business—essentially locking in the rate at which it will have to borrow capital to fund its mortgage purchases. By managing the interest rate at which it borrows, Fannie Mae is better able to manage its ability to ensure that the rate at which it borrows will remain lower than rate it earns on mortgages it purchases.

Fannie Mae regularly disclosed its use of these derivatives as well as the legitimate and prudent risk management purposes they served:

Derivative instruments are important tools that we use to manage interest rate risk and supplement our issuance of debt in the capital markets. We are an end user of derivatives and do not take speculative positions with derivatives. We primarily use interest rate derivatives as a substitute for notes and bonds we issue in the debt markets. The ability to either issue debt securities or modify debt through the use of derivatives increases our funding flexibility

and potentially reduces our overall funding costs. The funding flexibility provided by using derivatives also helps us to better match the cash flow variability inherent in mortgages.

(Fannie Mae, Form 10-Q for the period ending June 30, 2003, filed Aug. 14, 2003 (“2003 Q2 10-Q”) at 25; Stern Decl. ¶ 12; *see also* 2002 10-K at 68-70; Stern Decl. ¶ 9.)

D. Fannie Mae’s Accounting For Its Derivative And Hedging Activity

1. Background

In June 1998, the Financial Standards Accounting Board (“FASB”) promulgated a Statement of Financial Accounting Standard, FAS 133, *Accounting for Derivative Instruments and Hedging Activities*, that would dramatically change and complicate how a company accounts for derivatives on its financial statements. In its final form, effective January 1, 2001, FAS 133 is the most complex accounting statement ever enacted. (Todd Davenport, *The Uneven Evolution of Accounting Standards*, American Banker, July 28, 2004, at 16 (“It is hard to make the case for generally accepted accounting principles when they are not even generally understood.”) (referring to FAS 133); Stern Decl. ¶ 28; Todd Davenport, *Banks Have A Prime Beef With FASB Hedging Plan*, American Banker, Feb. 2, 2004, at 7 (“FAS 133 ‘is one of the most complicated rules that exists,’ according to a federal banking regulator, who asked not to be identified.”); Stern Decl. ¶ 29.) Including implementation issues and amendments, FAS 133 spans more than 870 pages and includes hundreds of implementation issues. (See Office of Thrift Supervision, *FAS No. 133 and Its Impact on Risk Management*, The Q. Rev. of Interest Rate Risk (Fourth Quarter, 2004), at 5; Stern Decl. ¶ 30.)

Perhaps in recognition of the immense challenges associated with interpreting and applying FAS 133, the FASB created the Derivatives Implementation Group (“DIG”), a small committee of nationally-renowned experts whose sole function is to “identify practice issues that arise from applying the requirements of Statement 133 and to advise the FASB on how to resolve those issues.” (See *Accounting for Derivative Instruments and Hedging Activities*, FASB

Statement No. 133 as amended and interpreted, as of Feb. 10, 2004 (“FAS 133”) at v; Stern Decl. ¶ 18.) At all relevant times, Fannie Mae’s outside auditor, KPMG, had a partner that was a member of the DIG.⁵

Adoption of this extremely complicated accounting guidance was even more complex for Fannie Mae. As OFHEO observed:

Fannie Mae faced significant challenges in qualifying for hedge accounting. Due to its extensive documentation and effectiveness calculation requirements, hedge accounting under SFAS 133 was most easily adopted by entities with simple, passive hedging approaches in which hedges are established and allowed to run their course. However, Fannie Mae’s hedging approach was neither simple nor passive. The complex nature of funding its massive mortgage portfolio and managing the associated interest rate risk necessitated an active, dynamic hedging approach to respond to changing market conditions and portfolio re-balancing requirements. Such an environment adds significant complexity to the administrative and systems requirements to support hedge accounting. Furthermore, Fannie Mae’s use of option-based derivative products further complicated the application of hedge accounting, due to additional complexities associated with such instruments.

(OFHEO Report at 84; Stern Decl. ¶ 1.)

To implement FAS 133, Fannie Mae, in conjunction with its auditor, KPMG, created a comprehensive Hedge Accounting Policy Manual (known internally at Fannie Mae as the Derivatives Accounting Guidelines (“DAG”)). (*Id.* at 85.) The DAG, which comprises hundreds of pages of detailed accounting policies, was completed before the Company’s implementation of FAS 133 in 2001. It was designed to serve as the foundation for Fannie Mae’s derivative accounting. (*See id.*) In 2000 and again in 2003, KPMG reviewed the DAG and concluded that Fannie Mae’s implementation of FAS 133 represented a reasonable application of GAAP. (*Id.*)

⁵ When the DIG was created in 1998, Steven Swad, a partner of KPMG, was named as a member. When Swad resigned from the DIG later that year, Enrique Tejerina, another KPMG partner, took his position.

2. Substantive Provisions of FAS 133

FAS 133 requires that, “An entity shall recognize all of its derivative instruments in its statement of financial position as either assets or liabilities depending on the rights or obligations under the contracts. All derivative instruments shall be measured at fair value.”⁶ (FAS 133 ¶ 17; Stern Decl. ¶ 18.) Changes in the fair value (*i.e.*, incremental gains or losses) on a derivative are to be recognized in earnings, unless the derivative is designated and qualifies as part of a hedging relationship. (*Id.* ¶ 18.a.)

For companies that speculate in derivatives these changes in fair value are highly relevant to investors. Alternatively, for companies like Fannie Mae that do *not* speculate in derivatives, FAS 133 does not require that all change in fair value be recognized in earnings. FAS 133 recognizes three types of qualifying hedges—(1) cash flow hedges⁷; (2) fair value hedges⁸; and (3) foreign currency hedges. The use of derivatives in one of these qualifying hedge relationships permit companies to largely avoid reporting the quarterly changes in value of

⁶ The requirement that these derivatives be reported at “fair value” on a company’s balance sheet means that the company must mark to market the derivative every quarter, *i.e.* reflect the derivative at the current value, not original cost.

The fair or market value of the derivatives used by Fannie Mae rise or fall in tandem with interest rates. For example, a derivative that allows Fannie Mae to ensure that it pays a fixed interest rate of 5% on its debt will fall in value if interest rates stay at or go below 5%. Conversely, the same derivative will rise in value should interest rates elevate above 5%. Because Fannie Mae does not speculate in derivatives, but instead uses them to hedge against interest rate risk, Fannie Mae is indifferent to changes in the underlying value of the derivative.

⁷ Where a derivative is designated and qualifies as part of a cash flow hedge, any gain or loss on its fair value derivative is reported on the balance sheet as a component of other comprehensive income (outside earnings). (*Id.* ¶¶ 18.c, 30.) Notwithstanding its name, “other comprehensive income” is a balance sheet entry that is not reflected on a company’s income statement. As a result, it does not directly affect the company’s earnings for a given period.

⁸ All gains or losses on derivatives that are part of a fair value hedge, by contrast, must be recognized in earnings on the income statement. (*Id.* ¶¶ 18.b, 22-23.) However, companies can offset gains or losses on fair value hedge derivatives against gains or losses on the value of the hedged asset or liability. To the extent that the hedge correlates perfectly, any increase in the value of the derivative will be offset by an equal and opposite decrease in the value of the hedged asset and liability. In the event that the fair value hedge is *not* perfectly effective, any difference between the gain or loss on the derivative and the gain or loss on the hedged item is reported in current earnings. (*See id.*)

derivatives.⁹ Fannie Mae employs both cash flow and fair value hedges.

To qualify for hedge accounting as either a fair value or cash flow hedge, a series of complex and technical criteria must be met. (*Id.* ¶¶ 20.a., 28.a.) Among other things, a company must create formal documentation of the hedge relationship and the entity's risk management objective and strategy for undertaking the hedge. (*Id.*) The documentation must include identification of: (1) the hedging instrument, (2) the hedged item, (3) the nature of the risk being hedged, (4) how the hedging instrument's effectiveness will be assessed, and (5) identification of a reasonable basis to expect that the hedge will be highly effective. (*Id.*) In addition, any ineffectiveness in the hedging relationship must be measured and reported in earnings unless additional criteria are met.¹⁰

Each of these criteria must be met independently, or the derivative will not qualify for hedge accounting. Indeed, a derivative may meet all of the substantive criteria, but if the "formal documentation" is lacking, hedge accounting under FAS 133 is unavailable. (*Id.* ¶¶ 20.a., 28.a.)

Where, as here, a company attempts to employ hedge accounting under FAS 133, but fails to satisfy any one of the technical criteria or the documentation requirement, the penalty for such a mistake is extremely harsh. A company's failure to achieve the benefits of hedge accounting means that the company must book all fluctuations in the values of its derivatives through earnings, irrespective of whether the derivatives are used to hedge assets or liabilities in

⁹ The particular accounting treatment for a derivative qualifying for hedge accounting under FAS 133 depends on the nature of the hedging relationship. (*See id.* ¶¶ 18. b-d.)

¹⁰ (*See, e.g.*, FAS 133 ¶ 65 ("If the critical terms of the hedging instrument and of the entire hedged asset or liability (as opposed to selected cash flows) or hedged forecasted transaction are the same, the entity could conclude that changes in fair value or cash flows attributable to the risk being hedged are expected to completely offset at inception and on an ongoing basis. For example, an entity may assume that a hedge of a forecasted purchase of a commodity with a forward contract will be highly effective and that there will be no ineffectiveness to be recognized in earnings..."); Stern Dec. ¶ 18; *Id.* ¶ 68 ("An assumption of no ineffectiveness is especially important in a hedging relationship involving an interest-bearing financial instrument and an interest rate swap because it significantly simplifies the computations necessary to make the accounting entries. An entity may assume no ineffectiveness in a hedging relationship of interest rate risk involving a recognized interest-bearing asset or liability and an interest rate swap (or a compound hedging instrument composed of an interest rate swap and a mirror-image call or put option as discussed in paragraph 68(d) below) if all of the applicable conditions in the following list are met...").)

economic reality. This outcome distorts the true financial state of the company and results in artificial volatility in the company's quarterly earnings because changes in the fair value of any assets or liabilities that are hedged by those derivatives, unlike the derivatives themselves, are not run through earnings. The result is that changes in the fair value of only half of the hedge are reflected in earnings. With a company like Fannie Mae, that employs billions of dollars in derivative instruments, this is precisely the reason that a restatement of FAS 133 accounting treatment appears to be so large.

