UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

IN RE FANNIE MAE 2008 SECURITIES LITIGATION	Master File No. 08 Civ. 7831 (PAC) **SECOND AMENDED JOINT CONSOLIDATED CLASS ACTION COMPLAINT** JURY TRIAL DEMANDED

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UNREDACTED DOCUMENT THAT CONTAINS DESIGNATED DISCOVERY MATERIAL; FILED CONDITIONALLY UNDER SEAL PURSUANT TO PARAGRAPH 15 OF THE STIPULATED PRETRIAL PROTECTIVE ORDER FILED JULY 18, 2011

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1. Lead Plaintiffs Massachusetts Pension Reserves Investment Management Board ("PRIM") and State-Boston Retirement Board ("Boston") (collectively, the "Massachusetts Public Pension Funds") bring this federal securities class action on behalf of themselves and a class of others similarly situated consisting of all persons and entities that, between November 8, 2006 and September 5, 2008, inclusive (the "Class Period"), purchased or otherwise acquired Federal National Mortgage Association ("Fannie," "Fannie Mae," or the "Company") *common stock* and/or *options* and were thereby damaged (the "Common Stock Class"). Lead Plaintiff Tennessee Consolidated Retirement System ("TCRS") brings this federal securities class action on behalf of itself and a class of others similarly situated consisting of all persons and entities that during the Class Period purchased or otherwise acquired Fannie *preferred stock* and were thereby damaged. The claims alleged herein arise under Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 (the "Exchange Act"), 15 U.S.C. §§ 78j(b) and 78t(a); and SEC Rule 10b-5, 17 C.F.R. § 240.10b-5.

2. Lead Plaintiffs' allegations are based upon their respective information and belief and the investigation of Lead Counsel which included, among other things, a review and analysis of (1) Fannie's public filings with the United States Securities and Exchange Commission (the "SEC"); (2) reports and/or press releases regarding Fannie prepared by its regulators, the Office of Federal Housing Enterprise Oversight ("OFHEO") and the Federal Housing Finance Agency ("FHFA"); (3) congressional testimony regarding Fannie and the housing and mortgage crisis from, among other individuals, current and former members of the Company's senior management, industry experts, and the director of OFHEO and FHFA; (4) congressional and federal commission reports regarding Fannie and the housing and mortgage crisis; (5) publicly

available trading information; (6) articles in the general and financial press; (7) interviews with confidential witnesses; and (8) the pleadings and related documents in certain other litigation.[1]

3. Lead Plaintiffs' allegations in ¶¶257-453 relating to Fannie's false representations about its exposure to subprime and Alt-A loans are based upon their respective information and belief and the investigation of Lead Counsel which included: (1) Fannie's public filings with the SEC; (2) reports and/or press releases regarding Fannie prepared by its regulators, OFHEO and FHFA; (3) congressional testimony regarding Fannie and the housing and mortgage crisis from, among other individuals, current and former members of the Company's senior management, industry experts and the director of OFHEO and FHFA; (4) congressional and federal commission reports regarding Fannie and the housing and mortgage crisis; (5) publicly available trading information; (6) articles in the general and financial press; (7) review of non-public, internal Company documents obtained by Lead Counsel through discovery; (8) the pleadings in *United States Securities and Exchange Commission v. Daniel H. Mudd, et al.*, 11civ9202 (S.D.N.Y.) (the "SEC Action"); and (9) the Non-Prosecution Agreement ("NPA") between the SEC and Fannie dated December 15, 2011 and signed by Fannie's current President and CEO, Michael J. Williams ("Williams"), and the statement of agreed-upon facts appended as Exhibit A thereto.[2]

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1 For the purpose of preserving any and all of Lead Plaintiffs' rights and privileges concerning certain claims alleged in the Joint Consolidated Amended Class Action Complaint filed June 22, 2009 ("June 2009 Complaint") (Dkt#102) including without limitation the right to appeal, Lead Plaintiffs hereby adopt by reference and incorporate Sections IX (¶¶423-520) XIV-XV (¶¶640-834), and ¶¶72-76; 586-592 of the June 2009 Complaint as if fully set forth herein, as permitted under Fed. R. Civ. P. 10(c). These adopted and incorporated sections and the paragraphs therein include those claims dismissed by the Court in its decisions dated November 24, 2009 (Dkt #190), at 4-6, and September 30, 2010 (Dkt#228), at 12-22, 27-39 (and specifically those allegations and claims dismissed by the Court's September 30, 2010 order at 45, numbers 1(a), 1(c), 2, 3(a), and 3(c)).

2 New information alleged in this second amended complaint regarding Fannie's exposure to subprime and Alt-A loans is based on Plaintiffs' independent investigation, review of internal Fannie Mae documents, and, in part, on the allegations of the SEC Action and statement of facts appended to the NPA ("Statement of Facts"). The SEC Action was filed after a 2½ year investigation that involved over 100 witness examinations and the collection of over 60 million pages; the facts appended to the NPA, which was signed by CEO Williams, form the factual basis

I. INTRODUCTION

4. On September 7, 2008, James Lockhart, the director of FHFA, Fannie's regulator, stunned investors by announcing that Fannie—always purportedly a model of safety and financial stability—would be placed under conservatorship. This move was understood to have been necessitated by Fannie's losing gamble with risky subprime and "Alt-A" loans (*i.e.*, loans that were approved for borrowers with slightly higher credit scores than subprime borrowers but that had little to no documentation). In direct contradiction to its conservative and prudent reputation, Fannie embarked on a multi-year strategy to shift its focus away from investing in, guaranteeing, and securitizing safe, "plain vanilla" loans and toward risky subprime and Alt-A loans. The Defendants (as defined herein) hid this material shift from investors and continued to depict Fannie as a picture of safety in the mortgage industry. The Defendants fostered this illusion by failing to disclose and/or misstating the Company's ability to adequately gauge the risk of subprime and Alt-A loans. As United States Senator Richard Shelby stated in a September 8, 2008 interview with *Bloomberg* while explaining why Fannie was placed in conservatorship, "**They found out [Fannie Mae] had a house of cards**. . . [O]nce [the U.S. Treasury Department] got someone looking closely at [Fannie's] books, they realized there just wasn't adequate capital there." (Emphasis added.)

5. Throughout the Class Period, Fannie crafted a pristine public image as one of the lowest-risk financial institutions in the world. Fannie was chartered by the United States Congress in 1968 with a statutory mission to provide stability, liquidity, and affordability to the U.S. housing market. Consistent with the requirements of its Congressional charter, the

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for the SEC Action's allegations. In signing the NPA, CEO Williams on behalf of Fannie accepted responsibility for Fannie's conduct and did not "dispute, contest, or contradict the factual statements set forth" in the Statement of Facts. NPA ¶1. To the extent that these sources are considered the basis for information and belief, Lead Plaintiffs allege facts with particularity and identify within the newly-added sections of this complaint the exact sources for the factual allegations. The information alleged is otherwise within Defendants' possession and knowledge.

Company had long been a cautious investor in safe, conventional mortgages. At the beginning of the Class Period, Fannie's senior executives specifically reported that the Company was staying away from riskier loans, such as no-document Alt-A loans, and would only consider getting involved with them on a limited basis if Fannie was paid for the extra risk it was taking. But its public image and statements were at odds with reality; there was a very different story behind the scenes.

6. By the mid-2000s, the mortgage market was rapidly expanding in the direction of high-risk, non-prime mortgage loans, and Fannie's market share was dropping rapidly. At the same time, Fannie was under increasing pressure to take on more risk by purchasing and securitizing these non-prime mortgage loans. In particular, Fannie's largest customer, Countrywide—with whom Fannie had a longstanding and lucrative relationship—threatened to sell its loans directly to Wall Street rather than to Fannie unless the Company bought a bigger piece of its highest-risk loans.

7. As the housing market changed, Fannie was presented with a fateful choice. As set forth in a June 2005 internal presentation ("June 2005 Presentation") that was found by Congressional investigators in the files of Fannie's now-former CEO, Defendant Daniel H. Mudd ("Mudd"), Fannie could either "stay the course" by continuing to focus on low-risk, traditional, 30-year fixed-rate mortgages or "meet the market" by focusing on high-risk, non-prime mortgage loans thereby generating higher revenue and profits, but exposing the Company to unprecedented risk.

8. Defendants chose to meet the market and caused Fannie to secretly deviate from its public persona as one of the lowest-risk financial institutions in the world. Yet, Fannie faced a problem. It was ill-prepared to "meet the market." As noted in the June 2005 Presentation, the

Company lacked "capabilities and infrastructure" as well as "knowledge of the credit risks." Defendants knowingly caused Fannie to begin accumulating high-risk loans without the resources—both human and structural—to identify and manage the credit risk associated with such loans. In fact, in October 2006, at the same time that the Company was continuing to dramatically ramp up its investment in high-risk, non-traditional loans, Fannie's Chief Risk Officer, Defendant Enrico Dallavecchia ("Dallavecchia"), warned Mudd that he had "a serious problem with the control process around subprime limits . . . . **There is a pattern emerging of inadequate regard for the control process.**" (Emphasis added.) Dallavecchia repeated his internal warning in July 2007, telling Mudd that Fannie was "not even close" to having proper risk controls. As Mudd later admitted at a December 2008 Congressional hearing, he was warned in October 2006 that Fannie "[was] rushing into billions of dollars worth of subprime loan purchases without really knowing what [it was] doing."

9. Because Fannie lacked the capabilities to assess the credit risks of high-risk, non-traditional loans, its move to "meet the market" was essentially an undisclosed high stakes gamble without adequate ability to judge the risk of the bet. As Marc Gott, a former director in Fannie's loan servicing department told the New York Times in October 2008, "**We didn't really know what we were buying . . . . This system was designed for plain vanilla loans and we were trying to push chocolate sundaes through the gears.**" (Emphasis added.)[3]

10. Despite these known facts, the Defendants began a radical shift in Fannie's business focus from high-quality prime loans to extremely risky non-prime and nontraditional loans, including subprime and Alt-A loans. Throughout much of the Class Period, the Defendants failed to disclose Fannie's existing, and mounting, exposure to such loans.

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3 Charles Duhigg, *Pressure to Take More Risk, Fannie Reached Tipping Point*, New York Times (Oct. 4, 2008).

11. Moreover, by the fall of 2006, Fannie, in analyzing the housing market, realized that its foray into the subprime and Alt-A markets would result in massive losses. Numerous internal reports pointed to severe declines in housing prices and offered projections of serious delinquencies and default rates that would adversely affect Fannie.

12. In particular, at the end of 2006, Fannie, deeply concerned about home value decline, assembled a team to build a home price model forecast. The result was a PowerPoint document, completed in January 2007, called the "Home Price Forecasting Report." According to this report, which was not made public during the Class Period, Fannie projected a 50% decline in home prices in the near term.

13. Notwithstanding Fannie's inadequate risk control and its projections of impending massive declines in home prices and increases in delinquency and default rates, the Defendants continued to tell investors that, regardless of the condition of the subprime/Alt-A mortgage market, the Company's book of business was strong because it was only purchasing products "comparable to the conventional book of business" and "the credit quality of [its Alt-A] looks like the credit quality of the rest of [its] book."

14. Unbeknownst to investors, Defendants misrepresented Fannie's exposure to subprime loans. While in its public filings Fannie described subprime loans as those "made to borrowers with weaker credit histories," or "a higher likelihood of default," Defendants failed to disclose that Fannie did not include in its subprime disclosures certain subprime-quality loan products that were specifically targeted at borrowers with weaker credit histories and higher default risks, including "Expanded Approval" ("EA") and "My Community Mortgage" ("MCM") loans. Defendants knew that EA loans, in particular, actually performed worse than Fannie's subprime loans and had similar credit characteristics. Further, Defendants falsely

represented that Fannie classified loans as "subprime" when they were originated by a "specialty" subprime lender or a "subprime division of a large lender." In fact, Fannie classified as "subprime" only the loans originated by 15 of approximately 210 lenders on the subprime lender list issued by the Department of Housing and Urban Development ("HUD"), and Fannie was unable to even identify loans originated by subprime divisions of large lenders.

15. Similarly, Defendants also misrepresented Fannie's exposure to Alt-A loans. While in its public filings Fannie described Alt-A loans as those with lower or alternative documentation requirements, Defendants failed to disclose that Fannie did not include in its Alt-A disclosures certain reduced-documentation loan products, such as those internally classified as "Lender-Selected." In addition, Defendants failed to disclose that while they stated that Fannie classified loans as "Alt-A if the lenders that deliver the mortgage loans to [Fannie Mae] have classified the loans as Alt-A based on documentation or other product features," Fannie actually mandated which loans lenders should classify as "Alt-A" versus the undisclosed "Lender-Selected."

16. By failing to disclose Fannie's true exposure to subprime and Alt-A loans, Defendants vastly understated Fannie's risk by magnitudes.

17. Thus, as the Defendants transformed Fannie from a low-risk, conservative institution into a highly-leveraged entity with massive risk exposure, they falsely represented to investors that Fannie's credit profile and underwriting standards were strong and unchanged. Accordingly, investors had no way of knowing that Fannie was no longer the same prudent mortgage investor and guarantor it had been for decades.

18. Fannie's misrepresentations misled even sophisticated research analysts. For example, on February 28, 2007, Bear Stearns issued a research report that stated, in part: "[T]o

date the [C]ompany has limited its exposures to sub-prime and Alt A loans .... [Fannie] believes its credit performance will remain significantly better than most other market participants ...." Further, on May 9, 2007, JP Morgan issued an analyst report which stated: "Single-family credit quality remains good, and what little exposure Fannie has to higher risk subprime and Alt-A products is largely credit enhanced to minimize Fannie's losses."

19. Even as it accumulated hundreds of billions of dollars of risky loans, Fannie falsely reassured investors that it had a healthy core capital cushion—a crucial financial safety net the Company was required to maintain to protect against both a downturn in the mortgage market and other financial losses—that would allow it to absorb any losses. The Company regularly affirmed to investors that its core capital level was well above the minimum required by federal regulators—an amount woefully inadequate to protect against the losses that the Defendants knew Fannie was facing based on its inadequate risk controls and internal projections regarding the housing market.

20. As the housing market continued to crater in late 2007 and 2008, Fannie's financial position became increasingly more difficult to hide. By this time, Fannie's internal projections had become a reality. With actual housing prices plunging and borrowers—particularly the high-risk borrowers who took out subprime and like loans—defaulting in huge numbers, the Defendants could no longer continue the charade and were forced to admit that Fannie was swamped by massive losses. Once the government discovered the truth, it had no choice but to assume control of Fannie as conservator.

21. By the start of the Class Period, the Defendants had set in motion the events that led to Fannie's destruction. The Defendants blatantly ignored the specific warnings from Fannie's Chief Risk Officer that the Company did not have the risk controls in place to monitor

and assess the risks of subprime/Alt-A products. They knew that they were gambling with Fannie's—as well as investors'—future by blindly rushing into subprime mortgage investments, but they decided simply to disregard the danger. As Columbia Business School professor and mortgage expert Charles W. Calomiris concluded in a written statement to Congress in December 2008, Fannie made a "conscious decision to encourage the underestimation of risk in subprime and Alt-A lending."[4]

22. In the hours and days following the government takeover, federal officials confirmed the utter falsity of the Defendants' Class Period representations to investors regarding Fannie's purportedly low-risk credit profile and adequate capital cushion. As Dallas Fed President Richard Fisher stated in a September 8, 2008 speech, quoted by *Bloomberg*, federal examiners "**concluded that the capital of these institutions was too low relative to their exposure.**" (Emphasis added.) In a September 23, 2008 report to Congress, FHFA Director Lockhart confirmed that "the credit profile at [Fannie] followed the market down in 2006 and 2007—**without commensurate pricing for risk.**" (Emphasis added.) As one pair of mortgage experts concluded:

> [T]he [Fannie Mae] propaganda machine purposefully misled people into believing that it was keeping risk low and operating under an adequate prudential regulatory regime.
>
> — Wallison and Calomiris, *The Last Trillion Dollar Commitment—The Destruction of Fannie Mae and Freddie Mac*, September 2008.

23. During the Class Period, the Defendants knew of Fannie's exposure to the risks and caused Fannie to sell more than $14 billion of common and preferred shares and more than $439 billion of bonds and other debt securities. As a result of Fannie's false and misleading statements, investors have suffered billions in losses: on September 8, 2008, the first day of

4 Written Statement of Charles W. Calomiris Before the Committee on Oversight and Government Reform, U.S. House of Representatives, Dec. 9, 2008, at 2 ("Calomiris Statement").

trading after the government announced the conservatorship, Fannie's common stock price plunged nearly 90%—from $7.04 to $0.73. The price of Fannie's preferred shares similarly declined. The Defendants are also responsible for earlier losses stemming from the partial corrective disclosures leading up to that final shock to the market. In light of the foregoing, Lead Plaintiffs bring this action seeking to recover the billions of dollars in damages caused by the Defendants' violations of the federal securities laws.