3. Fannie Mae's Reporting of Its "Core Earnings" in Pro Forma Financials

Even if hedge accounting is adopted, certain derivatives must be marked to market through the income statement. Because Fannie Mae understood that the application of FAS 133 would result in artificial volatility in earnings—specifically changes in the time value of its interest options—the Company believed it was important to shareholders to disclose financials that excluded fluctuations in the time value of these derivatives. (*See* 2002 Annual Report at 32; Stern Decl. ¶ 7.) As a result, throughout the Class Period, the Company reported its financial results in two different ways: GAAP results and a pro forma, non-GAAP measure called “core business earnings,” which excludes the effect of FAS 133.¹¹

While GAAP earnings reflect changes in value of options that are marked to market each period, Fannie Mae's core business earnings amortized these options over their respective lives. Because Fannie Mae was not purchasing the options for speculative purposes but rather bought them as insurance against changes in interest rates, the Company routinely held the options to maturity. Consequently, the Company believed that reporting core earnings reflecting amortization of these options, rather than marking them to market, more accurately reflects the

¹¹ Prior to 2003, Fannie Mae used the term “operating net income” rather than “core business earnings.” (*See* 2002 Annual Report at 23; Stern Decl. ¶ 7.)

economics of their hedging strategy, as prudent risk management and not speculative investing.

(*Id.*)

The difference between Fannie Mae's core business earnings and GAAP earnings was thoroughly disclosed and the significance of the reporting explained to the market:

Management relies primarily on core business earnings, a supplemental non-GAAP measure developed in conjunction with our January 1, 2001 adoption of FAS 133, to evaluate Fannie Mae's financial performance. *While core business earnings is not a substitute for GAAP net income, we rely on core business earnings in operating our business because we believe core business earnings provides our management and investors with a better measure of our financial results and better reflects our risk management strategies than our GAAP net income.* Core business earnings excludes the unpredictable volatility in the time value of purchased options because *we generally intend to hold these options to maturity*, and we do not believe the period-to-period variability in our reported net income from changes in the time value of our purchased options accurately reflects the underlying risks or economics of our hedging strategy. Core business earnings includes *amortization of purchased options premiums on a straight-line basis* over the original expected life of the options.... *[O]ur amortization treatment is more consistent with the accounting for embedded options in our callable debt and more accurately reflects the underlying economics of our use of purchased options as a substitute for issuing callable debt—two alternate hedging strategies that are economically very similar but require different accounting under FAS 133.*

(*Id.* (emphasis added).)

Moreover, for internal purposes, Fannie Mae's core business earnings, rather than its GAAP earnings, were the primary measure of the Company's financial results. (*See id.*) The Company relies on core business earnings "not only in developing the financial plans of our lives of business and tracking results, but also in establishing corporate performance targets and determining incentive compensation." (*Id.*)

Not only are Fannie Mae's core business earnings the significant measure internally, they were also the relevant metric for the markets. Many of Wall Street's leading equity analysts do

not even report Fannie Mae's GAAP financials.¹² Similarly, when media outlets reported Fannie Mae's financial results, most often they reported the Company's core earnings.

E. Fannie Mae's Application Of Financial Accounting Statement 91

Financial Accounting Standards No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases* ("FAS 91") governs the amortization of purchase premiums and discounts on securities and loans. When Fannie Mae purchases residential mortgage loans from primary lenders in the secondary mortgage market, (Compl. ¶¶ 32-34), it often does so at either a premium above, or a discount below, the mortgage's face value. (See 2002 10-K; Stern Decl. ¶ 9.) As disclosed in Fannie Mae's public filings:

When Fannie Mae buys MBS, loans, or mortgage-related securities, we may not pay the seller the exact amount of the unpaid balance ("UPB"). If we pay more than the UPB and purchase the mortgage assets at a premium, the premium reduces the yield we recognize on the assets below the coupon amount. If we pay less than the UPB and purchase the mortgage assets at a discount, the discount increases the yield above the coupon amount.

¹² See, e.g., Friedman, Billings, Ramsey, *FNM Reports Strong 3Q Earnings on Solid Portfolio Growth* (Oct. 17, 2003); Friedman, Billings, Ramsey, *FNM Reports Solid 2Q Earnings* (Jul. 16, 2003); J.P. Morgan, *Fannie Mae: Messy Quarter, Lower Revenue (Part 1 of 2)* (Oct. 17, 2003); J.P. Morgan, *Fannie Mae: Messy Quarter, Lower Revenue (Part 1 of 2)* (Oct. 16, 2003); Lehman Bros., *Fannie Mae 10Q: More Disclosures on Derivatives (Part 1 of 2)* (Nov. 18, 2003) (distinguishing between GAAP and core business earnings); Lehman Bros., *Fannie Mae: Strong 3Q; Raising '03 and '04 Estimates (Part 1 of 3)* (Oct 20, 2003) (referring to large swings in GAAP earnings associated with FAS 133 as "noises"); Lehman Bros., *Fannie Mae: 2Q 03 Earnings Preview (Part 1 of 2)* (Jul. 9, 2003); UBS, *Fannie Mae Beats 3Q 03 consensus by \$0.08* (Oct. 17, 2003); UBS, *Fannie Mae Assuming Coverage with a Buy 2 Rating* (Sep. 5, 2003) (explaining that despite GAAP earnings volatility, earnings are stable on an "economic 'operating' basis"); Wachovia Secs., *FNM Q3 2003 Results Ahead of Our Estimate (Part 1 of 2)* (Oct. 16, 2003); Credit Suisse First Boston Americas, *FNM Q3 First Impressions* (Oct. 16, 2003); Credit Suisse First Boston, *FNM: Revising Price Target* (Jul. 7, 2003); Morgan Stanley, *Fannie Mae: Fast Portfolio Growth Fuels Upside (Part 1 of 3)* (Oct. 16, 2003); Prudential Equity Group, Inc., *FNM: 3Q 03 EPS Upside; Raising 2003 EPS Estimate* (Oct. 17, 2003); Prudential Securities, Inc., *FNM: May Monthly Data-Retained Commitments at Record* (Jun. 12, 2003); Raymond James, *FNM: Additional Q3 Details (Part 1 of 2)* (Oct. 17, 2003); Raymond James & Associates, Inc., *Fannie Mae Reports Second Quarter Results (Part 1 of 2)* (Jul. 15, 2003); A. G. Edwards, Inc., *FNM Announces Restating Shareholder Equity Due to Accounting Errors – Part 1* (Oct. 29, 2003); Banc of America Securities, *FNM: 2Q 03 Results – Quick Highlights (Part 1 of 3)* (Jul. 15, 2003); Bear Stearns, *FNM: Q3 EPS Reflect Underlying Business Strength (Part 1)* (Oct. 16, 2003); Bear Stearns, *FNM: August Data (Part 1)* (Sep. 15, 2003); Prudential Securities, *FNM: 1Q 03 EPS Review* (Apr. 14, 2003); UBS Warburg, *Fannie Mae Q3 EPS \$1.62* (Oct. 15, 2002); Wachovia Securities, *FNM: Beats Q2 Estimate by \$0.03 Per Share* (Part 1 of 2) (Jul. 16, 2002) (collectively, "Analyst Reports"); Stern Decl. ¶ 25.)

(*See id.*)

FAS 91 provides the relevant guidance concerning how the Company should account for the discounts and premiums in these situations. (*See* FAS 91 at 4; Stern Decl. ¶ 17.) Under FAS 91, Fannie Mae must amortize any discount or premium paid in connection with the acquisition of a mortgage over the life of the mortgage and recognize the increased or decreased effect on income as incremental amounts, on top of the interest and principal payments.¹³ The end result is that the Company’s financial statements every year reflect a constant effective yield on that mortgage.

Estimating the expected life of a mortgage can be quite challenging. This is because although many, if not most, of the mortgages Fannie Mae purchases (and the mortgages used to collateralize MBS) are 30-year fixed rate mortgages, the “reasonably estimated” life of those mortgages is not thirty years. People often prepay their mortgages for a variety of reasons (*e.g.*, refinancing to get a lower rate, sale of their home, divorce, unemployment, death, etc.). Thus, the “reasonably estimated” life of a 30-year mortgage at a particular point in time—based upon sophisticated financial modeling – could be, for example, five years. In such a situation, the Company is to “consider *estimates* of future principal pre-payments in the calculation of the constant effective yield necessary to apply the interest method.” (*Id.* ¶ 19 (emphasis added).) Thus, assuming the “reasonably estimated” life of a 30-year mortgage is five years, FAS 91 requires Fannie Mae to calculate the constant effective yield of any premium or discount associated with its purchase of 30-year mortgages over five years, rather than thirty years.

Reasonably estimating the timing and amount of prepayments associated with millions of residential mortgages, in the aggregate, is further complicated by the fact that the “reasonably estimated” life of residential mortgages changes constantly. If, for example, interest rates fall,

¹³ The provisions of FAS 91 apply equally to any guaranty fees that Fannie Mae receives for its assumption of credit risk associated with its guarantee of the timely payment of principal and interest to MBS investors.

prepayments will increase and the “reasonably estimated” life will shorten. Quarterly, Fannie Mae is required to revisit its estimate of the timing and amount of these prepayments and, if it has changed, adjust its amortization of any premiums or discounts accordingly. (*Id.*) Thus, if the “reasonably estimated” life of mortgages it holds shortens, Fannie Mae would have to amortize more each quarter. Conversely, if the “reasonably estimated” life of its mortgages lengthens, Fannie Mae would amortize less each quarter.

Under FAS 91, when Fannie Mae recalculates the amortization of any fees, costs, discounts or premiums associated with the acquisition of the loan, based upon a new reasonably estimated life, it must make appropriate adjustments to reflect a constant effective yield. (*Id.*) FAS 91 requires that these changes to the accounting for the loan be reflected both *retroactively* and *prospectively*. *Id.* Thus, a company is not only expected to change its amortization going forward, but also calculate what the amortization schedule would have been *in the past* had the new revised life estimate been used all along. Any difference between the amount that would have been booked, had the premiums or discounts been amortized over the new life, and the amounts that were actually booked, is recognized during the relevant period. This entry is referred to as a FAS 91 “catch-up.” Given the number of *estimates* that could impact the calculation of the expected prepayment rate of mortgages—*e.g.*, estimates concerning current and future interest rates, unemployment rates, divorce rates, inflation, etc.—and the fact that slight changes in one or more of these assumptions can result in significant differences, calculating the amortization schedule and resulting catch-up entries are, at best, imprecise.

Because all of the estimates associated with FAS 91 are inherently subjective, Fannie Mae provides lengthy and fulsome disclosures concerning its reporting for deferred price adjustments in their public filings. (*See* 2002 10-K at 57; Stern Decl. ¶ 9; 2002 Annual Report at 51-52; Stern Decl. ¶ 7.) As Fannie Mae reported:

We apply the interest method to amortize the premiums, discounts, and other purchase price adjustments into income. We *estimate* future mortgage prepayments to calculate the constant effective yield necessary to apply the interest method. We believe the accounting estimates related to deferred premium/discount and deferred guaranty fees are ‘critical accounting estimates’ *because they require us to make significant judgments and assumptions about borrower prepayment patterns in various interest rate environments that involve a significant degree of uncertainty*. On a periodic basis, we evaluate whether we should change the estimated prepayment rates used in the amortization calculation. We reassess our estimate of the sensitivity of prepayments to changes in interest rates and compare actual prepayments versus anticipated prepayments. If changes are necessary, we recalculate the constant effective yield and adjust net interest income or guaranty fee income for the amount of premiums, discounts, and other purchase price adjustments that would have been recorded if we had applied the new effective yield since acquisition of the mortgage assets or inception of a guaranty.

(2002 Annual Report at 52 (emphasis added); Stern Decl. ¶ 7.)

F. The Events Leading Up To The Consolidated Complaint

Notwithstanding years of oversight and OFHEO’s previously glowing reports to Congress concerning Fannie Mae’s accounting and internal controls, on September 17, 2004, OFHEO issued a report concluding that Fannie Mae misapplied two GAAP provisions, specifically FAS 91 and FAS 133 ”). (OFHEO Report at i; Stern Decl. ¶ 1.) The OFHEO Report also questioned the adequacy of Fannie Mae’s internal controls. (*Id.*)

After reviewing the OFHEO Report and consulting with its outside auditors, Fannie Mae announced that it continued to believe its accounting had been appropriate. (Compl. ¶ 7.) It further indicated that it would request the Securities and Exchange Commission (“SEC”) to review Fannie Mae’s accounting to determine whether it had complied with GAAP, and announced that it would follow the SEC’s recommendations, whatever they might be. (*Id.* ¶ 8.) In response, SEC Chairman William Donaldson observed that the accounting issues raised by Fannie Mae were “not a simple matter; it’s not black and white... its going to have to be a really careful process.” (John Connor, *SEC Chief Says Fannie Issues Not Black And White*, Dow Jones

Int'l News, Oct. 22, 2004; Stern Decl. ¶ 20.)

Following a two month review of the Company's accounting, SEC Chief Accountant Donald Nicolaisen issued a statement in December 2004 on behalf of the SEC, ultimately concluding that Fannie Mae's application of FAS 133 and FAS 91 for 2001 through mid-2004 did not comply with GAAP and indicating that a restatement of financials was appropriate. (Compl. ¶ 8.) Fannie Mae has agreed to restate its financials as requested by the SEC. (*Id.* ¶ 10.)

Immediately following the release of the OFHEO Report on September 17, 2004, these securities class actions followed. The first such action was filed the very next day. Subsequently, another twelve securities class actions were filed. On December 16, 2004, the Court consolidated all of the securities class actions pending before it into the above-captioned action. A motion to consolidate the only remaining parallel securities class action (currently pending in the Southern District of Ohio) is currently pending before the Judicial Panel on Multidistrict Litigation.

On January 13, 2005, the Court appointed the Ohio Public Employees Retirement System ("OPERS") and the State Teachers Retirement System of Ohio ("STRS") as Lead Plaintiffs, who filed their Consolidated Class Action Complaint on March 4, 2005. Rather than identifying particular statements that plaintiffs allege are false or misleading, and explaining why those statements were inaccurate, the Complaint simply grafts over 140 pages of block quotations from Fannie Mae's public disclosures, such as press releases, Form 10-Ks, 10-Qs, 8-Ks, Annual Reports, conference call transcripts, and news reports. (*Id.* ¶¶ 174-271.) Interspersed among this monolith of block quotations are a handful of conclusory allegations that the quoted disclosures are false or misleading, but which do not identify each alleged false or misleading statement or explain why it is false and misleading as mandated by the PSLRA. (*Id.* ¶¶ 189, 220, 259, 271.)¹⁴

¹⁴ Pleading of this sort is insufficient and improper under the PSLRA and Federal Rule of Civil Procedure 8 because plaintiffs fail to parse out which sentences, which words, or which statements among the dozens of pages of quoted material are actually false or misleading. See *In re Harmonic Inc. Sec. Litig.*, 163 F. Supp. 2d 1079, 1090

G. Plaintiffs' Allegations Concerning Fannie Mae's Implementation of FAS 133

The centerpiece of plaintiffs' Complaint is Fannie Mae's pending restatement resulting from its misapplication of FAS 133. In sum, plaintiffs allege, based upon the preliminary findings in the OFHEO Report, that Fannie Mae's application of FAS 133 does not comply with GAAP in several respects. Specifically, plaintiffs allege that Fannie Mae:

- Failed to comply with the basic designation, documentation, and effectiveness measurement requirements of FAS 133. (Compl. ¶ 107.)
- Did not assess and record hedge ineffectiveness and applied hedge accounting to hedging relationships that did not qualify. (*Id.* ¶ 109.)
- Improperly assumed that the vast majority of its hedging relationships were "perfectly effective." (*Id.* ¶ 109.)
- Failed to account for any hedge ineffectiveness as required by FAS 133. (*Id.* ¶ 110.)
- Misapplied the "short-cut" method to hedge relationships that did not qualify for such treatment. (Compl. ¶ 112.)

Although plaintiffs make conclusory allegations about scienter, they make no effort to grapple with the fact that Fannie Mae's policy was fully transparent to KPMG, which approved Fannie Mae's FAS 133 Policy (i.e., the DAG) as a reasonable interpretation of GAAP¹⁵; that KPMG provided the Company with clean audit opinions for each year during the Class Period¹⁶;

(N.D. Cal. 2001) (dismissing complaint that was "confusing" and "unintelligible" in that it merely provided a "selection of quotations from various press releases, meetings and conference calls with analysts, and analysts' reports, organized chronologically ... [i]nterspersed [with] allegations that defendants 'knew'" that the foregoing were false); *Wenger v. Lumisys, Inc.*, 2 F. Supp. 2d at 1231, 1243 (N.D. Cal. 1998) (plaintiffs "thr[ew] the statements and the alleged 'true facts' together in an undifferentiated clump ... apparently expect[ing] the reader to sort out and pair each statement with a supposedly relevant 'true fact'" in violation of Federal Rules Civil Procedure 8).

¹⁵ (*See* OFHEO Report at 85 n. 227, 101-02, 115; Stern Decl. ¶ 1.)

¹⁶ (*See* 2002 10-K at 146; Stern Decl. ¶ 9; Fannie Mae, Form 10-Q for the period ending Mar. 31, 2003, filed May 15, 2003 ("2003 Q1 10-Q") at 27; Stern Decl. ¶ 11; 2003 Q2 10-Q at 33; Stern Decl. ¶ 12; Form 10-Q for the period ending Sept. 30, 2003, filed Nov. 14, 2003 ("2003 Q3 10-Q") at 36; Stern Decl. ¶ 13; 2003 10-K at 170; Stern Decl. ¶ 10; Fannie Mae, Form 10-Q for the period ending Mar. 31, 2004, filed May 10, 2004 ("2004 Q1 10-Q") at 38; Stern Decl. ¶ 14; 2004 Q2 10-Q at 60; Stern Decl. ¶ 15.)

and that OFHEO itself reviewed the Company's implementation of FAS 133.¹⁷

H. Plaintiffs' Allegations Concerning Fannie Mae's Application Of FAS 91

Plaintiffs also allege that Fannie Mae improperly applied FAS 91 in its accounting for the amortization of purchase premiums and discounts on mortgages and MBS. (Compl. ¶¶ 85-96.)

Specifically, Plaintiffs allege that Fannie Mae misapplied FAS 91 by:

- Calculating its "catch-up" adjustments with reference to its projected year-end position rather than recording amounts solely on the basis of quarter-end positions. (*Id.* ¶ 89.)
- Limiting application of FAS 91 to only those loans that exceeded a self-defined materiality limit, referred to as a "precision threshold." (*Id.* ¶ 91.)
- Failing to apply FAS 91 to Real Estate Mortgage Investment Conduit (REMIC) securities held in its portfolio until 1998. (*Id.* ¶ 92.)
- Deferring \$200 million of estimated expense in 1998. (*Id.* ¶ 92.)¹⁸

Plaintiffs' allegations, however, omit critical, yet judicially noticeable, information, and are based on selective and incomplete quotations from relevant disclosures. For example, Plaintiffs allege that OFHEO and the SEC found (and that Fannie Mae has subsequently admitted in a recently filed Form NT-10-Q) that Fannie Mae improperly applied FAS 91 during 2001 and 2002 by calculating its catch-up position with reference to the end of the year, rather than the end of each quarter. (*Id.* ¶ 89.) Fannie Mae's public disclosure, however, demonstrates that the effect of this misapplication of FAS 91 would have increased earnings in two of the relevant years, decreased it in another, and netted to zero:

The company is in the process of assessing the impact and estimates that the effect will be an *increase* in 2001 and 2002

¹⁷ (2002 OFHEO Report at 29; Stern Decl. ¶ 1.)