II. JURISDICTION AND VENUE

24. This Court has jurisdiction over the subject matter of this action pursuant to Section 27 of the Exchange Act, 15 U.S.C. § 78aa, and 28 U.S.C. §§ 1331, 1337, and 1367.

25. Venue is proper in this District pursuant to Section 27 of the Exchange Act, 15 U.S.C. § 78aa; 28 U.S.C. §§ 1391(b) and (c); and the order of the Judicial Panel of Multidistrict Litigation, dated February 11, 2009, transferring all related actions pending in other districts to the United States District Court for the Southern District of New York. Substantial acts in furtherance of the wrongs alleged and/or their effects have occurred within this District, and Fannie's securities traded on the New York Stock Exchange ("NYSE") during the Class Period.

26. In connection with the acts and omissions alleged in this Second Amended Joint Consolidated Class Action Complaint ("Complaint"), all of the Defendants, directly or indirectly, used the means and instrumentalities of interstate commerce, including, but not limited to, the mails, interstate telephone communications, and the facilities of the national securities markets.

III. PARTIES

A. Plaintiffs

27. Lead Plaintiff TCRS is a defined benefit pension plan that serves Tennessee state employees, higher education employees, K-12 public school teachers, and employees of political subdivisions who have elected to participate in the plan. TCRS purchased or acquired Fannie

securities as set forth in the amended certification filed with the Court on June 22, 2009 (Dkt#102) (appended to the June 2009 Complaint) and July 18, 2011 (Dkt#300) (Exhibit C to the Declaration Of Frederic S. Fox In Support Of Preferred Stock Lead Plaintiff's Motion For Class Certification An Appointment Of Class Representatives And Class Counsel).

28. Lead Plaintiff PRIM manages public pension funds established for the benefit of current and retired Massachusetts employees and public school teachers. PRIM purchased or acquired Fannie securities as set forth in the certification filed with the Court on June 22, 2009 (Dkt#102) (appended to the June 2009 Complaint) and July 18, 2011 (Dkt#303) (Exhibit E to the Declaration Of Jonathan M. Plasse In Support Of Common Stock Lead Plaintiffs' Motion For Class Certification And Appointment Of Class Representatives And Class Counsel ("Plasse Class Certification Declaration")).

29. Lead Plaintiff Boston oversees the management of retirement system funds on behalf of current and retired employees of The City of Boston. Boston purchased or acquired Fannie securities as set forth in the amended certification filed with the Court on June 22, 2009 (Dkt#102) (appended to the June 2009 Complaint) and July 18, 2011 (Dkt#303) (Exhibit F to the Plasse Class Certification Declaration). Federal National Mortgage Association

30. Defendant Fannie is a government-sponsored enterprise ("GSE") chartered by Congress, with its principal place of business located at 3900 Wisconsin Avenue NW, Washington, DC 20016-2892. Fannie is owned by the Company's shareholders, and the Company's equity securities were listed and traded on the NYSE during the Class Period. Fannie operates in the U.S. secondary mortgage market by providing funds to mortgage lenders through the purchase of mortgages and mortgage-related securities. Fannie also issues and guarantees mortgage-related securities.

B. Officer Defendants

31. Defendant Daniel H. Mudd was President, Chief Executive Officer ("CEO") and a director of Fannie during the Class Period. In his role as CEO, Mudd chaired the Management Executive Committee, which was responsible for reviewing and overseeing Fannie's overall risk management, which included addressing: (1) issues referred to it by Fannie's risk committees; (2) matters that involved multiple types of risks; and (3) other significant business and reputational risks. When the government took over Fannie, the Company announced that Mudd would be fired. Mudd signed each of the Company's Forms 10-K and 10-Q filed during the Class Period.

32. Defendant Enrico Dallavecchia was Executive Vice President and Chief Risk Officer ("CRO") during the Class Period until August 2008. In his role as CRO, Dallavecchia chaired the Allowance for Loan Losses Oversight Committee, which reviewed and approved the methodology and the amount of Fannie's allowance for loan losses and reserve for guaranty losses (combined loss reserves) on a quarterly basis. In addition, as CRO, Dallavecchia had an oversight role regarding credit, market, operational and liquidity risks. Among other things, Dallavecchia warned Defendant Mudd that Fannie's risk management systems were inadequate. Dallavecchia made a number of false and misleading statements in conference calls during the Class Period.

33. Defendants Mudd and Dallavecchia are referred to herein collectively as the "Officer Defendants." Each of the Officer Defendants made knowingly false and misleading statements concerning, *inter alia*, Fannie's (i) risk management and controls, and (ii) exposure to subprime and Alt-A mortgages in public filings and statements and in other public presentations, speeches, and/or testimony.

34. Throughout the Class Period, Defendant Mudd was responsible for ensuring the accuracy of Fannie's public filings and other public statements, and he personally attested to and certified the accuracy of Fannie's financial statements.

35. It is appropriate to treat the Officer Defendants as a group for pleading purposes and to presume that the false and misleading information contained in Fannie's public filings, press releases and other statements, as alleged herein, are the collective actions of this narrowly defined group of defendants. By virtue of their high level positions at Fannie, each of the Officer Defendants directly participated in the day-to-day management of Fannie, and each was privy to confidential, proprietary information about Fannie's business, operations and practices. The Officer Defendants were involved or participated in drafting, reviewing, approving, and/or disseminating the false and misleading statements alleged in the Complaint. Both were on the disclosure committee–Mudd as CEO and Dallavecchia as the only representative from the Chief Risk Office. They were thus aware that the statements were being made, and they nonetheless approved or ratified them in violation of the federal securities laws.

36. As officers and controlling persons of a publicly held company whose common stock was and is registered with the SEC pursuant to the Exchange Act, and traded on the NYSE, and is also governed by the provisions of the federal securities laws, the Officer Defendants each had a duty to disseminate promptly accurate and truthful information with respect to Fannie's financial condition, performance, operations, and business practices and to correct any previously issued statements that had become materially misleading or untrue so that the market price of Fannie's publicly traded securities would be based upon truthful and accurate information. The Officer Defendants' misrepresentations and omissions during the Class Period violated the federal securities laws.

37. Fannie and the Officer Defendants are referred to herein as the "Defendants."

D. Federal Housing Finance Agency

38. Defendant FHFA was created on July 30, 2008, when the President signed into law the Housing and Economic Recovery Act of 2008 ("HERA"). HERA gave FHFA the authority necessary to oversee Fannie Mae. In addition, HERA combined the staffs of OFHEO, the Federal Housing Finance Board (FHFB), and the GSE mission office at HUD. On September 7, 2008, James Lockhart, the director of FHFA, announced that Fannie would be placed under conservatorship and FHFA would assume the power of its board and management.

39. On September 3, 2009, FHFA requested a pre-motion conference on its anticipated motion to intervene in this action. (Dkt#180). On October 2, 2009, the Court conducted a scheduling conference wherein FHFA's request was addressed. *Id.* On October 13, 2009, pursuant to Rule 24(a) of the Federal Rules of Civil Procedure, the Court granted FHFA's request to intervene and ordered that FHFA may "intervene as a defendant." *Id.*

IV. FANNIE'S BUSINESS AND OPERATIONS

A. Fannie Is a Leading, Important Player in the Mortgage Market

40. Fannie is the nation's largest source of financing for home mortgages and one of the world's chief non-bank financial services firms. The Company's common stock was listed and publicly traded on the NYSE under the ticker "FNM" during the Class Period. Certain series of Fannie's preferred stock traded on the NYSE during the Class Period.

41. At the end of 2006, Fannie had reported stockholder equity of $41.5 billion, making it one of the most prominent companies on the NYSE. By comparison, a company such as Microsoft had stockholder equity of approximately $40 billion for the same time period. Indeed, as Ladenburg Thalman analyst Richard X. Bove noted in a July 2008 research report, Fannie's assets approached the size of those held by the Federal Reserve.

42. Fannie was chartered as a GSE in 1968 by the United States Congress for the purpose of providing liquidity in the secondary mortgage market to increase the availability and affordability of homeownership. The other GSE is its sister organization, Freddie Mac (also referred to herein as "Freddie"). Although a GSE is government-chartered, it is a private shareholder-owned and controlled institution that, while lacking an express government guarantee, benefits from the perception that the government stands behind its securities and financial obligations.

B. Fannie Has Two Symbiotic Businesses

43. Fannie operates exclusively in the secondary mortgage market and does not loan money directly to consumers. The foundation of its business is supported by two separate, but important pillars—its *credit guaranty* business and its *portfolio investment* business. With both businesses' lifeblood consisting primarily of acquired mortgages, the two generally flourish or flounder in tandem. Fannie refers to these two businesses together as its "mortgage credit book of business."[5]

44. Fannie's role in the *credit guaranty* business is to be financially responsible for borrowers' defaults. During the Class Period, Fannie purchased mortgages from lenders—mortgages it put into trusts for purposes of holding them separate from its other assets—and then packaged them into mortgage-backed securities ("MBS").[6] Then, for a fee, Fannie *guaranteed* its MBS holders that the borrowers whose mortgages made up the MBS would, in fact, timely pay their interest and principal.

[5] According to Fannie's 2007 Form 10-K, the *credit guaranty* side of Fannie's business represented 73% of Fannie's book of business, and the *portfolio investment* side represented 25%.

[6] Purchasers of Fannie MBS were buying a beneficial interest in pools of mortgage loans and other mortgage-related securities issued by Fannie.

45. On a regular basis, usually once or twice a year, Fannie bargained individually with each lender to determine (a) the types of loans that Fannie would accept from them and (b) the "guaranty fee" that the lender would pay Fannie. Fannie was typically compensated for providing a guarantee by retaining a portion of the borrowers' interest payments going into the MBS trust. While the guarantee obligation was Fannie's alone, it typically hedged that credit risk by either obtaining separate guarantees from third parties, such as lenders that originated the mortgages, or contracting with financial guarantors.

46. On the *portfolio investment* side, Fannie held mortgage loans, mortgage-related securities, and other securities that it purchased from commercial banks for its own investment purposes. The mortgage-related securities in which Fannie invested included both MBS created by third parties—referred to as "private label" MBS—and Fannie MBS. Fannie funded these portfolio purchases by issuing short and long term debt and debt securities to domestic and international capital market investors. Fannie profited to the extent that the income from mortgage assets and other investments in its portfolio exceeded the low amount of interest it was paying its debt-holders.

C. Fannie's Charter Places Restrictions on the Type of Loans in Which Fannie Can Transact, with a Clear Emphasis on Safety

47. As stated in an OFHEO "Report of the Special Examination of Fannie Mae," dated May 2006: "Fannie Mae senior management promoted an image of the Enterprise as one of the lowest-risk financial institutions in the world and as 'best in class' in terms of risk management, financial reporting, internal control, and corporate governance."

48. As explained in Fannie's 2006 10-K, under its charter, Fannie is not allowed to purchase or securitize mortgage loans with original principal balances larger than a certain limit, which, during 2006 and 2007, was $417,000 for a single-family residence.

49. Similarly, Fannie's charter requires credit enhancement on any conventional single-family loan purchased or securitized by Fannie with a loan-to-value ratio of over 80%.

50. As further explained in Fannie's 2006 10-K, Fannie is required under its charter "to obtain approval of the Secretary of HUD for any new conventional mortgage program that is significantly different from those approved or engaged in prior to the enactment of the [1992 Act]."

51. Throughout the 1990s, the mortgages purchased and securitized by Fannie remained overwhelmingly 30-year (*i.e.*, long term) fixed rate, prime mortgages.

52. Fannie's long-standing conservative reputation together with regulatory restrictions understandably gave investors false comfort — comfort that the Defendants exploited.

V. THE DEFENDANTS' FRAUDULENT SCHEME REGARDING FANNIE'S RISK MANAGEMENT AND CONTROLS

53. The Defendants are liable for violations of the Exchange Act arising out of the sale of Fannie common shares and preferred shares during the Class Period.

A. Subprime and Non-Prime Loans Fueled the Growth and Crash of the United States Housing Market

1. The Growth

54. In the early part of the last decade, low interest rates and easy credit conditions, followed by the availability of ample debt options, sparked a housing boom. With eager potential purchasers, the seemingly always-escalating value of real estate, and a supply of properties that trailed demand, lenders loosened their lending standards and offered more and more loans to higher-risk borrowers. During the early part of this decade, home prices rose exponentially faster than 25 years preceding it and at a dramatically faster rate than income. Somewhat illogically, between 2001 and 2006, while the premium charged by subprime lenders

over prime lenders shrunk by approximately 50%, the credit ratings of the subprime borrowers declined. In other words, while the risk of default went up, the cost of the loan went down.

55. To keep pace with a market that seemed increasingly out of reach, buyers sought less traditional loan structures that allowed them to keep more expensive home purchases affordable. For example, one widely-used structure was the adjustable rate mortgage ("ARM"), which had a two-part interest payment system: (a) several years at a very low rate, with (b) a jump to a higher adjustable rate for the remainder of the loan term. Borrowers generally assumed that they would re-finance before the jump in rates. But that assumption required stable rates to keep loans affordable, as well as level or rising home prices to ensure property values would cover the principal of the new loan, with room to spare.

56. During this period, buyers of all stripes attempted to buy new homes. Many did not have the credit or income history to justify lenders providing them with prime (*i.e.*, long-term, quality) loans. But as interest rates dropped, mortgage *investors* became dissatisfied with the limited returns that they were getting from traditional loan investments. They had an appetite for riskier debt, and loan originators obliged by expanding into the subprime and Alt-A market. In 2003, less than 11% of originations were non-prime (subprime or Alt-A); by 2006, more than one-third of all originations fit that category. During this period, "Alt-A originations increased almost fivefold."

2. The Crash

57. Securitizing riskier loans was premised on the notion that one could obtain return while passing the risk to others. Securitization of subprime and non-prime loans (*i.e.*, the creation of MBS) was fueled by the nexus of investor appetite and high ratings provided by the ratings agencies for these tranched instruments.

58. A construction boom had followed on the heels of the housing rush, and by this period, with demand satiated, there was a surplus of inventory on the market. According to the National Association of Realtors, during the year that started with the third quarter of 2006, home prices actually declined by 1.5%. The S&P/Case-Shiller Index puts the decline at 3.2%.

59. Home prices stopped rising in 2006. With property values maintaining or dropping (and with already scant equity evaporating), refinancing became a problem for those very borrowers who needed it the most—those in fear of rising interest rates. Borrowers who did not have verified income or sufficient documentation similarly began to have loan payment problems. Foreclosure rates began to noticeably increase in "early 2006," which can be attributed to the increase in the origination of subprime and other nontraditional mortgages, increases in short-term interest rates and declining home prices.

60. In the months prior to this critical period, after previously shunning this high risk market, Fannie belatedly entered and aggressively began to increase its position in subprime/Alt-A products. The Defendants abandoned Fannie's reputation as a bastion of safety. As the subprime/Alt-A market grew, the Defendants felt that the Company was missing out on all of the action and, in an effort to stay relevant and find return, they directed Fannie down a fateful path of pursuing higher risk loans even though they knew and/or recklessly disregarded that Fannie's infrastructure was ill-equipped to handle such risk.

B. In Order to Maintain Market Share and Increase Returns, the Defendants Severely Altered Fannie's Strategy and Caused it to Pursue Higher-Risk Subprime and Alt-A Loans

1. The Defendants Saw the Market Passing the Company By—It Risked Losing Market-Share, and Its Loans Yielded Unsatisfying Returns

61. By the mid-2000s, the credit market was quickly expanding beyond Fannie's comfort zone of safe, fixed rate loans, and into the abyss of riskier mortgage products, such as

subprime and Alt-A loans and related securities. To the extent that there was business opportunity in these new credit areas, it was passing Fannie by; Fannie's market share was dropping dramatically. As reported in Fannie's Form 10-K for 2004, which was filed in December 2006, "[d]uring 2005, our estimated market share of new single-family mortgage-related securities issuance was 23.5%, compared to 29.2% in 2004 and 45.0% in 2003."

62. CEO Mudd recognized this diminishing return. As he stated in an October 5, 2008 New York Times article entitled *Pressured to Take More Risks, Fannie Reached Tipping Point*, "Fannie Mae faced the danger that the market would pass us by. . . . We were afraid that lenders would be selling products we weren't buying . . . ."

63. Indeed, Fannie faced direct pressure from its biggest lender. The October 5, 2008 article reported on a meeting between Mudd and Countrywide Financial CEO Angelo Mozilo in or around late 2004/early 2005:

> Shortly after he became chief executive, Mr. Mudd traveled to the California offices of Angelo R. Mozilo, the head of Countrywide Financial, then the nation's largest mortgage lender. Fannie had a longstanding and lucrative relationship with Countrywide, which sold more loans to Fannie than anyone else. But at that meeting, Mr. Mozilo . . . threatened to upend their partnership unless Fannie started buying Countrywide's riskier loans. Mr. Mozilo . . . told Mr. Mudd that Countrywide had other options. For example, Wall Street had recently jumped into the market for risky mortgages. . . . "You're becoming irrelevant," Mr. Mozilo told Mr. Mudd, according to two people with knowledge of the meeting who requested anonymity because the talks were confidential. In the previous year, Fannie had already lost 56 percent of its loan-reselling business to Wall Street and other competitors. "You need us more than we need you," Mr. Mozilo said . . . .