¹⁸ Plaintiffs' Complaint includes additional allegations concerning Fannie Mae's application of FAS 91. (See Compl. ¶ 92.) However, as explained *infra* at III.D.2, those allegations are so vague and conclusory that they fail to satisfy Federal Rule of Civil Procedure 9(b) and the PSLRA's heightened pleading requirements.

earnings and a *decrease* in 2003 earnings, *with the cumulative effect of these changes across the three periods netting to zero*. The company will make adjustments to prior periods if and to the extent material. The company believes that the impact to the 2003 results provided herein is not material.

(Fannie Mae, Form NT-10-Q, for the period ending Sept. 30, 2004, filed November 15, 2004 (“Form NT-10-Q”) at 4 (emphasis added); Stern Decl. ¶ 16.)

Plaintiffs also allege that Fannie Mae misapplied FAS 91 by applying a self-defined materiality limit, referred to as a “precision threshold.” (Compl. ¶ 91.) Under the terms of the “precision threshold” adopted by Fannie Mae, amortization adjustments for discounts or premiums that were less than $\pm 1\%$ of Portfolio Net Interest Income or amortization adjustment for Guaranty Fees that were less than $\pm 2\%$ of related Guaranty Fee revenue would not be recognized. (See OFHEO Report at 19; Stern Decl. ¶ 1.) This policy was the result of Fannie Mae’s determination that in light of all the estimates necessary to calculate the amortization catch-up, the resulting number was inherently imprecise. To that end, the Company believed, and Fannie Mae’s outside auditor, KPMG, concurred, that a policy of not booking any adjustments to amortization that fell within the precision thresholds constituted a reasonable application of FAS 91. (See *id.* at 18-19.) In light of the various estimates upon which the ultimate calculation was based and its inherent imprecision, Fannie Mae and KPMG concluded that any amortization “catch-up” with the precision as accurate as any other number within that range, and hence, no adjustment to the amortization is required. (See *id.*)

Finally, plaintiffs allege that Fannie Mae improperly deferred \$200 million of estimated expenses in 1998. (Compl. ¶ 92.) Plaintiffs fail to allege, however, that the alleged deferred expenses had any material effect on any subsequent periods and specifically fail to allege any material effect on the financial statements issued during the class period of April 17, 2001 through September 21, 2004. Moreover, this “deferral” was disclosed to KPMG in 1998 (OFHEO Report at 9; Stern Decl. ¶ 1) and, after reviewing Fannie Mae’s treatment, KPMG

provided Fannie Mae with a “clean audit opinion.” (Fannie Mae 1998 Annual Report (“1998 Annual Report”) at 63; Stern Decl. ¶ 4.)

III. LEGAL ANALYSIS

A. Heightened Pleading Requirements Of The PSLRA

1. Elements Of A Claim Under Section 10(B) Of The Securities Exchange Act

To assert a viable claim under Section 10(b) and SEC Rule 10b-5 thereunder, plaintiffs must allege that each defendant (1) made a material misstatement or omission of a fact, (2) with scienter, (3) in connection with the purchase or sale of a security, (4) upon which the plaintiffs reasonably relied, and (5) that plaintiffs’ reliance was the proximate cause of their injury. *Kowal v. MCI Communications Corp.*, 16 F.3d 1271, 1276 (D.C. Cir. 1994). Plaintiffs’ Section 10(b), Rule 10b-5 and Section 20(a) claims are governed by the Private Securities Litigation Reform Act (“PSLRA”). *See* 15 U.S.C. §78u-4. Confronted with widespread evidence of “significant abuse” in securities litigation,¹⁹ Congress passed the PSLRA in 1995 to curb the proliferation of frivolous securities class actions, brought solely because an issuer’s stock price dropped precipitously, and supported only by insufficient allegations of “fraud by hindsight.” *IDT Corp. v. eGlobe Inc.*, 140 F. Supp. 2d 30, 33 (D.D.C. 2001) (citing *Novak v. Kasaks*, 216 F.3d 300 (2d Cir. 2000)). The PSLRA radically altered the landscape for adjudicating securities claims, imposing rigorous new pleading standards and mandating dismissal of any complaint that failed to measure up to these standards. *See* 15 U.S.C. §§ 78u-5, 77z-1, 77z-2, 78u-4.

¹⁹ *See* Joint Explanatory Statement of the Committee of Conference, H.R. Conf. Rep. No. 104-369, 104th Cong., 1st Sess. 31 (1995) (“Conf. Rep.”) at 31. Congress’s passage of the PSLRA was motivated by findings of specific abusive practices: (1) the routine filing of “cookie cutter” complaints without regard to an issuer’s culpability and with only a “faint hope” that later discovery might lead to a “plausible cause of action”; (2) the targeting of “deep pocket defendants” without regard to culpability solely for settlement value; (3) discovery practices designed to impose “massive costs,” making it more economic for defendants to settle than to litigate; and (4) the manipulation by plaintiffs’ lawyers of persons they purport to represent. Conf. Rep. at 31, 32..

2. Heightened Pleading Standard

In passing the PSLRA, Congress announced its clear intent to test the sufficiency of securities actions at the earliest possible stage, *i.e.*, by way of a motion to dismiss. Conf. Rep. at 31. Motions to dismiss under the PSLRA are to be treated different from other Federal Rule of Civil Procedure 12(b)(6) motions to dismiss:

The heightened pleading requirements of the Private Securities Litigation are an unusual deviation from the usually lenient requirements of federal rules pleading. In few other areas are motions to dismiss for failure to state a claim upon which relief can be granted so powerful. The various requirements are not satisfied merely by making a complaint long. For a securities fraud case based on false statements to survive a motion, the pleading has to state particularized facts that, taken as a whole, raise a strong inference that defendants intentionally or with deliberate recklessness made false or misleading statements to investors.

Ronconi v. Larkin, 253 F.3d 423, 437 (9th Cir. 2001). “The PSLRA contemplates that the district court will serve a gatekeeping role at the motion to dismiss stage.” *In re Scientific-Atlanta, Inc. Sec. Litig.*, 239 F. Supp. 2d 1351, 1357 (N.D. Ga. 2002) (citing *Sturm v. Marriott Marquis Corp.*, 85 F. Supp. 2d 1356, 1366 (N.D. Ga. 2000)).

Also unique to securities cases is the requirement on a motion to dismiss that the Court consider “all reasonable inferences to be drawn from the allegations, *including inferences unfavorable to the plaintiffs.*” *Gompper v. VISX, Inc.*, 298 F.3d 893, 897 (9th Cir. 2002) (emphasis added). Where the allegations could equally and plausibly support an inference of no fraud, plaintiffs have not met the pleading burden and the complaint must be dismissed. *Id.* at 896-97. It is not sufficient that plaintiffs plead a reasonable inference of fraud; plaintiffs must plead facts giving rise to a strong inference of fraud, after all reasonable inferences have been drawn from the facts alleged, incorporated by reference, or considered by the Court on judicial notice. *Id.* As the Third Circuit recently explained, in this respect, securities cases are very different from other federal cases:

[U]nless plaintiffs in securities fraud actions allege facts supporting their contentions of fraud with the requisite particularity mandated by Rule 9(b) and the PSLRA, they may not benefit from inferences flowing from vague or unspecific allegations – inferences that may arguably have been justified under a traditional Rule 12(b)(6) analysis.

In re Rockefeller Ctr. Props. Sec. Litig., 311 F.3d 198, 224 (3d Cir. 2002).

The PSLRA also mandates that a securities class action must be pled with a heightened degree of particularity, surpassing even the standards set forth in Federal Rule of Civil Procedure 9(b). *See In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1417 (3d Cir. 1997); Conf. Rep. at 41 (“[Rule 9(b)] has not prevented the abuse of the securities laws by private litigants.”). Plaintiffs must set forth “each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed, including the identity of plaintiffs’ source information.” 15 U.S.C. § 78u-4(b)(1)(B); *see In re Aetna Inc. Sec. Litig.*, 34 F. Supp. 2d 935, 941-42 (E.D. Pa. 1999); *Novak v. Kasaks*, 997 F. Supp. 425, 431-32 (S.D.N.Y. 1998).