2. The Defendants Knew and/or Recklessly Disregarded the Immense Risk of the Subprime/Alt-A Market

64. The Defendants materially altered Fannie's risk profile by accumulating subprime and Alt-A mortgage products and understood, but did not disclose, that they were exposing

Fannie to massive risk. Certain executives at the Company warned against its new strategic direction as Fannie had studied this market before. Edward J. Pinto, a former Fannie chief credit officer who testified before the U.S. House of Representatives Committee on Oversight and Government Reform on December 9, 2008 (the "December 9 Hearing"), noted in his written statement that "[i]n the early-1990s Fannie and Freddie publicly announced they were no longer buying [Alt-A] loans because they were too risky."[7]

65. In his testimony at the December 9 Hearing, Charles W. Calomiris (Henry Kaufman Professor of Financial Institutions, Columbia Business School), explained that while subprime and non-prime loans serve a purpose, they require that: (a) a risk premium be paid for the extra risk the lender is taking on and (b) balance in the loan portfolio so that it is not too heavily weighted toward these riskier loans. "The problem with these sorts of loans arises . . . when the risk is not priced properly . . . . [In such cases] the subprime portfolios may grow to be too large, may earn too little income and may be securitized with too high leverage, all of which results from the underestimation of their risk."[8]

66. Shortly before accumulating material amounts of subprime and non-prime mortgage products, Fannie was specifically warned of the high risks of entering this market and Fannie's lack of resources to gauge such risk. According to an internal Fannie presentation dated June 27, 2005 (the "June 27 Presentation"), the Defendants knew that Fannie faced obstacles in its ability to meet the market, including lack of: 1) capabilities and infrastructure and 2) knowledge of the credit risks.

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[7] Written Statement of Edward J. Pinto Before the Committee on Oversight and Government Reform, U.S. House of Representatives, Dec. 9, 2008, at 9 ("Pinto Statement").

[8] Written Statement of Charles W. Calomiris before the Committee on Oversight and Government Reform, U.S. House of Representatives, Dec. 9, 2008 ("Calomiris Statement").

67. Moreover, as the June 27 Presentation noted, market participants were not appropriately pricing for risk. The premium spreads between rates charged by subprime over prime lenders had narrowed significantly since 2001. Further, a Fannie document from March 2005 noted that: "Although we invest almost exclusively in AAA-rated securities, there is a concern that rating agencies may not be properly assessing the risk in these securities."

68. According to the June 27 Presentation, due to Fannie's perception that the market was passing it by, the Company faced two choices: (1) stay the course with safer loans or (2) meet the subprime and non-prime market. If Fannie did nothing, it would face lower revenue and growth and would continue to lose market share. On the other hand, as the Defendants knew, meeting the market involved more known risk, which Fannie was ill-suited to monitor and assess.

69. Accordingly, at the time of the June 27 Presentation, Fannie's Single Family Guaranty Business group recommended that Fannie choose the safer option—"stay the course"—and advocate a public position that educated the public of housing risks, but also dedicate resources to develop a subprime infrastructure, modeling capabilities for alternative markets, and a conduit capability. However, the immediate lure of revenues from subprime and Alt-A loans proved too tempting for the Defendants to forego, and they caused Fannie to quickly enter into the subprime/Alt-A market knowing that Fannie did not have the internal controls in place to monitor these riskier products.

70. On June 26 and 27, 2006, Fannie's senior management met for a weekend retreat in Cambridge, Maryland to discuss future strategies. The result was a report dated July 7, 2006, that, according to Congressional testimony, was circulated to Mudd and other top executives. The report set forth Fannie's "New business model and growth initiatives." One initiative

described Fannie's new focus on the subprime market: "Single Family's strategy is to say 'yes' to our customers by increasing purchases of sub-prime and Alt-A loans, reducing 'cut outs', and implementing new customer strategies."

C. Though the Defendants Were Bullish on Fannie's Abilities Publicly, Fannie's Risk Controls Were Unequal to the Challenge of the Alt-A and Subprime Markets, and Disproportionately Negative Results Followed

1. Publicly, the Defendants Touted Fannie's Ability to Manage Risk for Subprime and Alt-A Investing

71. As alleged above, despite Fannie's strong reputation as a highly risk-averse investor, the Defendants recognized in mid-2006, when analyzing whether to materially increase Fannie's exposure to the subprime and non-prime markets, that the Company lacked critical risk-management resources and skills to weather them. Nevertheless, the Defendants primed the market to believe that Fannie maintained a strong credit book of business and that its exposure to subprime and Alt-A loans was limited. For example, Fannie stated:

- "We believe that our assessment and approach to the management of credit risk continued to contribute in the third quarter of 2006 to the maintenance of a credit book of business with strong credit characteristics." (Nov. 8, 2006 Form NT 10-Q); and
- "[I]t is a very strong credit book. That will bode us very well as we move into what is going to be a very different housing environment." (December 6, 2006 conference call, statement by Tom Lund ("Lund"), Executive Vice President in charge of Fannie's Single Family Mortgage Business).

72. On February 27, 2007, Mudd repeated that "we have a book of business with very strong credit risk characteristics." Further, on the same day, Lund made the following statements concerning Fannie's exposure to Alt-A and subprime mortgages:

> Our participation has continued to remain in the higher credit quality segments of alternative documentation. . . .
>
> [W]e have told you we're only going to participate when we think we get the right price/risk equation. . . . and we feel good about the pricing . . . we have put on the books.

73. The market believed the Defendants' false statements. On February 27, 2007, Prudential Equity Group LLC analysts Matthew Park and Tony Hill issued an analyst report which stated that: "[W]e expect Fannie Mae to perform better relative to the overall industry due to the statutory requirements for conforming mortgages and the relatively limited exposure to riskier non-traditional mortgage products."

74. Further, on February 28, 2007, Bear Stearns issued a research report that stated, in part: "To date the company has limited its exposures to sub-prime and Alt A loans . . . . [Fannie] believes its credit performance will remain significantly better than most other market participants . . . ."

75. On May 2, 2007, during Fannie's conference call with analysts, Dallavecchia, Fannie's Chief Risk Officer, asserted that "[o]n average, the credit characteristics of our Alt-A portfolio is comparable to the conventional book of business that we have." Later during the same conference call, Lund joined in with the same talking point, asserting that "[o]n the Alt-A side . . . the credit quality of that book looks like the credit quality of the rest of our book."

76. On May 9, 2007, JP Morgan issued an analyst report which stated, in part, "Single-family credit quality remains good, and what little exposure Fannie has to higher risk subprime and Alt-A products is largely credit enhanced to minimize Fannie's losses."

77. On July 27, 2007, Bear Stearns issued a report that stated "Credit quality remains very high. The subprime mortgage crisis is not affecting Fannie Mae's loss experience. Delinquencies remain very low." The analysts also stated that they "continue to see Fannie Mae

as much more of a beneficiary of the current subprime/mortgage market crises than a victim, and expect the [C]ompany's business volumes to grow as the market pays more attention to risk."

78. On November 18-19, 2007, Bear Stearns issued reports that stated in part that "we believe the [C]ompany still faces far less credit risk than most other mortgage market participants" and that "[c]learly, severity is increasing with lower home prices, but we believe the [C]ompany's attention to underwriting and risk will result in significantly lower losses than most other mortgage market participants."

79. The Defendants continued to bolster Fannie's false public persona. As an example, the Company changed its policy on when to recognize a loss on a defaulted loan during a period where more loans were defaulting. *The New York Times* reported in a September 7, 2008 article that, after scrutinizing Fannie's books, federal regulators became concerned that Fannie further "**mischaracterized [its] financial health by relaxing [its] policies on when to recognize a loss on a defaulted loan, according to people familiar with the review. For years, [Fannie has] effectively done that when a loan is 90 days past due. But, in recent months, [Fannie] said [it] would extend that to two years.** As a result, tens of thousands of loans that previously would have been marked down have maintained their value." (Emphasis added.)

80. In yet another example of the Defendants falsely minimizing Fannie's true risk exposure, according to Confidential Witness 1, a former Fannie Customer Account Risk Manager who reviewed loans being proposed for purchase by Fannie's lender-customers,[9]

[9] Confidential Witness 1 is a former Fannie employee who worked for the Company from February 2006 through January 2009. Confidential Witness 1 started with Fannie as an Account Associate, during which time she worked on the Company's account with the mortgage lender Countrywide Financial. In January 2008, she was promoted to Customer Account Risk Manager. In her role working with Countrywide, Confidential Witness 1 gained specific knowledge as to Fannie's evaluation of loans from Countrywide. Further, as a Customer Account Risk Manager, Confidential Witness 1 gained insight into Fannie's overall loan evaluation process.

Fannie had a category of loans called "Expanded Approval" which it did not classify as being subprime but, which, if compared with Fannie's guidelines for what constituted a subprime loan, was in fact subprime.

2. Though They Realized the Company's Risk Was Extensive, the Defendants Failed to Support or Enforce Risk Control

81. As reported by the *Washington Post* on December 9, 2008, as long ago as March 2005, Fannie's *former* Chief Risk Officer, Adolfo Marzol, wrote to Defendant Mudd "to warn that entering new areas of the mortgage market represented significant risk," including the area of loans "that required little documentation . . . ."

82. Fannie's Chief Risk Officer for the Class Period similarly had concerns that Fannie's risk controls were defective at the same time as the Company was taking on more risk in the form of subprime/non-prime mortgages. On October 28, 2006, in a pointed email to Mudd, Dallavecchia complained as follows:

> Dan, I have a seri[ous] problem with the control process around subprime limits.
>
> The business actions in terms of ramping up business much faster than what would be consistent with the $5 [billion] limit for [the] year end we agreed upon less than two months ago is de facto preventing me to exercise my reserved authority to determine limits without damaging relationships with customers.
>
> This is on top of the recent lack of process on the Chase deal (also a limit excess on concentration and debt to income ratios), and after we approved twice (in March and in June) to buy loans without having completed the new business initiative.
>
> There is a pattern emerging of inadequate regard for the control process.

83. At the December 9 Hearing, Mudd confirmed that he understood Dallavecchia's email meant that Fannie was "ramping up too quickly on the subprime purchases and this acceleration prevented [Dallavecchia] from determining appropriate risk limits." Congressman Bruce Braley asked Mudd whether the e-mail meant that Dallavecchia "believed that you were

rushing into billions of dollars worth of subprime loan purchases without really knowing what you were doing. Isn't that what he is saying here?" Mudd responded, "Yes." Mudd also agreed with Congressman Braley's comment that "if the control processes [we]re not in proper working order, it prevent[ed] you from following a rational decision-making model ...."

84. Instead, according to Confidential Witness 2, a former risk modeler who worked for Fannie as Director of Risk Management in the Business Analytics division (which was overseen by Dallavecchia's Chief Risk Office) from May 1993 until August 2007,[10] Fannie did not evaluate the risk of the subprime mortgage pools it bought; it did not have a model to evaluate them. As late as August 2007, Fannie was still building those models.

85. According to Confidential Witness 2, because Fannie did not have the ability to analyze pools in-house, it instead relied on ratings issued by ratings agencies, such as Moody's, to guide its mortgage pool purchases.

86. As the Defendants subsequently admitted, in Fannie's 2006 Form 10-K, filed on August 16, 2007, "the prevalence of loans made based on limited or no credit or income documentation also increases the likelihood of future increase in delinquencies or defaults on mortgage loans. An increase in delinquencies or defaults likely will result in a higher level of credit losses, which in turn will reduce our earnings."

87. Fannie's own analytics predicted a surge in loan delinquencies by early 2007. Beginning in January 2007, Eric Rosenblatt, a Vice President ("VP") of Credit Risk for the Company's Single Family business, began producing a Comprehensive Credit Risk Assessment Report (the "Risk Report") that provided a detailed review of Fannie's overall credit risk. According to Confidential Witness 2, the Risk Report "had a way of showing whether a loss

[10] Confidential Witness 2 has specific knowledge of Fannie's credit risk as well as its modeling procedures and capabilities. Confidential Witness 2 was also privy to an internal home price forecasting report that warned top management at Fannie that home prices were about to suffer a massive decline.

attribute was worse than expected . . . . [For example y]ou could see what high [loan-to-value ratio ("LTV")] loans were doing." The Risk Report was updated on a monthly basis, said Confidential Witness 2, and was "a key thing consumed by the business people" in the Single Family division — it was distributed to "anyone in [the] Single Family business or credit." The Report was posted on the Company's internal website, for consumption by senior executives, which includes the Officer Defendants. Confidential Witness 2 recalled that, by August 2007, the Credit Risk department was "getting very worried" about the risks of Alt-A loans based on loss projections set forth in the monthly Risk Reports. In addition, Confidential Witness 2 stated, Rosenblatt ran an "internal quarterly portfolio review" of Alt-A loans at that time which specifically showed "the performance of Alt-A had started to deteriorate." The quarterly portfolio review result would have been posted on the internal web site as part of the Risk Report, again for consumption by senior executives including the Officer Defendants.

88. Fannie's analytics further predicted a massive decline in the housing market. According to Confidential Witness 2, in late 2006, Fannie was worried about a rapid decline in home prices that would wipe out Fannie's core capital. According to Confidential Witness 2, in January 2007, Rosenblatt also assigned a team to build a home price model forecast. The result was a Power Point document, completed in January 2007, called the "Home Price Forecasting Report." This report, which was a component of the Risk Report, was built using home prices from forty different regions of the country. The report showed that income was *far below* what it took to sustain the housing market and that home prices would therefore decline dramatically. According to Confidential Witness 2, Fannie saw a negative 50 percent drop in home prices in three to five years. Based on this forecast of home price decline, for the first time in Fannie's

history the report predicted "over a billion dollars—up from $300 to $400 million dollars—in losses. We finally broke a billion."

89. Confidential Witness 3 who, in her role as a Senior Business Manager in Fannie's Enterprise Risk Services department had direct knowledge of the Company's credit risk profile,[11] recalled that by late 2006 Fannie had produced internal reports warning of declining home prices and increased loan delinquency rates. These reports went to "senior [Vice-Presidents] and senior leadership," which includes the Officer Defendants. According to this source, there was no question that Fannie's senior leadership such as the Officer Defendants would have been aware of the dire warnings in the reports because the information from these reports came from the top down. In other words, in order for someone in Confidential Witness 3's position to have knowledge of the information in the reports, senior leadership would have had to approve release of such information.

90. Thus, by late 2006, the Defendants knew that their venture into risky subprime and Alt-A mortgages and mortgage related products was going to result in severe losses. In an effort to prolong the inevitable, the Defendants continued to pursue risky mortgages in pursuit of higher revenue. Fannie's Subprime Business Unit recommended to the Credit Risk Committee that the Company commit $11.25 billion more to subprime loans in 2007 than it did in 2006.

91. Even while proceeding with their risky strategy of accumulating subprime/non-prime products, the Defendants never remedied the fact that Fannie lacked the risk control processes to assess and monitor the heightened risk.

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[11] Confidential Witness 3 is a former Fannie employee who worked for the Company from 2004 through early 2009. In her position, she had direct knowledge of the decision-making that shaped the credit risk profile of Fannie's Single Family business.

92. Dallavecchia warned Mudd and the Company's Chief Operating Officer, Michael Williams, that cuts to his division's budget would materially impair Fannie's ability to manage risk. On July 16, 2007, Dallavecchia wrote an email to Williams and stated the following:

> **Doing the budget for n[e]xt year off my forecast and with a 16pct further reduction in budget is at best being ill informed or maybe . . . [is] due to malice.** I find it offe[n]sive to my intelligence and that of my staff.
>
> **The company has one of the weakest control processes I [have] ever witness[ed] in my career . . . . This company really doesn't get it, we are not even current and we are already back to the old days of scraping on controls and people** . . . .

(Emphasis added.)

93. That same day, Dallavecchia forwarded to Mudd the email that he had sent to Williams and further stated, in part, the following:

> In a nutshell, I am very upset as I had to stand at the Board meeting today and hear that we have the will and money to change our culture and support taking more credit risk.
>
> * * *
>
> It was inappropriate what was said today to the Board as if I had all the necessary means and budget to act on the strategic plan. **I do not even think that with what I was given for 2008 is adequate for the current risk, considering how far we already are from adequate market practices.** I had no part in some Board members asking questions on having the means to execute, but I cannot let the impression stand, as my credibility and reputation with them will be at stake.
>
> * * *
>
> ...I can only infer malice from some of your directs...when they are fully aware that CRO is in full build up mode, that I took leadership not only in cutting expenses from CRO but for the whole risk discipline this year, and that **I have been saying that we are not even close to have proper control processes for credit, market and operational risk. I get a 16pct budget cut. Do I look stupid?** And if they didn't act with malice, I would propose that maybe they don't get how you run budget custs [sic].

(Emphasis added.)