3. The Requirement Of Pleading Scienter

The standard for pleading scienter is also heightened, requiring that for each act or omission alleged, plaintiffs must “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.” 15 U.S.C. § 78u-4(b)(2); *Blum v. Semiconductor Packaging Materials Co.*, C.A. No. 97-7078, 1998 U.S. Dist. LEXIS 6868, at *4 (E.D. Pa. May 5, 1998). Although the District of Columbia Circuit has not yet spoken to the standard for pleading scienter under the PSLRA,²⁰ the majority of circuits hold that a plaintiff

²⁰ Although the D.C. Circuit has not spoken to this issue, it has confirmed, in line with the “middle ground” approach taken by some circuits, that “extreme recklessness” is sufficient to satisfy the scienter requirement for aiding and abetting liability in an action for civil damages brought by the SEC. *Howard v. SEC*, 376 F.3d 1136, 1144 (D.C. Cir. 2004) (“‘Extreme recklessness’ . . . ‘may be found if the alleged aider and abettor encountered ‘red flags,’ or ‘suspicious events creating reasons for doubt’ that should have alerted him to the improper conduct of the primary violator.”) (quoting *Graham v. SEC*, 222 F.3d 994, 1006 (D.C. Cir. 2000)).

must plead specific facts that demonstrate at least “severe recklessness” or a “conscious disregard” of problems or risks. *See Nathenson v. Zonagen, Inc.*, 267 F.3d 400, 409-12 (5th Cir. 2001) (adopting “severe recklessness” standard, and concluding that while “allegations of motive and opportunity may meaningfully enhance the strength of . . . scienter, . . . it would seem to be a rare set of circumstances indeed where those allegations alone are both sufficiently persuasive to give rise to a scienter inference of the necessary strength and yet at the same time there is no basis for further allegations also supportive of that inference.”); *Helwig v. Vencor, Inc.*, 251 F.3d 540, 550-51 (6th Cir. 2001) (required state of mind is recklessness, defined as “highly unreasonable conduct which is an extreme departure from the standards of ordinary care”); *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271 (11th Cir. 1999) (plaintiff must state with particularity facts leading to a strong inference of “severe recklessness” and, as such, allegations of motive and opportunity, without more, while highly relevant, are insufficient to allege a “strong inference” of scienter); *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 197, 199-200 (1st Cir. 1999); *In re Silicon Graphics Inc., Sec. Litig.*, 183 F.3d 970, 974 (9th Cir. 1999) (holding that plaintiffs must plead “in great detail, facts that constitute strong circumstantial evidence of deliberately reckless or conscious misconduct”).²¹ Although different courts have articulated the standard differently, regardless of how the standard is phrased, plaintiffs have failed to plead the strong inference of scienter imposed by the PSLRA.

²¹ A small minority of courts have held that a plaintiff can also plead a strong inference of scienter through allegations that the defendant possessed motive and opportunity to commit securities fraud. *Novak*, 216 F.3d 300, 307-08 (2d Cir. 2000); *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 531 (3d Cir. 1999); *Fl. State Bd. of Admin. v. Green Tree Fin. Corp.*, 270 F.3d 645 (8th Cir. 2001). The majority of courts have found “motive and opportunity” allegations to be insufficient standing alone. Moreover, the Second Circuit has narrowed considerably the field of “motive and opportunity” pleading that it will allow, and has held insufficient allegations based upon broadly held motives such as executive compensation or corporate credit rating. *Novak*, 216 F.3d at 307.

At the time the PSLRA was enacted, allegations of motive and opportunity were deemed sufficient to establish fraudulent intent in the Second Circuit. Congress, however, clearly intended to strengthen existing pleading requirements through the enactment of the PSLRA. Indeed, Congress could have adopted the Second Circuit standard, but declined to do so. As a result, motive and opportunity, standing alone, are inconsistent with the PSLRA's heightened standard for pleading scienter, and should be rejected as the applicable standard.

B. Allegations Of Errors In The Application Of GAAP, Without More, Are Insufficient To Support A Claim For Securities Fraud

The Complaint is grounded exclusively on Fannie Mae's alleged violation of GAAP and its announcement that it would restate its 2001 through mid-2004 financial results. It is well settled, however, that errors in the application of GAAP alone are insufficient to establish securities fraud. To the contrary, courts recognize that GAAP does not specify an absolute, black or white, treatment for every transaction, and rather "tolerate[s] a range of 'reasonable' treatments, leaving the choice among alternatives to the management." *Thor Power Tool Co. v. Comm'r*, 439 U.S. 522, 544 (1979); *see also In re Burlington Coat Factory Sec. Litig.*, 114 F.3d at 1420 n.10 ("GAAP is not a set of rigid rules ensuring identical treatment of identical transactions, but rather characterizes the range of reasonable alternatives that management can use.") Courts throughout the country have therefore consistently held that allegations of GAAP violations or the fact of a restatement, standing alone, are not sufficient to plead a strong inference of scienter. *See, e.g., Stelman v. Alias Research, Inc.*, 174 F.3d 79, 84 (2d Cir. 1999) (allegation of scienter based on restatement of three quarters of earnings due to improper revenue recognition insufficient to state a securities fraud claim); *In re Carter-Wallace, Inc. Sec. Litig.*, 150 F.3d 153 (2d Cir. 1998) ("one cannot state a claim for securities fraud merely by alleging a GAAP violation."); *Lovelace v. Software Spectrum*, 78 F.3d 1015, 1020 (5th Cir. 1996) (same); *In re The Vantive Corp. Sec. Litig.*, 283 F.3d 1079, 1090-91 (9th Cir. 2002); *City of Philadelphia v. Fleming Cos.*, 264 F.3d 1245, 1261 (10th Cir. 2001) ("[a]llegations of GAAP violations or accounting irregularities, standing alone, are insufficient to state a securities fraud claim.").²²

²² *See also In re Guess?, Inc. Sec. Litig.*, 174 F. Supp. 2d 1067, 1078-80 (C.D. Cal. 2001) (granting motion to dismiss notwithstanding two back-to-back restatements); *In re Sys. Software Assocs., Inc., Sec. Litig.*, No. 97*C*177, 2000 WL 283099, at *14 (N.D. Ill. Mar. 8, 2000) (to adequately allege scienter, plaintiffs must assert, in addition to the restatement, specific "facts supporting an inference that defendants recklessly disregarded the deviance or acted with gross indifference to the misrepresentations in [the] financial statements."); *In re Hudson Techs. Inc. Sec. Litig.*, No. 98 Civ. 1616, 1999 WL 767418, at *5 (S.D.N.Y. Sept. 29, 1999) (the "failure to comply

Accordingly, courts have long held that “[t]o state a valid securities fraud claim, allegations of violations of GAAP must be accompanied by factual allegations of *corresponding fraudulent intent*.” *Kennilworth Partners L.P. v. Cendant Corp.*, 59 F. Supp. 2d 417, 429 (D.N.J. 1999) (emphasis added). This principle requires plaintiffs to plead facts that demonstrate that Fannie Mae acted fraudulently *at the time it posted the financial results that were ultimately restated*, by alleging *specific contemporaneous conditions* known to Fannie Mae at the time the original financial statements were prepared. *See, e.g., In re The Vantive Corp. Sec. Litig.*, 283 F.3d at 1090-91; *City of Philadelphia*, 264 F.3d at 1261 (“Only where [allegations of GAAP violations or accounting irregularities] are coupled with evidence that the violations or irregularities were the result of defendant’s fraudulent intent to mislead investors may they be sufficient to state a claim.”).

Here, as set forth in detail below, plaintiffs fail to plead facts that suggest Fannie Mae’s alleged misapplications of GAAP were anything more than an error. Such allegations are simply insufficient to support a claim for securities fraud.

C. Plaintiffs Have Failed To Plead Specific Facts That Support A Strong Inference Of Scierter With Respect To Fannie Mae’s Implementation of FAS 133

Plaintiffs’ allegations regarding Fannie Mae’s implementation of FAS 133, without more, are simply insufficient to establish scierter. Because Fannie Mae’s application of FAS 133 was rigorously audited by KPMG and scrutinized in annual, thoroughgoing examinations by

with standard accounting practices coupled with later revisions of financial statements, does not alone constitute circumstantial evidence of misconduct or recklessness”); *In re Peritus Software Serv., Inc. Sec. Litig.*, 52 F. Supp. 2d 211, 224 (D. Mass. 1999) (collecting cases); *In re Credit Acceptance Corp. Sec. Litig.*, 50 F. Supp. 2d 662, 680 (E.D. Mich. 1999) (“GAAP violations or accounting errors, standing alone, do not give rise to scierter. . . . even in a situation where a statement of earnings must be restated.”); *In re Bell Atl. Corp. Sec. Litig.*, Civil Action Nos. 91-0514, 91-0673, 93-999, 91-0518, 91-0737, 91-0531, 91-7048, 1997 WL 205709, at *27 (E.D. Pa. Apr. 17, 1997) (mere publication of inaccurate accounting figures or failure to follow GAAP does not establish scierter); *Glickman v. Alexander*, No. 93 Civ. 7594, 1996 WL 88570 (S.D.N.Y. Feb. 29, 1996) (restatement of financial statements and recognition that they were based on erroneous accounting practices without more does not raise a strong inference of scierter); *Vosgerichian v. Commodore Int’l.*, 832 F. Supp 909, 915 n.8 (E.D. Pa. 1993), *vacated on other grounds*, 862 F. Supp. 1371 (E.D. Pa. 1994) (“Even deliberate violations” of GAAP, “without more, do not amount to fraud.”).

OFHEO, and deemed to be GAAP-compliant, plaintiffs are unable to plead sufficiently that Fannie Mae had any intent to deceive investors. *In re Baan Co. Sec. Litig.*, 103 F. Supp. 2d 1, 21 (D.D.C. 2000) (“GAAP violations are less indicative of scienter when, by their nature, the violations could easily be inadvertent.”).

1. Fannie Mae’s Implementation and Application of FAS 133 Was Transparent To Its Auditors and Regulator

Fannie Mae’s transparency in the implementation and application of FAS 133 is fundamentally inconsistent with an intent to defraud. Here, the Complaint does not allege that the adoption of the accounting approaches at issue was anything other than transparent. Nor could it. Indeed, with respect to FAS 133, Fannie Mae not only provided access to its Derivatives Accounting Guidelines (or “DAG”) to its independent auditor, it affirmatively sought KPMG’s review and approval of the approach outlined in the DAG. Additionally, prior to its implementation of FAS 133, Fannie Mae also provided OFHEO with full access to its accounting guidelines. OFHEO similarly reviewed Fannie Mae’s approach to the implementation of FAS 133 and, as noted in its Report to Congress, approved it as well. (2002 OFHEO Report at 29; Stern Decl. ¶ 2.)