94. None of these facts were disclosed to the investing public. Instead, the Defendants maintained that Fannie's financial condition was sound and the risks it had taken were prudent. On September 20, 2007, Mudd testified before Congress that Fannie could "provide more liquidity help to the home finance market today without taking risks we are not capable of managing" and that Fannie had "vastly reduced [its] material control weaknesses."

D. The Defendants Did Not Take Protective Steps to Reduce the Risk Associated With Fannie's Investments in and Guarantees of High-Risk Debt

95. At the same time that the Act Defendants shifted the business focus away from safe, "plain vanilla" loans and toward risky subprime and Alt-A loans, they failed to seek appropriate protection for the Company's enhanced risk through such things as higher pricing, stringent underwriting standards and financial guarantor hedging.

96. As explained by Professor Calomiris in his written testimony for the December 9 Hearing, subprime and non-prime loans may serve a legitimate purpose but require (a) a premium to be paid for the extra risk the lender is taking on and (b) balance in the loan portfolio so that it is not too heavily weighted toward these riskier loans:

> The problem with these sorts of loans arises . . . when the risk is not priced properly as the result of either a distorting government subsidy or a market failure. In the presence of such distortions, subprime portfolios may grow to be too large, may earn too little income and may be securitized with too high leverage, all of which results from the underestimation of their risk. If this happens in the extreme, as during the current financial crisis, the excessive lending and leveraging can lead to a systemic threat to the financial system.[12]

1. The Defendants Failed to Properly Price Fannie's Guarantees Related to Alt-A Loans

97. The Defendants failed to price Fannie's guarantees for MBS backed by Alt-A loans to compensate for the loans' increased risk and the correspondingly increased likelihood

[12] Calomiris Statement, at 2.

that the loans would default and leave Fannie liable for the remaining principal and loan payments.

98. As reported by the New York Times in an October 5, 2008 article focusing on the period between 2005 and 2007, a "former senior Fannie executive" explained that the Defendants "understood that [Fannie was] now buying loans that [it] would have previously rejected, and that **the models were telling us that [Fannie was] charging way too little**." (Emphasis added.) As FHFA director Lockhart confirmed in his September 23, 2008 report to Congress, "the credit profile at [Fannie] followed the market down in 2006 and 2007—**without commensurate pricing for risk**." (Emphasis added.)

2. The Defendants Did Not Maintain Fannie's Underwriting Standards

99. Fannie also failed to adequately monitor the underwriting of the lenders from which it acquired mortgage loans.

100. In the pursuit of ever-greater profits and market share, the Defendants essentially advocated abandoning Fannie's underwriting standards: Congressional testimony given at the December 9 Hearing indicated that beyond the $11.25 billion in additional subprime loans that Fannie's Subprime Business Unit proposed on January 17, 2007 to the Credit Risk Committee, the Unit also proposed **eliminating** restrictions on the volume of mortgages Fannie could purchase with lower borrower scores and unverified income.

101. According to Confidential Witness 1, who in her role as a Customer Account Risk Manager had a detailed knowledge of Fannie's loan evaluation process, the Defendants loosened Fannie's guidelines for the quality of the loans it would accept as early as 2006. For example, the Company accepted FICO scores that were as low as 500.

102. The Defendants also pulled back on the Company's use of Desktop Underwriter ("DU"), an automatic underwriting program that had previously been used to help screen out especially high risk loans. As former Fannie CEO Franklin Raines ("Raines") testified to Congress at the December 9 Hearing, "it appears that in taking on [high-risk] loans, Fannie Mae had altered its underwriting standards by, for example, not running many of those loans through [DU], an automated tool that helps lenders evaluate and price credit risk." Indeed, Lund admitted in the August 8, 2008 analyst conference call that "[a] significant portion of Alt-A doesn't go through DU."

3. The Defendants Failed to Manage Credit Risk Exposure by Allowing, for Critical Customer Relationships, Internal Rule-Bending of Policies Designed to Insulate the Company from Risk

103. Exhibiting a desire both to please lenders with whom Fannie had lucrative relationships and to obtain higher-risk/higher-yielding loans, the Defendants demonstrated an unwillingness—beyond already lax controls—to manage risk, as demonstrated by Fannie's relationship with its key customer/lending partners Countrywide Financial and IndyMac.

(a) Countrywide

104. Countrywide was Fannie's largest supplier; it delved heavily into subprime and non-prime loans. As mentioned previously, Countrywide CEO Anthony Mozilo put direct pressure on Fannie CEO Mudd for Fannie to start buying Countrywide's riskier loans, noting, "You need us more than we need you."

105. The relationship was one of continual pressure and disregard of internal rules and procedures. Fannie made exceptions to its loan and servicing criteria for Countrywide. According to Confidential Witness 4—a former Operations Manager in the Credit Loss Management ("CLM") Operations group, who coordinated loan document review for loans that

had been selected for review during Fannie's quality control review process[13]—Countrywide's working relationship with the CLM group deteriorated during the Class Period. Specifically, starting in late 2007, Countrywide refused to cooperate with Fannie's loan review process. According to Fannie's normal review policies, once a loan was selected for review, Fannie's policies and procedures required that the loan documentation be turned over within 45 to 60 days. If that deadline was not met, Fannie would, as a matter of course, ask the lender to repurchase the loan. But starting in late 2007, Confidential Witness 4 observed that there were a very excessive 6,000 to 7,000 Countrywide files that had been requested, but had yet to be produced within the required timeframe.

106. According to Confidential Witness 1, a former Account Associate at Fannie who worked specifically with Countrywide, the mortgage lender was Fannie's biggest client and was given "more room" than other lenders. When Countrywide spoke, said Confidential Witness 1, "Fannie Mae jumped." Fannie feared that if it did not cater to Countrywide, the lender would take its business elsewhere.

107. Under the Company's risk management guidelines, when a certain significant number of outstanding files accumulate, a trigger acts to prevent the lender from selling to Fannie (at least until the risk issue is resolved), or else change the terms of their agreement. According to Confidential Witness 4, Fannie disregarded its policies and procedures and did not enforce the trigger for the Countrywide relationship.

[13] Confidential Witness 4 is a former Fannie employee who worked for the Company from August 2006 through August 2008. From August 2006 until the end of 2007, Confidential Witness 4 was a member of the Central Business Analysis Team (CBAT)—a group which provided technology and business support to Credit Loss Management (CLM) and the National Underwriting Center (NUC), as well as the National Property Disposition Center (NPDC). In early 2008, Confidential Witness 4 assumed the role of Operations Manager in the CLM group, and remained in this role until he left Fannie in August 2008. The overall responsibility of CLM is to monitor credit loss management on Fannie's single family book of business. As a CLM operations manager, one of Confidential Witness 4's main responsibilities was to coordinate the loan review process, including loans that experienced early payment defaults or were foreclosed.

108. Also, according to Confidential Witness 4, Fannie and Countrywide disagreed on the amount Countrywide should have to pay Fannie to repurchase certain loans that Fannie had the right to put back to lenders. In the Spring of 2008, there was a directive from the VP for CLM setting the repurchase value that Fannie would seek from original lenders at 92% of the value of the loan. But, in the Spring of 2008, when Fannie sought to have Countrywide repurchase approximately $680 to $690 million in loans, the VP of Sales in charge of the Countrywide relationship was told to accept just $120 million—materially less than 92% of the amount sought.

(b) IndyMac

109. Prior to late 2007, IndyMac only had a limited relationship with Fannie. In November 2007, after its primary sales pipeline—the secondary market—completely dried up, IndyMac announced massive losses for the third quarter of 2007, and its survival depended on it finding another repository for its loans. In an attempt to find such a repository, IndyMac began to focus on loans that could be sold to the GSEs. According to IndyMac's 2007 Annual Report, sales to GSEs such as Fannie increased to 48% of total loan distribution for the year ended December 31, 2007, which was $71.2 billion.

110. Many of these loans were seriously flawed: According to Teri Buhl, an investigative reporter for the *New York Post*, after IndyMac was seized by regulators in July 2008, Fannie asked IndyMac to repurchase between $1 and $10 billion in loans because IndyMac violated representations and warranties on various loans sold to Fannie that continued to be serviced by IndyMac. According to Buhl, IndyMac originated billions of dollars of loans that experienced early payment defaults or were made under fraudulent conditions.

111. Fannie had advance warning of IndyMac's fraudulent loans in 2006, but nevertheless increased its exposure to that company anyway. As alleged in *Folsom v. IndyMac*

Bancorp, Inc. et al, 2:08-cv-03812-GW-VBK (C.D. Cal.), Michelle Leigh ("Leigh"), First Vice President and Division Head of Post Production Quality Control in the Consumer Lending Group at IndyMac from August 4, 2004 to September 2006, specifically told Fannie of IndyMac's failure to comply with regulatory guidelines. Leigh was responsible for sampling and reviewing all IndyMac loans. In her position, she prepared a preliminary report that identified 63 findings of significant problems in the loans that she had reviewed. These findings showed that the loan documentation was fraudulent. For instance, she identified a loan with a "stated income" of $90,000, but the borrower's loan file disclosed that she earned $11.00 per hour as a cafeteria cashier at Disneyland. The report, despite the objection of Leigh, was revised. Accordingly, on September 8, 2006, Leigh wrote to Fannie complaining about this issue, a warning Fannie failed to heed. Despite this warning, Fannie continued to purchase, and actually increased its purchase of, loans from IndyMac.

4. Fannie Did Not Diversify the Portion of its Book of Business That Was Concentrated in Geographically Risky States

112. During a housing boom, geographic areas that have experienced exceptional appreciation in home prices are at risk for correspondingly disproportionate decreases when prices decrease. Fannie's book of business was concentrated in states that had been particularly affected by the real estate boom, leaving the Company with massive risk exposure: falling home prices lead to rising delinquencies, as the prices fall below unpaid mortgage principal.

113. In past filings, Fannie had identified California—and California alone—as a geographic source of risk. In **each** of its Forms 10-K's for the years **2004**, **2005** and **2006**, which were filed, respectively, on December 6, 2006, May 2, 2007, and August 16, 2007, the Exchange Act Defendants only claimed concentrations in California—"Except for California . . . no other significant concentrations [of Fannie's book of business] existed in any state."

114. However, unknown to the investing public, Fannie also had concentrations in other high risk geographic areas. On November 9, 2007, when it filed its 2007 third quarter 10-Q, Fannie disclosed: "We have also experienced a significant increase in delinquency rates in loans originated in California, Florida, Nevada and Arizona. These states had previously experienced very rapid home price appreciation and are now experiencing home price declines." Elsewhere in the filing, Fannie noted its exposure in California and Florida: "California and Florida . . . represent the two largest states in our single family mortgage credit book of business . . . ." And building on those disclosures, Fannie's 2008 first quarter 10-Q, filed before the start of trading on May 6, 2008, stated that "[o]ur credit losses for the quarter were concentrated primarily in our Alt-A and other higher risk loan categories, in loans originated in 2005 through 2007, and in areas of the country experiencing steep declines in home prices (such as **Florida, California**, **Nevada** and **Arizona**) . . . ." (Emphasis added.)

115. Indeed, California, Florida, Nevada, and Arizona had been and were states in which Fannie's book of business had significant concentrations, and in which Fannie was at risk for experiencing disproportionate amounts of credit losses.

5. The Defendants Did Not Protect against, or Disclose, Fannie's Significant Exposure to Financially Unsound Mortgage Guarantors

116. Fannie had significant exposure to unsound financial mortgage guarantors. Financial guaranty contracts, which assure the collectability of payments and principal on guaranteed MBS if the loans underlying the MBS go into default or delinquency, were crucial to the smooth operation of Fannie's business. If the guarantors fail, so too do the good values of the securities they guarantee. Where it was probable that any of the companies, or financial guarantors, that provide such contracts to Fannie would not fulfill their obligations, the value of the securities that Fannie insured would be impaired.

117. Starting no later than November 2007, many financial guarantors were downgraded by credit ratings agencies and had seen their stock prices significantly decline, materially increasing the risk that they would fail to fulfill their obligations. Both the Wall Street Journal (on November 8, 2007) and EuroWeek (on November 9, 2007) published articles warning that the financial guarantors were in fiscal danger as a result of their exposure to subprime mortgages.

118. In December 2007 and early January 2008, there was a series of downgrades of the credit ratings of major financial guarantors.

119. The events starting in November 2007 demonstrated it was probable that Fannie's financial guarantors would be unable to fulfill their contractual obligations to Fannie. Fannie had exposure to financial guarantors of at least $12.3 billion as of December 31, 2006 and $11.8 billion as of December 31, 2007. However, Fannie did not start to disclose such concentration of risk to investors until February 27, 2008, in the Company's annual report for the year ended December 31, 2007.

120. The Defendants were further aware that the financial deterioration of financial guarantors and that the risk of non-payment had materially increased because, according to Fannie's SEC filings, Fannie managed its exposure to financial guarantors through in-depth analyses of their financial position and stress analyses of their financial guarantees and available capital. Such in-depth analyses surely would have revealed that extreme circumstances that led to the guarantors' credit downgrades.

121. Fannie's undisclosed exposure to its financial guarantors was highly material. As the Company stated in its quarterly report for the quarter ended September 30, 2008—after the government takeover: "**we do not believe that we can rely on all of our counterparties to**

repay us in full in the future . . . . Further downgrades in the ratings of our financial guarantor counterparties could result in a reduction in the fair value of the securities they guarantee, which could adversely affect our earnings, liquidity, financial condition and net worth." (Emphasis added.)

E. Fannie's Lack of Control Mechanisms or Desire to Enforce Then-Existing Protocols Buckled Fannie's Finances

122. In the end, as the Defendants knew, Alt-A and subprime loans proved for Fannie to be more risky and damaging than traditional loans. Accepting reduced documentation led to greater default risk. Alt-A loans generally had riskier characteristics, and Fannie's loans were no exception.

- As one example, as disclosed in Fannie's 2008 Credit Supplement, filed with the SEC on February 26, 2009, at the end of 2008, 26.7% of Fannie's Alt-A loans also involved adjustable rate rather than fixed rate mortgages. Because borrowers stretch themselves financially to borrow and rely on stable housing prices and interest rates, the risk of default is greater.
- As another example, at the end of 2008, 22.2% of Fannie's Alt-A also involved mortgages on "other-than-principal residences." Mortgages on other-than-principal residences are considered riskier to lenders and purchasers than mortgages on principal residences because a borrower is more likely to be fully committed to paying back the mortgage if he or she must do so in order to continue living in their home. Indeed, many mortgages on other-than-principal residences are examples of speculation.

123. As discussed above at ¶¶72, 75-76, while Dallavecchia and Lund were assuring analysts—in the presence of CEO Dan Mudd—that the Alt-A in Fannie's book of business had

the same credit quality as the rest of that book, Fannie had determined that the credit quality of the Alt-A in Fannie's book of business was so poor, and the default expectations so grim, that Fannie should significantly scale back their endeavor into Alt-A mortgages and mortgage related securities.

124. In mid-2007, with the expectation of crushing losses, Fannie significantly reduced its investments in, and guarantees of, new Alt-A loans. As Defendant Mudd stated in a May 2008 call with analysts—approximately a year later: "We stopped largely doing Alt-A a year ago, the concentration is a late '05, '06 or early '07 kind of a book . . . the Alt-A book [is] where we are seeing a disproportionate share of our losses . . . ."

125. According to Confidential Witness 2, by the time he left in August 2007—just as Fannie was drastically pulling back on its new investments in Alt-A loans—the Company appointed a Vice President of subprime lending within its Single Family division and began "trying to build a model for sub prime" in a last ditch attempt to "evaluate loans bought directly from lenders like Countrywide."

126. Indeed, the Defendants' expectations of increased losses came to fruition: as disclosed in Fannie's 2009 First Quarter Credit Supplement, although Alt-A debt accounted for only 10% of Fannie's Single-Family Conventional Mortgage Credit Book of Business in that quarter, it was responsible for 39.2% of the quarterly credit losses. Mr. Pinto testified at the December 9 Hearing that while expected defaults on non-prime loans originated in 2005 were 8%, they were nearly 40% for those originated in 2007.

VI. FALSE AND MISLEADING STATEMENTS REGARDING FANNIE'S RISK MANAGEMENT AND CONTROLS

127. Lead Plaintiffs repeat and reallege each of the materially false and misleading statements set forth above in ¶¶40-126, as if fully set forth herein. The false and misleading

statements further detailed below were made with scienter during the Class Period. The Defendants made these statements in, among other things, Fannie's SEC filings, public conference calls, press releases, statements to the media and Congressional testimony.

128. As detailed below, during the Class Period, the Defendants, knowingly or with reckless disregard, misled Lead Plaintiffs and the other members of the Classes by making materially misleading statements or omissions, detailed herein:

a. Fannie failed to adequately monitor the underwriting by the lenders from which it acquired mortgage loans, which had the effect of increasing the amount of poorly-underwritten, high-risk loans purchased or guaranteed by the Company (¶¶99-102).

b. Even as Fannie dramatically ramped up its investment in subprime and Alt-A mortgages and related securities, Fannie's risk controls were inadequate and the Company lacked the ability to measure the credit risk of such securities and, specifically:

   i. in stark contrast to Fannie's statements throughout the Class Period that it carefully monitored the credit risk of loans it purchased, as stated by Confidential Witness 2, as late as August 2007 the Company did not have its own credit analysis models but instead relied solely on the judgment of ratings agencies (¶¶84-85); and

   ii. by the beginning of the Class Period, Defendant Dallavecchia had sounded the alarm that Fannie's risk controls were materially defective and incapable of assessing the risks of the Company's subprime investments: in October 2006, Dallavecchia complained to Mudd that Fannie was "ramping up" its subprime business such that the Company was exceeding its own limits on risk exposure and that "[t]here is a pattern emerging of inadequate respect for the control process."

c. That Defendants falsely maintained that Fannie's credit book of business had strong credit characteristics when, in fact:

   i. Fannie had a massive credit risk exposure to Alt-A and subprime mortgages and related securities; and

   ii. In January 2007, as Defendants knew or recklessly disregarded, Fannie's business analytics division predicted a 50% decline in home prices and warned that such a decline would drastically increase the Company's losses and wipe out core capital (¶¶87-88).

d. That the credit risk profile of Fannie's Alt-A and subprime mortgage and related securities was materially more risky than the credit profile of Fannie's portfolio of conventional 30 year fixed mortgages. (¶¶102-103).

e. In July 2007, Fannie materially lowered its risk management capabilities by sharply cutting the Chief Risk Officer's budget and staff: as Dallavecchia complained to Mudd and the Company's Chief Operating Officer, Michael Williams, on or around July 16, 2007, Fannie had one of "the weakest control processes" he had ever witnessed, the Company's budget was inadequate for Fannie's risk exposure and that it was not even close "to having proper control processes for credit, market and operational risk."

f. Rather than increase its guaranty fees to compensate for the increased risk of non-prime loans, including subprime and Alt-A, Fannie failed to seek appropriate protection for its enhanced risk (¶¶97-99).

A. November 8, 2006 Form NT 10-Q

129. On November 8, 2006, the Defendants caused Fannie to file a Form NT 10-Q for the period ending September 30, 2006 (the "Nov. 8 NT 10-Q") and stated the following concerning the Company's Alt-A and subprime exposure:

> We have increased our participation in [Alt-A and subprime] types of products where we have concluded that it would be economically advantageous or that it would contribute to our mission objectives. Our participation in these products reflects our assessment of anticipated guaranty fee income in light of our expectation for potentially higher credit losses. We continue to closely monitor credit risk and pricing dynamics across the full spectrum of mortgage product types. . . . **We believe that our assessment and approach to the management of credit risk continued to contribute in the third quarter of 2006 to the maintenance of a credit book of business with strong credit characteristics.**

(Emphasis added.)

130. These statements were materially false and misleading because Fannie's credit book of business did not have strong credit characteristics, but rather, by the beginning of the Class Period Fannie had massive exposure to billions of dollars of risky subprime and Alt-A mortgage loans. Specifically, these statements were materially false and misleading for the reasons set forth in ¶128.

B. Fannie's 2004 Annual Report

131. On December 6, 2006, the Defendants caused Fannie to file its annual report with the SEC on Form 10-K (the "2004 Annual Report") that stated the following concerning the impact of trends in the mortgage market on the Company:

> In recent years, an increasing proportion of single-family mortgage loan originations has consisted of non-traditional mortgages such as interest-only mortgages, negative-amortizing mortgages and sub-prime mortgages, and demand for traditional 30-year fixed-rate mortgages has decreased. We did not participate in large amounts of these non-traditional mortgages in 2004 and 2005 because we determined that the pricing offered for these mortgages often was insufficient compensation for the additional credit risk associated with these mortgages.

132. These statements were false and misleading for the reasons set forth in ¶128.

C. December 7, 2006 Conference Call

133. On December 7, 2006, Fannie conducted a conference call (the "Dec. 7 Conference Call"). Lund, who at the time ran Fannie's Single-Family Credit Guaranty business, stated: "if you look at the tables in the [2004] 10-K ... that shows the credit characteristics, it is a very strong credit book. That will bode us very well as we move into what is going to be a very different housing environment."

134. These statements were false and misleading for the reasons set forth in ¶128.

135. The market believed the Defendants' false statements. On February 7, 2007, Bear Stearns issued an analyst report stating that "[t]he [C]ompany made a strategic decision in 2005 NOT to participate in the market for exotic mortgage products, particularly those in the subprime segment because pricing did not adequately reflect the risk. Fannie Mae did not want to support a market that it believed was unsound."

D. February 23, 2007 Reuters News Interview

136. On February 23, 2007, in an interview with *Reuters News*, Mudd falsely assured the public that: "We have a very small subprime effort . . . . We have entered the market prudently with a lot of standards and high credit quality."

137. These statements were materially false and misleading for the reasons set forth in ¶128.

E. February 27, 2007 Form NT 10-K, Conference Call and Related Statements

138. On February 27, 2007, the Defendants caused Fannie to file a Form NT 10-K with the SEC (the "Feb. 27 NT 10-K"). The Company represented that Fannie's foray into the subprime and Alt-A market was a careful and prudent one:

> Alt-A loans are generally defined as loans with lower or alternative documentation requirements, while sub-prime loans typically are made to borrowers with weaker credit histories... [W]e have increased our participation in these types of products by developing strategies to better support business, where we have concluded that it would be economically advantageous and/or that it would contribute to our mission objectives. Our participation in these products reflects our assessment of anticipated guaranty fee income in light of our expectation for potentially higher credit losses. We continue to closely monitor credit risk and pricing dynamics across the full spectrum of mortgage product types.

139. These statements were materially false and misleading because the Defendants misrepresented and/or failed to disclose the material facts set forth in ¶128.

140. Also on February 27, 2007, Fannie conducted a conference call with investors (the "Feb. 27 Conference Call"). On the call, Dallavecchia further represented that, to the extent it invested in subprime and Alt-A loans, Fannie did so carefully and with the benefit of strong risk controls:

> [W]e have increased our participation in subprime product in 2006. **Our purchases have been prudent and have been made when we concluded that they would contribute to our mission objectives or they would generate a profitable return. . . . [W]e participate in the subprime market in**

accordance with parameters that were agreed between my team and the business leaders. These parameters were developed to carefully calibrate exposure to layered risk, for example, the exposure to the combination of high loan-to-value duration and stated accommodation. . . . [W]e have acquired subprime loans from selected lender partners whose underwriting practices and standards we reviewed. . . . I believe that our activity in the subprime market represents an appropriate and prudent engagement in a segment that has been important to the housing market in this country. . . . I would advise that you consider our exposure in light of the strength of the risk characteristics I have described and the immaterial size of our participation in the subprime market.

* * *

I think from a control and risk underwriting standpoint, we want to continue maintaining prudent underwriting standards. One thing that we always look very carefully to is the layering of the risk, not that all subprime loans are bad, but there's some conditions where all the risks are layered one on top of the other, which makes the risk higher. And we want to make sure that we understand the risk and we are remunerated for it.

(Emphasis added.)

141. Further, during the February 27, 2007 conference call Mudd repeated that "we have a book of business with very strong credit risk characteristics…."

142. The statements in ¶¶140-41 were false and misleading because the Defendants misrepresented and/or failed to disclose the material facts set forth in ¶128. In particular, these statements were at odds with the dire warnings Dallavecchia had previously sounded in his internal October 2006 email to Mudd regarding Fannie's inability to assess and manage the risks of subprime loans.

143. In response to a question during the February 27 Conference Call by Citigroup analyst Brad Ball regarding Fannie's strategy with respect to no-doc and low-doc loans, Fannie executives Dallavecchia and Lund falsely represented that Fannie's risk controls for Alt-A loans were so strong that such loans did not carry a heightened risk of default:

> [Dallavecchia]: On no-doc or limited documentation. . . , **you have many instances where a lower level of documentation is not a clear indication that there is a heightened risk for default.** But if you start compounding low-level documentation, low FICO score, high loan-to-value ratio, maybe high debt-to-income ratio, then it becomes a critically more riskier loan. So that is how we tend to look at that.
>
> * * *
>
> [Lund]: [Y]ou can't look at a single factor. What we have tried to talk about historically is layering of risk—documentation, loan to values, credit scores—and we look very broadly at all of these things. And I don't think you can separate it from subprime, because I think low documentation began to bleed into subprime and it made it very difficult to even distinguish one from the other. We look at all these characteristics individually and then combined. And ... we also looked at economic factors—home prices, things of that nature. And then the final point is we look at the price available to cover the risk associated with that product. And when we think those characteristics are in line and the underwriting is prudent around that, we can participate.
>
> * * *
>
> [Dallavecchia]: [W]e are trying to work with our lender partners to review the standards that they utilize to generate, to originate these loans. We work with them in defining the type of standards that we are comfortable with with regard to the risk profile and the return that we can gain on the product. And therefore, we do not really exclude the specific segment a priori. We want to see what is the layering of the risk. We want to understand what is the return for the layer on the risk. And then we determine if we feel that there is a proper risk/reward for that type of risk.

(Emphasis added.)

144. These statements above were false and misleading because the Defendants misrepresented and/or failed to disclose the facts set forth in ¶128.

145. On the Feb. 27 Conference Call, Lund emphasized that Fannie's "participation has continued to remain in the higher credit quality segments of alternative documentation . . . . [W]e have told you we're only going to participate when we think we get the right price/risk equation . . . and we feel good about the pricing . . . we have put on the books." On that same call, Mudd further trumpeted Fannie's risk controls: "With the creation of the CRO position and

the CRO office also came an appropriate set of processes and controls that went around that . . . that involved a process of setting standards and setting limits." Mudd added: "We have enough engagement so far to be knowledgeable about the market, but we don't have so much that this is a major, significant exposure on our books."

146. These statements were false and misleading because the Defendants misrepresented and/or failed to disclose the material facts set forth in ¶128.

F. March to April 2007 Congressional Testimony

147. On March 15, 2007 Mudd testified as follows before the United States House of Representatives Committee on Financial Services (the "Financial Services Committee") with regard to Fannie's exposure to subprime loans:

> We said a couple of years ago that this [subprime] market was evolving in a direction that we didn't like. The layering of some of the products presented excessive risk to consumers. We stepped away from it.
>
> * * *
>
> [Subprime is] 80 percent insured. It's highly unsubordinated. We've been in it very carefully, consistent with some very strong anti-predatory lending guidelines we have.

148. Mudd's statements to Congress were materially false and misleading for the reasons set forth in ¶128.

G. Fannie's May 2, 2007 Earnings Release, 2005 Annual Report and Conference Call

149. On May 2, 2007, Fannie issued a news release that disclosed the Company's financial results for 2005 and the Company filed its annual report for the year ended December 31, 2005 with the SEC on Form 10-K (the "2005 Annual Report").

150. The 2005 Annual Report stated that Fannie applied its risk controls to limit the financial hazards of such loans:

> We consider the risk of default in determining our guaranty fee and purchase price. . . . We have worked to enhance our credit analytics and data to better understand, assess and price for the risks associated with these products to allow us to closely monitor credit risk and pricing dynamics across the full spectrum of mortgage product types.

151. These statements were false and misleading for the reasons set forth in ¶128.

152. In the 2005 Annual Report, Fannie added "To date, our purchases of subprime mortgage loans generally have been accompanied by the purchase of credit enhancements that materially reduce our exposure to credit losses on these mortgages." Finally, in the same Report, Fannie represented that: "We believe our credit exposure to the subprime mortgage loans underlying the private-label mortgage-related securities in our portfolio is limited because we have focused our purchases to date on the highest-rated tranches of these securities."

153. In actuality, Fannie's subprime holdings were highly risky and the Company had significant subprime exposure. As such, these statements were false and misleading for the reasons set forth in ¶128.

154. Also on May 2, 2007, Fannie conducted a conference call with investors (the "May 2 Conference Call").

155. During the May 2 Conference Call, KBW analyst, Fred Cannon, asked: "One of the major criticisms in [Alt-A and subprime] has been the lack of income criteria and documentation of income. And I was wondering what kind of standards you're looking for as you invest in both areas moving forward?" Mudd and Lund responded to this question as follows:

> [Mudd]: [T]he important characterization of all of our efforts with respect to subprime and Alt-A . . . is that we stood back from the market. We adhered to our standards . . . . [N]ow the marketplace is moving back toward us." . . . .
>
> So if you go too far down the path that says that we're changing our standards or changing our risk criteria, I think you wind up in the wrong place. Rather, I think

> we have stayed pretty steady....It's just that now, we are emerging as the best outlet for it . . . .
>
> [Lund]: On the Alt-A side . . . the credit quality of that book looks like the credit quality of the rest of our book . . . our philosophy has always been price to the risk. **And we have maintained that."**

(Emphasis added.)

156. These statements were false and misleading for the reasons set forth in ¶128.

157. On the May 2 Conference Call, in response to a question posed by Merrill Lynch analyst, Ken Bruce, regarding Fannie's opportunities in the Alt-A sector in light of the dislocation in the subprime and Alt-A market, Lund and Dallavecchia reassured him as follows:

> [Lund]: On the subprime and Alt-A front, I think we see significant opportunity for us as a Company. As Dan mentioned a little bit earlier, on a lot of these products and the layered risk that existed in the market, we backed away because we did not see the risk/return equation being appropriate.
>
> That has obviously had significant dislocation in the last x number of months. We have seen much tighter underwriting guidelines. We have seen significant credit spread widening. As a result, we've seen the market really move back more towards where Fannie Mae was.
>
> * * *
>
> Second, in recent years, Alt-A has been predominantly associated with the ARM market, with the floating rate, the resetting markets, which accounts for approximately [70]% of the issuance of [non-agencies]. In contrast, the majority of our Alt-A portfolio is comprised of fixed-rate mortgages.
>
> And finally, Fannie Mae uses credit enhancements to reduce our exposure to credit losses. And a significant proportion, about two times greater than our conventional portfolio, in our Alt-A book is covered by (multiple speakers) credit enhancement.
>
> As such, although there has been a weakness in terms of the slow down of house prices' appreciation, I feel fairly comfortable that we continue to maintaining [sic] a solid credit portfolio.

(Emphasis added.)

158. On the same May 2 Conference Call, Robert Blakely ("Blakely"), Chief Financial Officer and Executive Vice President of Fannie, said "We have already disclosed the strong characteristics for our credit book of business through year-end 2006, and our minimal exposure to subprime loans and securities backed by subprime loans."

159. The Defendants' reassurances as to Fannie's Alt-A and subprime holdings in ¶¶157-58 were false and misleading for the reasons set forth in ¶128.

H. May 9, 2007 Form NT 10-Q

160. On May 9, 2007, the Defendants caused Fannie to file a Form NT 10-Q with the SEC (the "May 9 NT 10-Q"). In addition to reiterating the statements in its prior Forms NT 10-Q and NT 10-K, as detailed above, ¶¶129, 138, the Company stated the following concerning the Company's Alt-A and subprime mortgages:

> We have continued to work with our lender customers to support a broad range of mortgage products, including Alt-A and subprime products, which have represented an increased proportion of mortgage originations in recent years. . . . **We believe that our assessment and approach to the management of credit risk contributed to the maintenance of a conventional single-family mortgage credit book of business with strong credit characteristics in the first quarter of 2007. . . .** During 2006 and 2007, mortgage lenders have experienced higher levels of delinquencies relating to subprime loans. **We believe our credit exposure to the subprime mortgage loans underlying the private-label mortgage-related securities in our portfolio is limited because we have focused our purchases on the highest-rated tranches of these securities to date.**

(Emphasis added.)

161. These statements were false and misleading for the reasons set forth in ¶128.

162. The Company's statements reaffirmed investors' that the Company's credit performance would be better than that of other market participants. For example, on May 9, 2007, J.P. Morgan issued a research report that stated, in part, the following:

Single-family credit quality remains good, and what little exposure Fannie has to higher risk subprime and Alt-A products is largely credit enhanced to minimize Fannie's losses.

I. Fannie's August 16, 2007 News Release, 2006 Annual Report and Conference Call

163. On August 16, 2007, Fannie issued a news release concerning its financial results for 2006 (the "Aug. 16 News Release"). The Aug. 16 News Release quoted CEO Mudd as stating:

> "We made a decision several years ago to step back from the riskier margins of the mortgage market. That decision cost us significant market share at that time, but as the market began to correct, particularly in the latter half of 2006, we began to get some of that market share back."
>
> * * *
>
> "While we do expect our credit loss ratio to increase in 2007 from continuing strain in the housing market, we believe Fannie Mae is well positioned to weather the turmoil in the mortgage market. . . ."
>
> * * *
>
> "Though the housing market continues to cool in 2007 and the credit environment remains challenging, I believe Fannie Mae is well situated for the future," Mudd said. "Strategic decisions we made in the past several years—particularly with respect to our discipline in the non-traditional parts of the mortgage finance market—have positioned us to do well as the housing market stabilizes. . . ."