Courts have long recognized that “reliance on the guidance of outside auditors is inconsistent with the intent to defraud.” *Morse v. McWhorter*, 200 F. Supp. 2d 853, 899 (M.D. Tenn. 1998) (citing *Stavroff v. Mayo*, No. 95-4118, 1997 U.S. App. LEXIS 32774, at *19 (6th Cir. Nov. 12, 1997)); *see also SEC v. DCI Telecomm., Inc.*, 122 F. Supp. 2d 495, 500 n.2 (S.D.N.Y. 2000); *SEC v. Caserta*, 75 F. Supp. 2d 79, 94 (E.D.N.Y. 1999). In implementing FAS 133, Fannie Mae developed and adopted guidelines that set forth the treatment of every hedging relationship into which it enters. (*See* OFHEO Report at 85; Stern Decl. ¶ 1.) These guidelines, which were contained in the DAG, were reviewed and approved by KPMG, which had particular expertise with FAS 133 given that one of its partners was a member of FASB’s DIG. Indeed,

one of KPMG's partners was a member of the DIG throughout the entire class period. KPMG, for each of the relevant reporting periods, represented in Fannie Mae's public filings that the reported financial statements "present fairly, in all material respects, the financial position of Fannie Mae . . . in conformity with accounting principles generally accepted in the United States of America." (*See, e.g.*, 2001 Annual Report at 72; Stern Decl. ¶ 6.)

Although the Complaint is replete with allegations that Fannie Mae's accounting guidelines were later determined to be noncompliant with GAAP, (*see, e.g.*, Compl. ¶¶ 107-14), it is notably bereft of any allegation that the DAG was not reviewed by KPMG, or that its detailed provisions were somehow hidden from or secretly misapplied without the knowledge and approval of KPMG. Nor are there any allegations that suggest that KPMG ever took issue with Fannie Mae's implementation of FAS 133 *at the time the financial results in question were posted and disclosed to investors. See In re The Vantive Corp.*, 283 F.3d at 1090-91 (requiring allegations of contemporaneous knowledge of accounting improprieties or noncompliance with GAAP in order to plead scienter adequately); *City of Philadelphia*, 264 F.3d at 1261 (same). Indeed, the Complaint does not, and cannot, even allege that KPMG currently believes that the accounting approach contained in Fannie Mae's DAG was anything other than a reasonable application of FAS 133.

Not only is KPMG's review and approval of Fannie Mae's DAG inconsistent with any intent to defraud, any suggestion of scienter becomes even more implausible in light of the regulatory examination to which Fannie Mae was subjected during the class period. Specifically, Fannie Mae provided free access to its DAG to OFHEO, which reviewed the DAG and found it fully compliant with FAS 133 during its annual examination of virtually all aspects of Fannie Mae's operations. (2002 OFHEO Report to Congress at 29; Stern Decl. ¶ 2.) There have been no allegations that any information was withheld or misrepresented to OFHEO. In short, Fannie

Mae's accounting was transparent to not only its auditors but its regulator. Under these circumstances, plaintiffs cannot possibly allege any facts demonstrating the requisite strong inference that Fannie Mae had any intent to deceive through its financial reporting. Indeed, the more reasonable inference to be drawn is that Fannie Mae did not knowingly or recklessly commit securities fraud. *See, e.g., Gompper*, 298 F.3d at 897.

2. Fannie Mae's Disclosure Of Pro Forma "Core Business Earnings" Refutes Any Suggestion Of Scienter For Its Alleged Noncompliance With FAS 133

Plaintiffs essentially allege that Fannie Mae intentionally misapplied FAS 133 to hide from its investors the volatility that FAS 133 would introduce. But that assertion is nonsensical, given that at all relevant times Fannie Mae also reported a non-GAAP measure of earnings that backed out all volatility associated with FAS 133. Plaintiffs do not, and cannot, explain why a company would attempt to remove volatility from its financial statements through the deliberate misapplication of GAAP, when it was already removing such volatility from an alternative presentation of its financial situation that it published contemporaneously with its GAAP earnings. In short, Fannie Mae's repeated disclosure of its "core business earnings" throughout the class period further refutes any suggestion that Fannie Mae intended to deceive its investors.

Fannie Mae understood that, whether or not it elected hedge accounting, FAS 133 would create volatility in its financial statements. The Company repeatedly disclosed throughout the class period that the application of FAS 133 was one of the company's "critical accounting policies," and that its application created "significant volatility in our reported net income. . . ." (*See, e.g.*, 2002 10-K at 23, 55; Stern Decl. ¶ 9; 2001 Annual Report at 22-23; Stern Decl. ¶ 6; 2003 Q2 10-Q at 3, 22; Stern Decl. ¶ 12.) For that reason, in every quarter throughout the class period, Fannie Mae prepared, disclosed and emphasized, in addition to its GAAP financials, pro

forma “core business earnings” that excluded the impact of FAS 133.²³ As it repeatedly disclosed to investors, Fannie Mae’s management relies “on core business earnings in operating our business because we believe core business earnings provides our management and investors with a better measure of our financial results and better reflects our risk management strategies than our GAAP net income.” (*E.g.*, 2002 Annual Report at 32; Stern Decl. ¶ 7.) Securities analysts appeared to understand this fully, frequently reporting core business earnings only, and giving little or no attention to Fannie Mae’s GAAP results. *See supra* note 12.

Notably, the Complaint nowhere alleges that Fannie Mae’s reported “core business earnings” were in any way false or misleading to investors, or that they created a misleading or incomplete presentation of Fannie Mae’s financial results. Nowhere do plaintiffs dispute that Fannie Mae’s “core business earnings” presented an accurate picture of Fannie Mae’s hedging strategy and a more meaningful indication of its financial results. And critically, nowhere do plaintiffs make any effort to explain why the Company would deliberately misapply GAAP in an effort to remove volatility from its GAAP earnings, when it was already removing that volatility in a fully transparent and understood manner in its reported core earnings. Plaintiffs’ failure to do so negates any suggestion that Fannie Mae had an intent to deceive its investors.

D. Plaintiffs’ Allegations Concerning Fannie Mae’s Alleged Misapplication Of FAS 91 Are Insufficient To Support A Claim

Plaintiffs claim that Fannie Mae’s accounting under FAS 91 during 1998 was improper. In particular, plaintiffs assert that Fannie Mae inappropriately “deferred” \$200 million in expenses and that Fannie Mae inappropriately accounted for certain REMIC securities. As discussed above, however, Fannie Mae’s treatment of the FAS 91 “catch-up” amounts was fully disclosed to its auditors who, after reviewing the company’s treatment, signed off on the

²³ Specifically, these “core business earnings” reflected the amortization of options, as opposed to the GAAP formulation, which required that options be marked to market for each financial reporting period.

company's 1998 financial statements. The Court need not reach the substance of this claim, however, because it is clearly time barred.

1. The Bulk Of Plaintiffs' FAS 91 Claims Relate To Events Occurring In 1998 And Must Be Dismissed Because They Are Time Barred.

The Sarbanes-Oxley Act of 2002 amended the statute of limitations for Section 10(b) claims, and requires that all such claims be brought within two years after "the discovery of the facts constituting the violation," and not later than five years after the violation. 28 U.S.C. § 1658(b). "[A] motion to dismiss on statute of limitations grounds should be granted 'when the statement of the claim affirmatively shows that the plaintiff can prove no set of facts that would entitle him to relief.'" *New England Health Care Employees Pension Fund v. Ernst & Young, LLP*, 336 F.3d 495, 501 (6th Cir. 2003) (quoting *Ott v. Midland-Ross Corp.*, 523 F.2d 1367, 1369 (6th Cir. 1975)). The Complaint here affirmatively shows that these claims are time barred.

Plaintiffs allege that Fannie Mae improperly deferred \$200 million of estimated expense in its 1998 financial statements. (Compl. ¶ 92.) Fannie Mae's 1998 financial statements were published in *April 1999*. There are simply no allegations that this alleged misapplication of FAS 91 had any impact on Fannie Mae's financial statements for any subsequent years. Similarly, plaintiffs allege that Fannie Mae improperly applied FAS 91 to certain REMIC securities that it held in its portfolio until 1998. The Complaint, again, nowhere alleges that Fannie Mae accounted inappropriately for any REMIC securities *after* 1998.

The lawsuits that were consolidated into this action were initiated in September 2004, more than five years after the disclosure of the expense deferral and the purported misapplication of FAS 91 to the REMIC securities, and well over five years after the acts comprising the purported Section 10(b) violation occurred. Based upon these irrefutable disclosures, and upon plaintiffs' own allegations, any claims arising from these alleged misapplications of FAS 91 are

time barred. Accordingly, these claims are insufficient to support a claim. *See New England Healthcare Employees Pension Fund*, 336 F.3d at 501; *Doe v. U.S. Dep't of Justice*, 753 F.2d 1092, 1115 (D.C. Cir. 1985) (“[A] motion to dismiss may be granted on the basis that the action is time-barred only when it appears from the face of the complaint that the relevant statute of limitations bars the action.”).

2. The Remaining FAS 91 Claims Also Fail Due To Their Lack Of Specificity.

Plaintiffs’ remaining allegations concerning Fannie Mae’s application of FAS 91 do not satisfy the pleading requirements of the PSLRA or Rule 9(b). As set forth in detail above, the PSLRA and Rule 9(b) require plaintiffs to specify “each statement alleged to have been misleading [and] the reason or reasons why the statement is misleading.” 15 U.S.C. § 78u-4(b)(1)(B); *see Williams v. WMX Techs. Inc.*, 112 F.3d 175, 177-78 (5th Cir. 1997). Plaintiffs’ remaining allegations concerning FAS 91 are too vague and conclusory to support a claim for securities fraud.