164. The Aug. 16 News Release stated the following concerning credit risk:

> **The Single-Family book of business grew at a rate of 7.2 percent.** This growth rate—somewhat slower than the overall market—reflects the company's strategic decision to limit participation in certain non-traditional segments of the market when management concluded that pricing did not adequately reflect underlying risks in assets made available for securitization.

165. The Aug. 16 News Release also included a "Discussion of Credit Book of Business" using data as of June 30, 2007 that stated, in part, the following concerning Fannie's credit book of business and exposure to Alt-A and subprime loans:

How would you characterize the quality of your current single-family mortgage credit book of business?

We believe our conventional single-family mortgage credit book has characteristics that reflect our historically disciplined approach to risk management. Our book is highly diversified based on date of origination, geography and product type.

* * *

How would you characterize your exposure to Alt-A loans?

We believe that our guaranteed Alt-A loans have more favorable credit characteristics than the overall market of Alt-A loans.

* * *

How would you characterize your exposure to subprime loans?

* * *

We have reduced our exposure to credit losses through the purchase of credit enhancement. We have also invested in highly rated private-label securities backed by subprime mortgage loans—primarily the highest rated tranches of these securities at the time of acquisition.

* * *

We believe that the subprime loans in our single-family mortgage credit book of business have more favorable credit characteristics than the overall market of subprime loans.

* * *

Aside from your traditional core business, subprime and Alt A, are there other segments/product features in your book of business that could be viewed as particularly sensitive to further declines in home prices and/or further regional weakness in employment? What is Fannie Mae doing to mitigate risk in these segments?

Certain product features and loan attributes are often associated with a greater degree of credit risk. For example, loans with low FICO scores, high LTV ratios, and negative amortization typically contribute to higher levels of delinquency, default and credit losses. We have taken a disciplined approach in our acquisition of mortgage loans with these features and generally limit our participation in these segments to where we are able to appropriately price for the risks.

166. The statements in ¶¶163-65 were false and misleading for the reasons set forth in ¶128.

167. On August 16, 2007, the Defendants caused Fannie to file its annual report with the SEC on Form 10-K (the "2006 Annual Report"), signed by Mudd.

168. The 2006 Annual Report stated the following as to the credit profile of Fannie mortgage credit book of business:

> **Market and Economic Factors Affecting Our Business**
> ***Market Environment: 2001 to Mid-2006 . . .***
>
> As the composition of loan originations shifted from fixed-rate mortgages to a greater share of higher risk, less traditional mortgages, we concluded that the market's pricing of a significant portion of these loans did not appropriately reflect the underlying, and often layered, credit risks associated with these products. Based on this assessment, we made a strategic decision to forgo the guaranty of a significant proportion of mortgage loans because they did not meet our risk and pricing criteria. . . . We believe . . . that this decision has helped us maintain a mortgage credit book of business with strong credit characteristics overall.

169. These statements were false and misleading for the reasons set forth in ¶128.

170. The 2006 Annual Report represented:

> We believe that the limited scale and disciplined nature of our participation in the subprime market has helped to protect the company from a material adverse impact of the recent disruption in that market to date.

171. The 2006 Annual Report stated:

> We believe that our approach to the management of credit risk during the past several years has contributed to our maintenance of a credit book with strong credit characteristics overall, as measured by loan-to-value ratios, credit scores and other loan characteristics that reflect the effectiveness of our credit risk management strategy.
>
> * * *
>
> **Single-Family Business**

Our conventional single-family mortgage credit book of business remained relatively strong from 2004 to 2006. We believe that our assessment and approach to the management of credit risk during these years allowed us to maintain a conventional single-family mortgage credit book of business with strong credit risk characteristics as evidenced by our credit losses, which remained low during the three-year period from 2004 to 2006. We are focused on understanding and serving our customers' needs, strengthening our relationships with key partners, and helping lenders reach and serve new, emerging and nontraditional markets by providing more flexible mortgage options, including Alt-A and subprime products, which have represented an increased proportion of mortgage originations in recent years. We have increased our participation in these types of products where we have concluded that it would be economically advantageous and/or that it would contribute to our mission objectives. Our participation in these products reflects our assessment of anticipated guaranty fee income in light of our expectation for potentially higher credit losses. We continue to closely monitor credit risk and pricing dynamics across the full spectrum of mortgage product types. Our assessment of these dynamics will continue to determine the timing and level of our acquisitions of these types of mortgage products.

* * *

Credit Risk Management

...The degree of credit risk to which we are exposed will vary based on many factors, including the risk profile of the borrower or counterparty, the contractual terms of the agreement, the amount of the transaction, repayment sources, the availability and quality of collateral and other factors relevant to current market conditions, events and expectations. **We evaluate these factors and actively manage, on an aggregate basis, the extent and nature of the credit risk we bear, with the objective of ensuring that we are adequately compensated for the credit risk we take, consistent with our mission goals.**

* * *

Acquisition Policy and Standards

We use proprietary models and analytical tools to price and measure credit risk at acquisition. **Our loan underwriting and eligibility guidelines are intended to provide a comprehensive analysis of borrowers and mortgage loans based upon known risk characteristics.**

(Emphasis added.)

172. The statements in ¶¶170-71 were false and misleading because Fannie's participation in the subprime market was neither limited in scale nor disciplined in nature. Indeed, the Defendants failed to disclose the material facts set forth in ¶128.

173. The 2006 Annual Report included the following statements concerning Fannie's chief risk office:

> **RISK MANAGEMENT . . . .**
>
> ***Chief Risk Office***
> The Chief Risk Office is an independent risk oversight organization with responsibility for oversight of credit risk, market risk, operational risk and liquidity risk. The Chief Risk Officer is responsible for establishing our overall risk governance structure and providing independent evaluation and oversight of our risk management activities. In 2006 and 2007, we centralized oversight of our business continuity efforts, information security programs, corporate insurance program and SOX Finance Team under our Operational Risk Oversight function within the Chief Risk Office to further strengthen our existing operational risk programs.

174. These statements were false and misleading because Fannie's Chief Risk Office was not independent and had not been strengthened. In fact, in July 2007, Fannie materially lowered its risk management capabilities by materially reducing the Chief Risk Officer's budget and staff. With respect to the budget and personnel cut, Dallavecchia complained to Mudd and Williams on or around July 16, 2007 that Fannie had one of "the weakest control processes" he had ever witnessed, that the Company's budget was inadequate for Fannie's risk exposure and that Fannie "was not even close" to having proper control processes for credit, market and operational risk. As alleged in ¶¶92-93, instead of strengthening the Chief Risk Office, Fannie weakened the office by materially reducing its budget.

175. The 2006 Annual Report also stated:

> We use internally developed models to assess our sensitivity to credit losses based on current data on home values, borrower payment patterns, non-mortgage consumer credit history and management's economic outlook. We examine a

> range of potential economic scenarios to monitor the sensitivity of credit losses. Our models indicate that home price movements are an important predictor of credit performance. We disclose on a quarterly basis the estimated impact on our expected credit losses from an immediate 5% decline in single-family home prices for the entire United States, which we believe is a stressful scenario based on housing data from OFHEO. Historical statistics from OFHEO's house price index reports indicate the national average rate of home price appreciation over the last 20 years has been about 5.3%, while the lowest national average annual appreciation rate in any single year has been 0.3%. However, we believe that the decline in home prices in 2007 is likely to continue.

176. These statements were false and misleading for the reasons set forth above in ¶128.

177. The 2006 Annual Report included a certification pursuant to the Sarbanes-Oxley Act of 2002 ("SOX Certification") signed by Mudd. Mudd's SOX Certification stated, in part, the following:

> 2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
>
> 3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
>
> 4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
>
> > (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
> >
> > (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our

supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

(c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

178. Mudd's SOX Certification was materially false and misleading for the reasons set forth in ¶128.

179. Also on August 16, 2007, the Company conducted a conference call with investors (the "Aug. 16 Conference Call") in which the following statements were made:

[Mudd] "[O]ur risk position is excellent . . . We're more than adequately capitalized . . . the Alt-A loans we guarantee have more favorable credit characteristics than the overall market of Alt-A loans, including a weighted average FICO score of 720 and low exposure to high LTVs."

[Dallavecchia regarding the guarantee business] "[L]et me look ahead quickly to 2007 and 2008"... [t]he market is returning to more rational products and pricing."

> [Mudd]: [04 through 06 the market changed] but] "our underwriting . . . our due diligence, our audit of these firms has remained the same . . . we fundamentally held our standards where they were."

180. These statements were false and misleading for the reasons set forth in ¶128.

181. Also during the Aug. 16 Conference Call, the following statements were made:

> [Dallavecchia]: An important point for both our [subprime] and Alt-A backed securities is our use of stress tests to assess potential losses under multiple scenarios. We include the scenarios as severe as two consecutive years of 10% declines in home prices, coupled with the two consecutive years of 2% increase in interest rates. And the outcome of these scenarios project better (inaudible) loss and cash flow even under the direst scenario.

(alteration added).

182. These statements were false and misleading for the reasons set forth in ¶128.

183. On August 17, 2007, the *Washington Post* reported that "District-based Fannie Mae said it was less vulnerable to the turmoil than other players in the mortgage industry and could wind up with a larger share of the market. 'We'll come out of this in pretty good shape,' chief executive Daniel H. Mudd told analysts."

184. This statement was materially false and misleading as Mudd knew and had reasons to know that Fannie was not in good shape for the reasons set forth in ¶128.

J. September 10-11, 2007 Lehman Brothers 5th Annual Financial Services Conference

185. At the September 10, 2007 Lehman Brothers Financial Services Conference, Lund said,

> [W]e believe the nature of our participation in these [subprime and Alt-A] segments and our use of credit enhancements has mitigated our potential loss exposure to a significant degree. . . .
>
> * * *
>
> First, we generally acquire loans originated as Alt-A from our traditional lender partners. We review and approve lenders' underwriting guidelines, and are very familiar with their origination practices. Alt-A loans originated by these lenders

> will typically follow an origination path similar to what will be used for prime mortgages.
>
> **Second, and partly as a result of my first point, the credit characteristics of our Alt-A loans are more favorable than what you would see in the overall market, including a weighted average FICO of 720 and a low exposure to high LTVs.** Lastly, we own about $43.5 billion in securities backed by Alt-A loans. These securities have a weighted average subordination of 20%, and they are subjected to stress testing to assess potential losses under multiple scenarios. And the outcome of these scenarios project very little cash flow loss even under the most dire scenarios.
>
> **In light of these factors, I believe we have engaged in non-traditional segments in the market in an appropriate and prudent way.** We largely limited our participation in more conservative traunches of these products, and we've taken additional steps to mitigate our loss exposure.

(Emphasis added.)

186. These statements were materially false and misleading for the reasons set forth in ¶128.

187. On September 20, 2007, Defendant Mudd testified before Congress that Fannie could "provide more liquidity help to the home finance market today without taking risks we are not capable of managing" and that Fannie had "vastly reduced [its] material control weaknesses."

188. These statements were false and misleading for the reasons set forth in ¶128.

K. Fannie's November 9, 2007 News Release, Financial Results for Three and Nine Months Ended September 30, 2007 and Conference Call

189. On November 9, 2007, Fannie issued a news release that disclosed its financial results for three and nine months ended September 30, 2007 (the "Nov. 9. News Release"). The Nov. 9 2007 News Release quoted Mudd as stating the following:

> During the last year, we vastly reduced our material weaknesses in internal controls, expanded our risk-management functions, reduced our headcount, and cut our operating expenses," Mudd said. "The company is in solid shape to support the market, and is in better shape to benefit when the market correction ends."

* * *

> "At the same time, our book of business is growing, our guaranty revenue is rising, and our market share is returning. **Further, in 2007 we're seeing the value of some of the tough choices we made in recent years to hold on to our credit discipline. Those choices have shielded us from the worst effects of the housing and mortgage market correction."**

(Emphasis added.)

190. Mudd's statements were materially false and misleading because investors did not have a current picture of Fannie's performance and Fannie was not in solid shape. Mudd's statements were false and misleading for the further reasons set forth in ¶128.

191. Also on November 9, 2007, the Defendants caused Fannie to file the First Quarter 2007 10-Q with the SEC which was signed by Mudd.

192. The First Quarter 2007 10-Q stated the following concerning Fannie's subprime mortgages:

> Subprime loans: . . . Our acquisitions of subprime mortgage loans have a combination of credit enhancement and pricing that we believe adequately reflects the higher credit risk posed by these mortgages. In order to respond to the current subprime mortgage crisis and provide liquidity to the market, we intend to increase our purchase of subprime mortgages. **We will determine the timing and level of our acquisition of subprime mortgage loans in the future based on our assessment of the availability and cost of credit enhancement with adequate levels of pricing to compensate for the risks.**

(Emphasis added.)

193. These statements were false and misleading for the reasons set forth in ¶128.

194. The First Quarter 2007 10-Q included a SOX Certification signed by Mudd that was substantially the same as the SOX Certification alleged in ¶177.

195. Mudd's SOX Certification was false and misleading for the reasons set forth in ¶128.

196. Also on November 9, 2007, the Defendants caused Fannie to file the Second Quarter 2007 10-Q with the SEC. The Second Quarter 2007 10-Q was signed by Mudd.

197. The Second Quarter 10-Q 2007 stated the following concerning Fannie's subprime and Alt-A mortgages:

> *Subprime Loans:* . . . Our acquisitions of subprime mortgage loans have a combination of credit enhancement and pricing that we believe adequately reflects the higher credit risk posed by these mortgages. In order to respond to the current subprime mortgage crisis and provide liquidity to the market, we intend to increase our purchase of subprime mortgages. **We will determine the timing and level of our acquisition of subprime mortgage loans in the future based on our assessment of the availability and cost of credit enhancement with adequate levels of pricing to compensate for the risks.**

(Emphasis added.)

198. These statements were false and misleading for the reasons set forth in ¶128.

199. The Second Quarter 2007 10-Q included a SOX Certification signed by Mudd that was substantially the same as the SOX Certification alleged in ¶177.

200. Mudd's SOX Certification was false and misleading for the reasons set forth in ¶128.

201. Also on November 9, 2007, the Defendants caused Fannie to file its Third Quarter 2007 Form 10-Q with the SEC. The Third Quarter 2007 10-Q was signed by Mudd.

202. The Third Quarter 2007 10-Q stated that "Our acquisitions of Alt-A mortgage loans have a combination of credit enhancement and pricing that we believe adequately reflects the higher credit risk posed by these mortgages."

203. This statement was false and misleading because the Defendants misrepresented and/or failed to disclose that the Company had acquired Alt-A for which it failed to adequately increase the guarantee fee charged to loan originators to compensate Fannie for the increased credit risk.

204. The Third Quarter 2007 Form 10-Q made the following misrepresentations, which minimized Fannie's credit risk exposure to subprime and Alt-A mortgages:

> *Subprime Loans:* . . . Our acquisitions of subprime mortgage loans have a combination of credit enhancement and pricing that we believe adequately reflects the higher credit risk posed by these mortgages. In order to respond to the current subprime mortgage crisis and provide liquidity to the market, we intend to increase our purchase of subprime mortgages. We will determine the timing and level of our acquisition of subprime mortgage loans in the future based on our assessment of the availability and cost of credit enhancement with adequate levels of pricing to compensate for the risks.
>
> *Alt-A and Subprime Securities:*
>
> * * *
>
> We are subject to increased credit risk exposures related to subprime and Alt-A mortgage loans that back our private-label mortgage-related securities investments, and any increased delinquency rates and credit losses could adversely affect the yield on or value of our investments, which could negatively affect our earnings and financial condition.
>
> We invest in private-label mortgage-related securities that are backed by Alt-A and subprime mortgage loans. In October 2007, Standard & Poor's downgraded the credit ratings of a small number of private-label securities held in our portfolio that are backed by subprime mortgage loans, and Moody's placed under review for possible downgrade several additional subprime-backed private-label securities held in our portfolio. In recent months, mortgage loan delinquencies and credit losses generally have increased, particularly in the subprime and Alt-A sectors. In addition, home prices in many states have declined, after extended periods during which home prices appreciated. If delinquency and loss rates on subprime and Alt-A mortgages continue to increase, or there is a further decline in home prices, we could experience reduced yields or losses on our investments in private-label mortgage-related securities backed by subprime or Alt-A loans. In addition, the fair value of these investments may be adversely affected. A reduction in the fair value of these investments could negatively affect our earnings and financial condition.

205. These statements were false and misleading for the reasons set forth in ¶128.

206. The Third Quarter 2007 10-Q explained Fannie's management of its institutional counterparty credit risk—but misrepresented the enormity of the increase to its counterparty risk:

> Our potential exposure to the risks associated with our dependence on the institutional counterparties to provide services that are critical to our business has

> increased in recent months, and our earnings and liquidity may be reduced if one or more of our institutional counterparties defaults on its obligations to us.
>
> Our primary exposure to institutional counterparty risk is with our mortgage insurers, mortgage servicers, lender customers, depository institutions, dealers that commit to sell mortgage pools or loans to us, issuers of investments held in our liquid investment portfolio, and derivatives counterparties. Our business with many of these institutional counterparties is heavily concentrated... [A]s of September 30, 2007, our ten largest single-family mortgage servicers and their affiliates serviced 78% of our single-family mortgage credit book of business, and Countrywide Financial Corporation and its affiliates, which is our largest single-family mortgage servicer, serviced 23% of our single-family mortgage credit book of business.