Specifically, Plaintiffs allege that Fannie Mae misapplied FAS 91 by:

- Calculating its “catch-up” adjustments with reference to its projected year end position rather than recording amounts solely on the basis of quarter-end positions. (Compl. ¶ 89.)
- Limiting application of FAS 91 to only those loans that exceeded a self-defined materiality limit, referred to as a “precision threshold.” (*Id.* ¶ 91.)
- Making “discretionary adjustments to financial statements ‘for the sole purpose of minimizing volatility and achieving desired financial results.’” (*Id.* ¶ 92.)
- “Forecast[ing] and manag[ing] unrecognized income and expense to measure and maintain a ‘cookie jar’ reserve.” (*Id.*)
- “Appl[y]ing discretion to the selection of market rate assumptions in order to achieve desired accounting results.” (*Id.*)

- “Incorrectly and inconsistently appl[ying] adjustments to the estimate of amortization. (*Id.*)

Rather than identify any statements by defendants that were false or misleading in light of these alleged accounting errors, plaintiffs cut and paste over 140 pages of Fannie Mae’s public disclosures into the Complaint, leaving the Court and defendants to puzzle through these generalized allegations concerning Fannie Mae’s application of FAS 91 and somehow determine which, if any, might be a material misstatement. Accordingly, these general allegations do not satisfy plaintiffs’ heightened burden of pleading each alleged misstatement with particularity. *See In re Burlington Coat Factory*, 114 F.3d at 1417-18. If plaintiffs’ claim is that Fannie Mae applied of FAS 91 resulted in materially false and misleading financials, they must allege specific facts demonstrating *which* financial statements were rendered false by this misapplication and *how* and *why* they were false. *See Rombach v. Chang*, 355 F.3d 164, 175 (2d Cir. 2004) (“[P]laintiffs cannot rest on their say-so that these statements are fraudulent; they must explain why. Having neglected to do so, they fail to plead with the requisite particularity.”); *Williams*, 112 F.3d at 177 (holding that a complaint must “specify the statements contended to be fraudulent, identify the speaker, state when and where the statements were made, and explain why the statements were fraudulent”); *May v. Borick*, No. CV 95-8407 LGB, 1997 WL 314166, at *8 (C.D. Cal. Mar. 3, 1997) (dismissing complaint because it “fails to specify, for any individual statement, how and why it was fraudulent”). Plaintiffs utterly fail to meet this burden, making no effort to tie any of Fannie Mae’s alleged FAS 91 accounting errors to any specific misstatements or omissions. Indeed, at no point do plaintiffs explain whether

these alleged misapplications of FAS 91 had *any* impact on Fannie Mae's financial statements, much less that such an impact was material and therefore actionable.²⁴

3. Plaintiffs Have Failed To Plead Specific Facts Supporting A Strong Inference Of Scierter Concerning Fannie Mae's Misapplication Of FAS 91

a. Fannie Mae's Policy Concerning FAS 91 Were Transparent To Its Auditor And Regulator

Fannie Mae's implementation of FAS 91, like its implementation of FAS 133, was transparent to its auditors and regulator. Plaintiffs do not allege that Fannie Mae withheld information from, or otherwise misled, KPMG or OFHEO with respect to FAS 91, including Fannie Mae's adoption of a "precision threshold." Indeed, KPMG concurred with Fannie Mae that a policy of not booking any adjustments to amortization that fell within the precision thresholds constituted a reasonable application of FAS 91. (*See* OFHEO Report at 18-19; Stern Decl. ¶ 1.) Moreover, the application of FAS 91 was one of a handful of policies that Fannie Mae repeatedly identified as "critical accounting policies" in its SEC filings. (*See, e.g.*, 2003 10-K at 42; Stern Decl. ¶ 10; 2002 10-K at 57; Stern Decl. ¶ 9.) KPMG, after reviewing these filings, concluded that they complied with GAAP in all material respects. (2003 10-K at 170; Stern Decl. ¶ 10; 2002 10-K at 146; Stern Decl. ¶ 9.) Such transparency refutes any allegation of fraudulent intent, as "reliance on the guidance of outside auditors is inconsistent with the intent to defraud." *Morse v. McWhorter*, 200 F. Supp. 2d 853, 899 (M.D. Tenn. 1998) (citing *Stavroff v. Mayo*, No. 95-4118, 1997 U.S. App. LEXIS 32774, at *19 (6th Cir. Nov. 12, 1997)).

²⁴ Presumably, the reason that plaintiffs do not provide the requisite detail is that if they were to do so, they would have to reveal that Fannie Mae estimated the net effect of the catch-up adjustments on Fannie Mae's financial statements to be *zero*. In the same Form NT-10-Q, filed November 15, 2004, in which Fannie Mae acknowledged that it should have been calculating the catch-up adjustments on a quarterly rather than an annual basis, it also estimated that "the effect will be an *increase* in 2001 and 2002 earnings and a *decrease* in 2003 earnings, with the cumulative effect of these changes across the three periods netting to zero." (Form NT-10-Q, at 4; Stern Decl. ¶ 16.) Plaintiffs' allegations, at best, suggest that Fannie Mae's alleged noncompliance with FAS 91 had a minor impact on the Company's financial statements. Such an insignificant impact on earnings, without more, is immaterial as a matter of law. *See Parnes v. Gateway 2000, Inc.*, 122 F.3d 539, 547 (8th Cir. 1997) (holding alleged overstatement of 2% of assets was immaterial as a matter of law because the amount was insignificant when viewed in context of total assets).

b. **Allegations By A Single Disgruntled Employee Are Facially Inadequate To Support A Strong Inference of Scienter**

Plaintiffs' sole basis for inferring any scienter regarding Fannie Mae's alleged misapplication of FAS 91 is the testimony of Roger Barnes, a former manager in Fannie Mae's Controller's Division. (*See* Compl. ¶¶ 119-35.) Even taken at face value, however, plaintiffs' allegations concerning Mr. Barnes cannot support any inference regarding Fannie Mae's application of FAS 91 because Fannie Mae immediately investigated Mr. Barnes' concerns, and the Company's external auditors concluded that the Company's practices were consistent with GAAP.

As the OFHEO Report recounts, Fannie Mae's Internal Audit Division conducted a full review of the controls over changes in amortization factors and alleged amortization factor anomalies. (OFHEO Report at 73; Stern Decl. ¶ 1.) This internal investigation involved a number of procedures to evaluate the issues raised by Mr. Barnes, including:

- determining whether the transactions identified by Mr. Barnes were included in Fannie Mae's catch-up analysis; and
- reviewing the underlying documentation supporting a \$6.5 million manual factor change, which Mr. Barnes alleged "was made to make iPDI 'agree' with forecasted amortization expense."

(*Id.* at 74-75.)

Plaintiffs attempt to dismiss Fannie Mae's diligence in investigating Mr. Barnes' issues by claiming that the Internal Audit Division's investigation was "incomplete, perfunctory, and ineffective." (Compl. ¶ 131.) Although the OFHEO Report concluded that Fannie Mae could have been more diligent in conducting its investigation, (OFHEO Report at 73; Stern Decl. ¶ 1.), OFHEO did *not* conclude that the investigation was motivated by an improper purpose. Neither the plaintiffs nor OFHEO have made any non-conclusory allegations that the Internal Audit Division's investigation was anything other than a good faith effort by the Company to

investigate the accounting issues raised by Mr. Barnes.

As the OFHEO report explains, Mr. Barnes' allegations were also discussed thoroughly during an "all hands" meeting on August 8, 2003, which was attended by representatives of the Controller's Department, Financial Standards, Office of Auditing, Office of Corporate Compliance, Fannie Mae's independent auditor, KPMG, as well as Mr. Barnes himself. (OFHEO Report at 73, 75 n.199; Stern Decl. ¶ 1.) During that meeting, Mr. Barnes' concerns were expressly considered and discussed. (*Id.*) No one at the meeting—including Mr. Barnes—objected to the conclusion that Fannie Mae's modeling process was in compliance with GAAP. (*Id.* at 73.) KPMG was at the meeting and concurred with the conclusions reached. Plaintiffs do not allege that Fannie Mae withheld any information from KPMG or made any false and misleading statements to KPMG.

At most, plaintiffs' allegations suggest that Fannie Mae's response to Mr. Barnes' issues was inadequate. Such allegations of negligence or corporate mismanagement, without more, are simply insufficient to support a claim for securities fraud. *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 479 (1977) ("Congress by [Section] 10(b) did not seek to regulate transactions which constitute no more than internal corporate mismanagement.") (quoting *Superintendent of Ins. v. Bankers Life & Casualty Co.*, 404 U.S. 6, 12 (1971)); *In re Digital Island Sec. Litig.*, 357 F.3d 322, 332 (3d Cir. 2004) ("Recklessness is not intended to encompass 'claims essentially grounded on corporate mismanagement.'") (quoting *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 540 (3d Cir. 1999)); *Colin v. Onyx Acceptance Corp.*, No. 01-55499, 2002 U.S. App. LEXIS 2556, at *4 (9th Cir. Feb. 14, 2002) ("Section 10(b) does not embrace causes of action for breach of fiduciary duties or corporate mismanagement."); *Stevelman*, 174 F.3d at 85 (noting that allegations of corporate mismanagement are not actionable under Rule 10b-5). Accordingly, plaintiffs' allegations regarding Mr. Barnes cannot suffice to remedy their failure to plead the requisite facts establishing a strong inference of scienter with respect to their FAS 91 claims.

E. Allegations That Fannie Mae's Internal Controls Were Weak Are Insufficient To Support A Strong Inference Of Scienter

Plaintiffs attempt to bolster their scienter allegations with respect to all of their claims by alleging that “[t]hroughout the Class Period, Defendants knew, or were reckless in not knowing, that the Company’s internal controls suffered from material weaknesses.” (Compl. ¶ 136.) Even if this allegation were true—which Fannie Mae by no means concedes—it would still amount to no more than a claim for mismanagement that is not actionable under the securities laws. *See Shapiro v. UJB Fin. Corp.*, 964 F.2d 272, 283 (3rd Cir. 1992) (“[I]t is not a violation of the securities laws to simply fail to provide ... sufficient internal controls.”). Moreover, allegations of weak internal controls plainly do not turn a complaint that does not adequately alleged scienter into one that does. As a Florida district court recently explained, “[a]lthough the breakdown of or lack of such internal controls might amount to negligence ..., *these deficiencies do not raise an inference of severe recklessness.*” *In re Sunterra Corp. Sec. Litig.*, 199 F. Supp. 2d 1308, 1326 (M.D. Fla. 2002) (emphasis added).

In addition to being legally deficient, plaintiffs’ claim that management knew its internal controls were inadequate is belied by judicially noticeable facts. During this time period, OFHEO told Fannie Mae that Fannie Mae’s internal controls were strong. In its 2002 Report to Congress, OFHEO explained that it had examined Fannie Mae’s internal controls and found them to be adequate and effective. (*See* 2002 OFHEO Report at 23; Stern Decl. ¶ 2.) In particular, OFHEO concluded that “Fannie Mae’s internal control framework and the management of that framework exceed safety and soundness standards.” (*Id.*) OFHEO elaborated that Fannie Mae’s “[m]anagement has an accurate and reliable process for identifying risks to business processes and implementing appropriate controls. Implemented controls properly address risks assessed by management.” (*Id.*) In light of these findings, no reasonable inference can be drawn that Fannie Mae knew or recklessly disregarded the possibility that its

internal controls were inadequate. As a result, these allegations are insufficient to support a strong inference of scienter.

F. Plaintiffs Are Unable To Allege Loss Causation For Any Remaining Claim Under The Standard Recently Promulgated By The Supreme Court

Plaintiffs' Complaint must be dismissed in its entirety for yet another, independent reason—plaintiffs have not adequately pleaded loss causation under the standards recently set forth by the United States Supreme Court in *Dura Pharms., Inc. v. Broudo*, 125 S. Ct. 1627 (2005). Put simply, plaintiffs fail to plead sufficient facts to show that any loss that they suffered was caused by defendants' alleged misstatements or omissions.

As the Supreme Court explained, an essential element of a claim for violations of Section 10(b) and Rule 10b-5 is loss causation—the causal connection between the alleged misrepresentations or omissions and the investors' alleged economic loss. *See id.* at 1631. Section 21D(b)(4) of the PSLRA provides that “the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages.” 15 U.S.C. § 78u-4(b)(4). A plaintiff must prove both transaction and loss causation in order to satisfy the PSLRA's causation provision. *See Dura Pharms.*, 125 S. Ct. at 1631.

Loss causation is the causal connection between a defendant's fraud and a plaintiff's injury. *See id.* It is insufficient for plaintiffs to allege merely that they purchased a security at an inflated price. Moreover, it is not enough for the misrepresentation to “touch upon” an investment's subsequent decline in value. *Id.* at 1632. Rather, as the Supreme Court held just last month:

[T]he logical link between [an] inflated share purchase price and any later economic loss is not invariably strong. Shares are normally purchased with an eye toward a later sale. But if, say, the purchaser sells the shares quickly before the relevant truth begins

to leak out, the misrepresentation will not have led to any loss. If the purchaser sells later after the truth makes its way into the market place, an initially inflated purchase price *might* mean a later loss. But that is far from inevitably so. When the purchaser subsequently resells such shares, even at a lower price, that lower price may reflect, not the earlier misrepresentation, but changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events, which taken separately or together account for some or all of that lower price.

Id. at 1631-32. The misrepresentation, not other factors, must actually cause a loss. *Id.* at 1632.

Here, plaintiffs have not adequately pled that any decline in the price of Fannie Mae common stock can be traced to any of the alleged misstatements or omissions. Although plaintiffs assert that Fannie Mae's restatement of its GAAP financial results was the misstatement that allegedly caused the loss, this vague assertion is flatly belied by judicially noticeable facts. As discussed below, Fannie Mae's GAAP financial results historically have not influenced Fannie Mae's stock price. The market's disinterest in Fannie Mae's GAAP earnings is evidenced by the fact that many of Wall Street's leading equity analysts do not even report Fannie Mae's financial results on a GAAP basis, and instead only report core earnings.²⁵

Indeed, plaintiffs' own allegations provide even further support for the notion that Fannie Mae's stock does not react to the Company's GAAP financials. For example, on October 15, 2002, Fannie Mae reported its financial results for the third quarter of 2002. (Compl. ¶ 197.) These results revealed that Fannie Mae's operating net income increased by 18.4 percent from the same quarter the previous year while its *GAAP net income declined by 19.1 percent*. (*Id.*) Nevertheless, on this news, Fannie Mae's stock price *increased by over four dollars*, from a close of \$66.48 on October 14 to a close of \$70.98 on October 15. (*See* Fannie Mae Historical Stock Prices for the Period Apr. 17, 2001-Sept. 21, 2004, *at*

<http://finance.yahoo.com/q/hp?s=FNM&a=03&b=17&c=2001&d=08&e=21&f=2004&g=d> (last

²⁵ *See supra* note 12.

visited May 3, 2005).) Conversely, on October 16, 2003, Fannie Mae announced that its GAAP net income for the third quarter of 2003 increased by 168 percent from the previous year (Compl. ¶ 240), but in response the price of Fannie Mae stock declined from \$72.57 to \$72.35. (See Fannie Mae Historical Stock Prices for the Period Apr. 17, 2001-Sept. 21, 2004, at <http://finance.yahoo.com/q/hp?s=FNM&a=03&b=17&c=2001&d=08&e=21&f=2004&g=d> (last visited May 3, 2005).)

This highlights the ways in which Fannie Mae's common stock reacts to many unique factors including: (1) concerns about increased Congressional or regulatory oversight of Fannie Mae; (2) interest rate movements; and (3) trends in the housing market. For example, during the approximately four years from the beginning of the class period to the present, the day on which Fannie Mae common stock experienced the greatest single-day percentage drop in price was March 10, 2003. On that day, the stock fell 6.87 percent, from \$63.28 to \$58.93. (See Fannie Mae Historical Stock Prices for the Period Apr. 17, 2001-Sept. 21, 2004, at <http://finance.yahoo.com/q/hp?s=FNM&a=03&b=17&c=2001&d=08&e=21&f=2004&g=d> (last visited May 3, 2005).) This decline occurred after William Poole, the president of the Federal Reserve Bank of St. Louis, stated that Fannie Mae should lose its implied government backing and be required to hold more capital. (Michael S. Derby, *Fed's Poole: Size of GSEs Presents Risk to US Economy*, Dow Jones Capital Markets Report, Mar. 10, 2003; Stern Decl. ¶ 22.)

Similarly, the second largest decline—6.66 percent—occurred on September 17, 2002, after OFHEO had “heightened its supervision of [Fannie Mae], requiring weekly reports on its exposure to interest-rate risk through this latest refinancing boom.” (Dawn Kopecki, *Fannie Mae Regulator Increases Portfolio Insight*, Dow Jones Int'l News, Sept. 16, 2002; Stern Decl. ¶ 23.) Another of the largest single-day declines was on June 9, 2003. That day, Fannie Mae's common stock fell 4.84 percent. (See Fannie Mae Historical Stock Prices for the Period Apr. 17,

2001-Sept. 21, 2004, *at*

<http://finance.yahoo.com/q/hp?s=FNM&a=03&b=17&c=2001&d=08&e=21&f=2004&g=d> (last visited May 3, 2005).) The decline was the result of OFHEO having sent a letter to Freddie Mac's board of directors outlining initial actions related to the restatement process and which led to widespread reports that critics of Freddie Mac and Fannie Mae said they GSEs needed a stronger regulator. (*See, e.g.,* John Connor, *ODJ Freddie/Fannie Critic Blasts GSE Regulatory Scheme*, Dow Jones Int'l News, June 9, 2003; Stern Decl. ¶ 24.)

Plaintiffs' main allegation supporting loss causation appears to be that Fannie Mae's stock price declined on the announcement of OFHEO's preliminary conclusions, (Compl. ¶¶ 3, 43), and on the release of OFHEO's September 2004 report. (*Id.* ¶¶ 5, 51.) But the OFHEO report also included various conclusions regarding Fannie Mae's internal controls and OFHEO's loss of confidence in Fannie Mae's management, in addition to its criticism of the Company's alleged misapplication of GAAP. Plaintiffs have failed to allege any facts from which one can conclude that the decline in Fannie Mae's stock price in response to the report was due to the possibility of an earnings restatement and not based upon the likelihood that Fannie Mae would face increased regulation. In fact, the inference that any decline in Fannie Mae's stock following the OFHEO Report was attributable to disclosure of the impending restatement is undermined by the market's reaction to the SEC's conclusion, on December 15, 2004, that Fannie Mae's application of FAS 91 and FAS 133 were inconsistent with GAAP. That day, the SEC released its conclusions, Fannie Mae agreed to restate its financial results and the Company's common stock price *increased* from the previous day's close of \$70.39 to a close of \$70.69. (*See* Fannie Mae Historical Stock Prices for the Period Dec. 14, 2004-Dec15, 2004, *at* <http://finance.yahoo.com/q/hp?s=FNM&a=11&b=14&c=2004&d=11&e=15&f=2004&g=d> (last visited May 3, 2005).)

In short, plaintiffs have failed to adequately plead that any misstatement by any defendant actually *caused* them any loss. Instead, in precisely the manner that the Supreme Court has declared to be insufficient, they allege merely that they “suffered damages in connection with their purchases of Fannie Mae common stock at artificially inflated prices.” (Compl. ¶ 285.) For this reason, as well, plaintiffs’ complaint should be dismissed.

IV.
CONCLUSION

As Fannie Mae has demonstrated in great detail above, plaintiffs’ allegations consist of nothing more than countless references to the OFHEO Report and extended excerpts from Fannie Mae’s public filings. For that, and the other foregoing reasons, Fannie Mae respectfully requests that the complaint be dismissed.

Dated: May 3, 2005

Respectfully submitted,

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CERTIFICATE OF SERVICE

I certify that on May 3, 2005, I electronically filed the foregoing with the Clerk of Court using the CM/ECF system, which will send notification of such filing to the following counsel of record in this matter who are registered on the CM/ECF. Service was accomplished on any of the following counsel not registered through the CM/ECF system via regular U.S. mail on the 3rd day of May, 2005.

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