207. These statements were false and misleading because the Defendants misrepresented and/or failed to disclose that it made material exceptions to its risk management guidelines for Countrywide, Fannie's largest customer. Starting in late 2007, Confidential Witness 4 observed that there were 6,000-7,000 outstanding loans that Fannie had selected to review. Countrywide failed to provide the information, which under Fannie's guidelines should have triggered a limitation of Fannie's business with Countrywide. However, Fannie failed to enforce the triggers on Countrywide, violating Fannie's risk management guidelines.

208. The Third Quarter 2007 10-Q included a SOX Certification signed by Mudd that was substantially the same as the SOX Certification alleged in ¶177.

209. Mudd's SOX Certification was false and misleading for the reasons set forth in ¶128.

210. On the November 9 Conference Call, the following statements were made:

> [Mudd]: **We've already tightened our underwriting and pricing, really going back to the early summer of '07 where we began requiring higher down payments, more documentation and higher credit scores.** That came after the period where we made a specific decision not to get into some of the riskier segments of the market. Just this week we have announced a nationwide increase in our single-family guarantee fee to make sure that we are compensated for the risks that we manage. . . ."

* * *

> Now, looking ahead, we expect the current market trends to continue through next year. We see home prices falling by an average of 2% nationwide this year and 4% next year . . . .

* * *

> [Lund]: [T]he '06 and '07 books are clearly not going to be the credit quality books that we saw previously. But you've got to remember where we're coming from is from a historical low, too, in terms of credit losses. So, when we look at our projections moving forward, that we take that into account.
>
> [Mudd]: [T]he underwriting standards on our side have always stayed fairly constant.

* * *

> [An analyst asks given exposure to subprime and Alt-A, couldn't things get "a lot worse."] [Mudd in response]: [A]re we prepared for scenarios that are somewhat historical? Yes.

(Emphasis added.)

211. These statements were false and misleading because the Defendants misrepresented and/or failed to disclose that, even to the extent Fannie tightened its underwriting and pricing, the damage was already done: the Company was exposed to billions of dollars of Alt-A and subprime mortgages and MBS that were acquired pursuant to materially looser underwriting guidelines and Fannie failed to adequately price for the risk it assumed. Further, the Defendants failed to disclose the facts set forth in ¶128.

L. Preferred Series R Offering

212. On November 16, 2007 Fannie issued 20,000,000 shares of 7.625 Non-Cumulative Preferred Stock Series R at $25 per share pursuant to an Offering Circular (the "Preferred Series R Offering Circular"). The Preferred Series R Offering Circular incorporated by reference the following documents: (i) the 2006 Annual Report; and (ii) the First, Second and Third Quarter 2007 10-Qs.

213. The documents incorporated by reference in the Preferred Series R Offering Circular were materially false and misleading for the reasons set forth in ¶¶168-176 (identifying false and misleading statements in the 2006 Annual Report); ¶¶191-209 (identifying false and misleading statements in the First, Second and Third Quarter 2007 10-Qs).

M. Preferred Series S Offering

214. On December 6, 2007, Fannie issued 280,000,000 shares of Fixed-to-Floating Rate Non-Cumulative Preferred Stock Series S pursuant to an Offering Circular (the "Series S Offering Circular"). The Series S Offering Circular incorporated by reference the following documents: (i) the 2006 Annual Report; and (ii) the First, Second and Third Quarter 2007 10-Qs.

215. The documents incorporated by reference in the Preferred Series S Offering Circular were materially false and misleading for the reasons set forth in ¶¶168-176 (identifying false and misleading statements in the 2006 Annual Report); ¶¶191-209 (identifying false and misleading statements in the First, Second and Third Quarter 2007 10-Qs).

N. Mudd's Testimony Before the Senate Committee on Banking on February 7, 2008

216. Also on February 7, 2008, during testimony before the Senate Banking Committee, Mudd represented that the Company carefully managed its subprime exposure:

> SENATOR RICHARD SHELBY: Are [the subprime loans] performing?
>
> MUDD: They are [performing]. And we look at those very closely in terms of their performance. We look very closely at where they're rated, but we do have our own separate rating system.
>
> There is credit enhancement, mortgage insurance, other forms there, but we also stress test that and discount that, if need be.
>
> We're watching it very closely.

217. These statements were false and misleading for the reasons set forth in ¶128.

218. During that same February 7, 2008 testimony before the Banking Committee, in response a question as to whether, "[g]iven Countrywide's recent financial problems and loan performances, do you have any concerns as to the quality of those purchases?", Mudd answered "We review [the Countrywide loans] very carefully. . . . [W]**e have good confidence in that portfolio**." (Emphasis added.)

219. These statements were false and misleading because, in stark contrast to Mudd's false representations that Fannie carefully reviewed the loans it purchased from Countrywide, Fannie actually made material exceptions to its risk management guidelines for Countrywide. Specifically in late 2007, Confidential Witness 4 observed that there were 6,000-7,000 outstanding loans that had Fannie had selected to review. According to Confidential Witness 4, Countrywide failed to provide the information necessary to conduct such reviews, which under Fannie's guidelines should have triggered a limitation of Fannie's business with Countrywide. However, unbeknownst to investors, Fannie failed to enforce the triggers on Countrywide, violating Fannie's risk management guidelines.

O. February 27, 2008 News Release, 2007 10-K and Conference Call

220. On February 27, 2008, Fannie issued a news release that disclosed the Company's fourth quarter and full-year 2007 results (the "Feb. 27 News Release"). The Feb. 27 News Release quoted Mudd as follows:

> [Mudd]: Our strategy for moving through another tough year is to protect and conserve our capital base, and control credit losses. We have also increased our credit loss reserves. Finally, we will also provide liquidity to the market by growing our guaranty business as we build a very strong credit book. These steps will help us do our part to maintain a liquid, stable and affordable mortgage market—and also position us well when the market recovers.

221. These statements were false and misleading because for the reasons set forth in ¶128.

222. Also on February 27, 2008, the Defendants caused Fannie to file the 2007 10-K (the "2007 Annual Report"), which was signed by Mudd.

223. The 2007 Annual Report included Fannie's fiscal year 2007 financial results as previously set forth in the Feb. 27 News Release above at ¶220.

224. The 2007 Annual Report included the following statements concerning Fannie's credit risk management:

> ***Building a Solid Mortgage Credit Book of Business by Managing and Mitigating Credit Exposure***
>
> We have implemented a variety of measures designed to help us manage and mitigate the credit exposure we face as a result of our investment and guarantee activities. These measures include:
> • establishing guidelines designed to limit our credit exposure, including tightening our eligibility standards for mortgage loans we acquire;
> • limiting losses associated with our guaranty contracts by increasing our guaranty fees and implementing an adverse market delivery charge to compensate us for the added risk we incur during this period of increased market uncertainty; and
> • working to mitigate realized credit losses, both by working closely with our servicers to enhance our ability to act promptly when borrowers fall behind on their loan payments and by offering an expanded array of loss mitigation alternatives.

225. In its 2007 Annual Report Fannie represented that it "closely monitor[ed] housing and economic market conditions and loan performance to manage and evaluate our credit risks, adjusting our eligibility requirements and pricing as necessary to ensure that we are appropriately compensated for risk." The Company further stated in the 2007 Annual Report that

> Our loan underwriting and eligibility guidelines are intended to provide a comprehensive analysis of borrowers and mortgage loans based upon known risk characteristics ... **We have policies and various quality assurance procedures that we use to review a sample of loans to assess compliance with our underwriting and eligibility criteria.** If we identify underwriting or eligibility deficiencies, we may take a variety of actions, including increasing the lender credit loss sharing or requiring the lender to repurchase the loan, depending on the severity of the issues identified.

(Emphasis added.)

226. The statements in ¶¶224-25 were false and misleading because, as described in ¶207 above, the Defendants misrepresented and/or failed to disclose that Fannie made material exceptions to its risk management guidelines for Countrywide, Fannie's largest customer.

227. The 2007 Annual Report contained the following statements minimizing Fannie's credit risk exposure to Alt-A and subprime mortgages:

> **In order to manage our credit risk in the shifting market environment, we lowered maximum allowable LTV ratios and increased minimum allowable credit scores for most Alt-A loan categories. We also limited our acquisition of some documentation types and made other types ineligible for delivery to us. Finally, we implemented pricing increases to reflect the higher credit risk posed by these mortgages.** As a result of these eligibility restrictions and price increases, we believe that our volume of Alt-A mortgage loan acquisitions will decline in future periods.

The majority of our Alt-A mortgage loans are fixed-rate, and the weighted average credit score of borrowers under our Alt-A mortgage loans is comparable to that of our overall single-family mortgage credit book of business.* * *

> **Our acquisitions of subprime mortgage loans have a combination of credit enhancement and pricing that we believe adequately reflects the higher credit risk posed by these mortgages.** We will determine the timing and level of our acquisition of subprime mortgage loans in the future based on our assessment of the availability and cost of credit enhancement with adequate levels of pricing to compensate for the risks.

(Emphasis added.)

228. These statements were false and misleading for the reasons set forth in ¶128.

229. The 2007 Annual Report included the following statements concerning Fannie's credit loss sensitivities:

> We use internally developed models to assess our sensitivity to credit losses based on current data on home values, borrower payment patterns, non-mortgage consumer credit history and management's economic outlook. We also review and compare publicly available credit loss analyses and predictions. We examine a range of potential economic scenarios to monitor the sensitivity of credit losses. Our models indicate that home price movements are an important predictor of credit performance. Due to the continued housing market downturn and our expectation that home prices will decline further in 2008, we expect a significant increase in our credit-related expenses and credit loss ratio.

> Pursuant to our September 2005 agreement with OFHEO, we disclose on a quarterly basis the present value of the change in future expected credit losses from our existing single-family guaranty book of business from an immediate 5% decline in single-family home prices for the entire United States. For purposes of this calculation, we assume that, after the initial 5% shock, home price growth rates return to the average of the possible growth rate paths used in our internal credit pricing models. The present value change reflects the increase in future expected credit losses under this scenario, which we believe represents a reasonably high stress scenario because it assumes an instantaneous nationwide decline in home prices, over the future expected credit losses generated by our internal credit pricing models without this shock.

230. The 2007 Annual Report included a SOX Certification signed by Mudd that was substantially the same as set forth above at ¶177.

231. Mudd's SOX Certification was materially false and misleading for the reasons set forth in ¶128.

232. On a February 2008 Conference Call, Mudd reported that Fannie projected a larger decline in home prices, but still did not disclose that Fannie predicted a 50% decline in home prices over three to five years. Mudd said:

> We now expect home prices to decline nationwide by 5 to 7% this year on average, instead of the 4 to 5% decline we last projected. So we have moved that projection for home price declines up one notch. Second, we do not expect national home prices to bottom out until late '09, and that drives a peak-to-trough decline on average nationally in the range of 13 to 17%, which is, again, a notch up from the last projection of 8 to 12%.

233. This statement was materially false and misleading for the reasons set forth in ¶128.

P. Fannie's Financial Results for the Period Ended March 31, 2008 and Conference Call

234. In anticipation of certain offerings of common and preferred stock, on or around May 2, 2008 Fannie published "Fannie Mae Capital Raise Roadshow" that represented that

Fannie was actively monitoring counterparties and enhancing counterparty collateral requirements.

235. This statement was materially false and misleading because, as set forth above at ¶¶104-108, the Defendants misrepresented and/or failed to disclose that Fannie made material exceptions to its risk management guidelines for Countrywide. Further, these statements were materially false and misleading because the Defendants misrepresented and/or failed to disclose that Fannie settled a loan repurchase dispute with Countrywide in May 2008 for approximately $0.23-0.26 on the dollar for a claim of $680-690 million, which was a violation of the Fannie's stated policy concerning repurchase requests, as alleged in ¶225.

236. Also on May 6, 2008, the Defendants caused Fannie to file its First Quarter 2008 Form 10-Q with the SEC (the "First Quarter 2008 10-Q"). The First Quarter 2008 10-Q was signed by Mudd.

237. The First Quarter 2008 10-Q stated the following concerning Fannie's credit loss sensitivity:

> Pursuant to our September 2005 agreement with OFHEO, we disclose on a quarterly basis the present value of the change in future expected credit losses from our existing single-family guaranty book of business from an immediate 5% decline in single-family home prices for the entire United States. Table 17 shows for first lien single-family whole loans we own or that back Fannie Mae MBS as of March 31, 2008 and December 31, 2007, the credit loss sensitivity results before and after consideration of projected credit risk sharing proceeds, such as private mortgage insurance claims and other credit enhancement. The increase of $625 million in the net credit loss sensitivity to $5.2 billion as of March 31, 2008, from $4.5 billion as of December 31, 2007 was primarily attributable to the continued decline in home prices during the first quarter of 2008.

238. This statement was materially false and misleading for the reason set forth in ¶128.

239. The First Quarter 2008 10-Q included a SOX Certification signed by Mudd that was substantially the same as the SOX Certification alleged in ¶177.

240. Mudd's SOX Certification was false and misleading for the reasons set forth in ¶228.

241. On the May 6, 2008 analyst conference call, Mudd made the following statements concerning risk management:

> [Mudd]: Well, let me start and then either Rob or Mike Quinn, who is our Single-Family Chief Credit Officer, can jump in.... [M]ost of our business model is built off of a set of reps and warranties that the originators provide to us. So, we have always had a history of enforcing those reps and warranties. Because the documentation is lower in the Alt-A book which is after all the point of Alt-A, that's an area that we make sure that we focus on. With that, I would let Mike Quinn pick up.
>
> [Quinn]: Thanks Dan. [or ellipsis] Yes, every loan that defaults, we do an underwriting review to make sure it didn't tie out to our guidelines and what our contract with the lender was. So we're doing those review reviews of old loans that default. And we're issuing more make-whole and repurchase request that the volume has increased of that.

242. This statement was materially false and misleading because Fannie was not doing an underwriting review of every loan that defaulted. As alleged in ¶¶104-108, Fannie made material exceptions to its risk management guidelines for Countrywide, and, further, misrepresented and/or failed to disclose that Fannie violated its stated policy regarding repurchase requests when it settled a loan repurchase dispute with Countrywide in May 2008.

Q. May 8, 2008 — Common Stock Offering Circular

243. On May 8, 2008, Fannie offered 82,000,000 shares of common stock pursuant to an Offering Circular dated May 8, 2008 (the "May 8 Common Stock Offering Circular"). The May 8 Offering Circular incorporated by reference the following documents: Fannie's 2007 10-K and 2008 First Quarter 10-Q.

244. The documents incorporated by reference in the May 8 Common Stock Circular were materially false and misleading set forth in ¶¶236-240 (identifying materially false and misleading statements in the 10-Q for the quarter ended March 31, 2008); and ¶¶222-231 (identifying materially false and misleading statements in the 10-K for 2007).

R. May 8, 2008 — Preferred Series 2008-1 Offering Circular

245. Also on May 8, 2008, Fannie offered 45 million shares of 8.75% Non-Cumulative Mandatory Convertible Preferred Stock, Series 2008-1 shares of preferred shares Series 2008-1 pursuant to an Offering Circular dated May 8, 2008 (the "2008-1 Offering Circular"). The 2008-1 Offering Circular incorporated by reference Fannie's 2007 10-K and 2008 First Quarter 10-Q that were materially false and misleading for the reasons set forth above.

S. May 13, 2008 — Preferred Series T Offering Circular

246. On May 13, 2008, Fannie offered 80,000,000 shares of 8.25% Non-Cumulative Preferred Stock, Series T shares of preferred stock pursuant to an Offering Circular dated May 13, 2008 (the "Series T Offering Circular."

247. The Series T Offering Circular incorporated by reference the following documents: Fannie's 2007 10-K and 2008 First Quarter 10-Q that were materially false and misleading for the reasons set forth above.

T. Fannie's August 8, 2008 News Release, Financial Results for the Quarter ended June 30, 2008 and Conference Call

248. On August 8, 2008, Fannie issued a news release that disclosed the Company's financial results for the period ended June 30, 2008 (the "Aug. 8 News Release"). As quoted in the Aug. 8 News Release, Defendant offered the following reassurances as to Fannie's safety and soundness, and its ability to generate revenue:

> [Mudd]: We are taking the necessary steps to meet the needs of our lending partners, provide liquidity to the market, and channel global capital into housing. The housing market will inevitably stabilize and recover, and we are working to make sure Fannie Mae will be at the center of that recovery, for our shareholders and the market we serve.

249. As Defendant Mudd knew or recklessly disregarded, Fannie was sinking under the weight of its losses by that time, rendering their statements above materially false and misleading.

250. Also on August 8, 2008, the Defendants caused Fannie to file its Second Quarter 2008 Form 10-Q with the SEC (the "Second Quarter 2008 10-Q"). The Second Quarter 2008 10-Q was signed by Mudd.

251. The Second Quarter 2008 10-Q stated the following concerning credit loss sensitivities:

> Pursuant to our September 2005 agreement with OFHEO, we disclose on a quarterly basis the present value of the change in future expected credit losses from our existing single-family guaranty book of business from an immediate 5% decline in single-family home prices for the entire United States. Table 17 shows the credit loss sensitivity before and after consideration of projected credit risk sharing proceeds, such as private mortgage insurance claims and other credit enhancement, as of June 30, 2008 and December 31, 2007 for first lien single-family whole loans we own or that back Fannie Mae MBS. The sensitivity results represent the difference between our base case scenario of the present value of expected credit losses and credit risk sharing proceeds, derived from our internal home price path forecast, and a scenario that assumes an instantaneous nationwide 5% decline in home prices. The increase in the credit loss sensitivities since December 31, 2007 reflects the decline in home prices during the first half of 2008 and the current negative near-term outlook for the housing and credit markets. These higher sensitivities also reflect the impact of updates to our underlying credit loss estimation models to capture the credit risk associated with the rapidly changing and worsening of conditions in the housing market. An environment of continuing lower home prices affects the frequency and timing of defaults and increases the level of credit losses, resulting in greater loss sensitivities. Although the anticipated credit risk sharing proceeds have increased as home prices have declined, the expected amount of proceeds resulting from a 5% home price shock are lower. As home prices decline, the number of loans without mortgage insurance that are projected to default increases. . . . .

252. These statements were materially false and misleading because the Exchange Act Defendants misrepresented and/or failed to disclose that in January 2007, Fannie's business analytics division was predicting a 50% decline in home prices over three to five years that would materially increase Fannie's losses and wipe out Fannie's core capital.

253. The Second Quarter 2008 10-Q included a SOX Certification signed by Mudd that was substantially the same as the SOX Certification alleged in ¶177.

254. Mudd's SOX Certification was false and misleading for the reasons set forth in ¶128.

255. On the August 8, 2008 analyst conference call (the "August 8 Conference Call"), Mudd stated the following about Fannie's exposure counterparty risk:

> [M. DeVries] [Lehman Brothers Analyst]: [C]ould you discuss the extent to which and you know, if at all, you have factored in counterparty risk with the financial guarantors and the MIs [mortgage insurance] in your reserving and impairments that you've taken?
>
> [D. Mudd]: We've as a broad matter, we've moved with the installation of the Chief Risk Officer function, we have created the systems and the ability to look at our counterparty exposure to all of our counterparties on a divisible basis or on an aggregate basis.
>
> We look at that. We measure that. We understand where the risk is and as you've seen some of the larger counterparty changes along the way, with respect to some of the originators or some of the servicers that have changed form or as, for example, in the case of IndyMac, we've been able to manage through those by using that system; getting ahead of the curve, and having a very high degree of recovery.
>
> * * *
>
> [G. Gordon]: OK, thanks. The other is, I guess, sort of a counterparty risk in your loss mitigation efforts. Obviously, the people you're going back to collect in most cases are your clients; your customers delivering loans. How does that limit your ability to collect and obviously, there've been a number of bankruptcies of lenders. How does that limit your ability to collect?

> [D. Mudd]: So that said, in the situations that have been more publicized recently, I think it would go back, Gary, to my prior comment, which is we monitor these in advance. We see where there are signs of stress. The big concern there for us is that we're able to get in front and ensure that there's uninterrupted servicing because by-and-large you know the underlying quality of the loans is what it is, but it's the servicing that you don't want to have interrupted. And we have been able to very efficiently, very quickly, and somewhat painlessly move those servicing books into hands where the servicing will continue uninterrupted. With that Tom can give you a little flavor of the discussions.
>
> [T. Lund]: Sure. Let me just reiterate what Dan said. I mean this is a practice that we have had in place forever. This is the way we operate with our customers. Our customers understand this and as a team we've done a very good job, in a very tough environment managing counterparties. And I think part of the reason is we've got people on the ground; we're inside these people's shops. We have a great understanding of what they do.
>
> In terms of the rep and warrant, our customers make rep and warrants to us and when the products that they sell meet the contracts. They're very clear about what they're due. They know how we do this. We have ongoing discussions. This is not a surprise to them. I wouldn't even put this in an adversary way. This is an understanding about how this business gets done. It partly creates the efficiency in the secondary market and it's well accepted. So I would say these continued discussions are ongoing and we're successful in that as we go forward.

256. These statements were materially false and misleading because the Defendants misrepresented and/or failed to disclose that Fannie did not have a high degree of recovery concerning repurchase requests against Countrywide and that it was not true that Fannie was able to manage its exposure to IndyMac and have "a very high degree of recovery." Specifically, the Defendants misrepresented and/or failed to disclose, as alleged in ¶¶104-108, that Fannie settled a loan repurchase dispute with Countrywide in May 2008 for approximately $0.23-0.26 on the dollar for a claim of $680-690 million and that, as alleged in ¶¶109-111, Fannie was aware that loans it had purchased from IndyMac were defective, and in fact, Fannie had asked IndyMac to repurchase between $1 and $10 billion in loans after IndyMac had been seized by regulators in

July 2008. These statements were materially false and misleading for the further reason that in July 2007, Fannie materially lowered its risk management capabilities by materially reducing the Chief Risk Officer's budget and staff, as alleged in ¶¶92-93.

VII. DEFENDANTS' FRAUD REGARDING FANNIE'S EXPOSURE TO SUBPRIME AND ALT-A MORTGAGES

257. The Defendants are liable for violations of the Exchange Act arising out of the sale of Fannie common shares and preferred shares during the Class Period.

A. Fannie's Underwriting System

258. Fannie Mae's Single Family business principally acquired loans through one of two channels: (i) the Lender (or flow) channel, which obtained loans from lenders on a going-forward or contractual basis through agreements to purchase loans from lenders before those loans were originated based on certain terms and conditions; and, (ii) the Investor (or bulk) channel, which acquired loans from lenders that had already been originated based on data files for those loans that were provided by lenders to Fannie Mae for review prior to purchase. SEC Cmpl ¶31.

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

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

261. While many mortgage originators used Fannie Mae's DU system as part of the underwriting process, many large mortgage lenders also had their own automated origination and underwriting platforms. For instance, during the Class Period, Countrywide Financial Corporation's ("Countrywide") proprietary underwriting system was called Clues, and Freddie Mac had a system similar to DU that was called Loan Prospector. SEC Cmpl ¶34.

262. Not all loans acquired by Fannie Mae were underwritten using DU. During the Class Period, Fannie Mae acquired and securitized mortgage loans that were underwritten through other automated underwriting systems or simply by agreed-upon standards in a manual process. For instance, Fannie Mae acquired loans under Countrywide's Fast and Easy loan program that were underwritten using Countrywide's Clues system. *E.g.*, FMCIV-NY-02_00529408 (document listing Fannie's internal Special Feature Codes for third party automated underwriting that was outside of Fannie's internal definition of Alt-A, including "Countrywide CLUES EASY PROGRAM," "Freddie Mac's LP," and others). Similarly, most of the My Community Mortgage ("MCM") loans that Fannie Mae acquired during the Class Period were manually underwritten by loan officers and mortgage brokers at various companies nationwide and not evaluated using DU. SEC Cmpl ¶35.

B. The Officer Defendants' Roles at Fannie and Their Disclosure Responsibilities

1. Mudd's Role at Fannie Mae and His Disclosure Responsibilities

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

264. As CEO, and based on his prior role as COO, Mudd possessed detailed operational knowledge concerning Fannie Mae's subprime and reduced documentation loan exposure. Further, during the Class Period, Mudd routinely received acquisition, delinquency and credit loss data concerning subprime and Alt-A loans. Mudd certified filings and made public statements describing Fannie Mae's subprime and reduced documentation loan exposure knowing that those public statements were false and misleading. SEC Cmpl ¶37.

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

266. Mudd was well aware of the Company's increased acquisition of reduced documentation loans—indeed, Mudd himself directed the company to pursue that market. For

instance, in an April 26, 2006, Credit Risk meeting following a presentation on reduced documentation loans and their risks by the Single Family credit officer (who noted low documentation loans were riskier), Mudd stated that "the market is moving to low documentation and we need to actively pursue the keys to this market." SEC Cmpl ¶39.

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

268. Throughout the Class Period, in addition to wages earned, Mudd—like all Fannie Mae executives—received an Annual Incentive Plan ("AIP") bonus that was tied to two things: (i) Company performance, measured by attaining corporate year-end goals; and, (ii) personal performance, measured by attaining individual year-end goals. The AIP program was designed to "put part of the participants' total compensation package at risk, based on the achievement of one-year goals for both the participant and the corporation" with individual performance driving the AIP payout each year, adjusted for corporate goal performance. The AIP bonus for a given year's performance was paid out in the following fiscal year such that an AIP bonus for performance in 2006 was received in 2007. SEC Cmpl ¶41.

269. In his 2006 year-end report to the Board, Mudd noted that the Single Family business increased its market share, in part "by entering new markets—especially Alt-A and subprime," that in response to filing the Company's 2004 Form 10-K, "[t]he market and ratings agency reactions generally were positive—there were no big surprises," and that the Company's

stock price improved by more than 20%. FMCIV-NY-02_00269370, at 9372, 9375, 9380 (memorandum dated Jan. 3, 2007 from Mudd to Fannie's Board of Directors). Mudd's 2006 taxable compensation was more than $6 million with approximately $2.5 million from his AIP bonus. In 2007, Fannie Mae's corporate goals included growing revenue, which the Single Family business set about doing by increasing its book by 5.6% with a plan to acquire more Alt-A and subprime loans. In 2007, Mudd's taxable compensation was more than $10 million–with $3.5 million from his AIP bonus alone. Mudd served as CEO for only eight full months in 2008, but his taxable compensation in 2008 was $7.4 million–with more than $2.2 million from his AIP bonus based on his personal performance for 2007. SEC Cmpl ¶42.

270. Mudd was also well aware that investors were increasingly focused on subprime loans. In a February 6, 2007 memo to the Board of Directors of Fannie Mae, Mudd wrote that investors and analysts were "focused on our market share, subprime risk and our portfolio strategy." As CEO of Fannie Mae, Mudd routinely interacted with investors and the media. During the Class Period, as investors and the media increasingly focused their attention on the credit risks associated with subprime and Alt-A mortgage loans, Mudd made numerous false and misleading statements that downplayed the Company's exposure to such loans and provided false assurance to the market that Fannie Mae was participating in a safer segment of the mortgage market. Indeed, Mudd created the false perception that Fannie Mae's participation in high-credit-risk loans such as Alt-A and subprime was small and contained, and reinforced this false and misleading impression, telling investors that Fannie Mae was in the prime—not the subprime—market with a different, higher set of standards and underwriting. SEC Cmpl ¶43.

271. Mudd was knowledgeable about the mortgage markets. While CEO of Fannie Mae, Mudd made numerous appearances before Congress to testify about the mortgage markets,

the role of the GSEs and the subprime market. In that setting, Mudd repeatedly minimized Fannie Mae's reported exposure, falsely claiming it was less than 2% of the Company's book or that Fannie Mae held about zero percent subprime. SEC Cmpl ¶44.

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

2. Dallavecchia's Role at Fannie Mae and his Disclosure Responsibilities

273. Enrico Dallavecchia served as Fannie Mae's EVP and Chief Risk Officer from June 2006 through August 2008. In that position, Dallavecchia reported directly to Mudd and was responsible for credit, market, counterparty, and operational risk oversight for all business units within Fannie Mae, which included measuring, reporting, and monitoring Fannie Mae's risk profile and formulating the Company's risk policies. As the senior-most executive in charge of credit risk, Dallavecchia received and provided regular reports on the actual volumes of subprime and reduced documentation loan acquisitions, the associated delinquency rates, and credit losses for those loans at Fannie Mae. SEC Cmpl ¶53; *e.g.*, FMCIV-NY-02_00005445, at 5463 (presentation dated Sept. 17, 2007 titled "Risk Policy and Capital Committee Chief Risk Officer Report" with chart listing Fannie's Subprime and Non-Full Doc loans as a percentage of acquisitions and of single family book of business); FMCIV-NY-02_00006413, at 6445 (presentation dated Oct. 15, 2007 titled "Risk Policy and Capital Committee Chief Risk Officer

Report" with graph showing Fannie's Alt-A, Subprime, and other types of loans as a percentage of single family book of business, and serious delinquency rates); FMCIV-NY-02_00021643, at 1651 (email dated Apr. 20, 2006 attaching presentation titled "CEO Credit Risk Briefing" with chart showing "Select Book and Acquisition Trends").

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

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

276. Dallavecchia and the Single Family CRO team assisted in drafting the definition of subprime contained in the February 27, 2007, Form 12b-25 in which Fannie Mae first quantified its subprime exposure. SEC Cmpl ¶56; FMCIV-NY-02_00341436 - FMCIV-NY-02_00341437 (emails dated Feb. 23, 2007 between Dallavecchia and Michael A. Shaw (SVP Credit Risk Oversight); Brenda Nettles (CRO VP Credit Risk Oversight); Pam Johnson (SVP Single Family Risk Management); and Eileen M. O'Malley (Director, Aggregate Reporting,

Policy & Administrative) regarding "Subprime Definition" in which Dallavecchia stated on Feb. 22 that "[t]he way I read it we have no definition at FNM" and stated on Feb. 23 that "[w]e have a whole morning to create a definition.").

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

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

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

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

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

C. Overview of Fannie's Loan Programs

1. Fannie Mae's Reduced Documentation Loan Programs

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

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

284. The *Fast and Easy* loan program was popular. Fannie Mae executives referred to it as Countrywide's "signature" or "flagship" mortgage product. By the mid-2000s, other

mortgage lenders developed similar reduced documentation loan programs such as Mortgage Express and PaperSaver-many of which Fannie Mae acquired in ever-increasing volumes throughout the Class Period. *E.g.*, FMCIV-NY-02_00529408 (document listing reduced documentation loan programs from numerous lenders, including Countrywide, that are outside of Fannie's "Internal ... Definition of Alt-A"); SEC Cmpl ¶64.

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

2. Fannie Mae's Subprime Loan Programs

286. Since the late 1990s, Fannie Mae acquired and guaranteed subprime mortgage loans described in Fannie Mae periodic filings during the Class Period as loans made to "borrowers with weaker credit histories" or "weaker credit profile[s]" that "have a higher likelihood of default than prime loans" as part of the Company's two primary programs for borrowers with weaker credit histories: Expanded Approval/Timely Payment Rewards ("EA") and My Community Mortgage ("MCM"). SEC Cmpl ¶66.

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

contributed disproportionately to Fannie Mae's credit losses. SEC Cmpl ¶67; *e.g.*, FMCIV-NY-02_00009036, at 9037-38 (presentation dated Feb. 29, 2008 titled "Single Family Book of Business and Update on Loss Mitigation"); FMCIV-NY-02_00023054, at 3054, 3060 (email dated Aug. 5, 2007 from Michael Shaw to Mudd and Dallavecchia attaching Aug. 3, 2007 draft of Fannie's Credit Supplement and stating: "Pages 3 through 8 are the reports my team created in response to your request for basic data on our credit book."); FMCIV-NY-02_00299696 at 9701 (presentation dated Jan. 2008 titled "Expanded Approval/Subprime Analysis, Key Observations and Recommendations" stating as "Bottom Line:" "The EA products look like and largely perform like Subprime collateral").

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

289. Traditionally, Fannie Mae treated EA loans as part of its subprime exposure. For example, a March 2002 Report prepared for HUD with the participation of Fannie Mae, entitled "Subprime Markets, the Role of GSE and Risk-Based Pricing," stated under a section entitled "Agency Subprime Lending Products" that:

> The agencies are increasing their presence in the subprime market by rolling-out new subprime mortgage products through updated versions of their automated underwriting systems. Fannie Mae seller/servicers now offer loan products to three groups of credit-impaired borrowers under two new programs. Fannie Mae's Expanded Approval program allows lenders to approve borrowers who would have been formerly classified as 'Refer with Caution' ... by Fannie Mae's Desktop Underwriter (DU). ... The Expanded Approval products are recent innovations, and, according to Fannie Mae representatives, account for a relatively small portion of that GSE's book of business ... At most, according to a Fannie Mae stock analyst, these subprime loan purchases will account for no more than five percent of that GSE's purchase volumes. (Emphasis added).

SEC Cmpl ¶69.

290. Similarly, in its annual exam process in 2004 and 2005, Fannie Mae's then-primary regulator, OFHEO asked for information on Fannie Mae's total Single Family subprime loan exposure, specifically requesting: "[t]he volume of loans purchased in 2004 [and 2005] defined as CE structured subprime ... or sub-prime as otherwise defined." In March of 2005 and April of 2006, respectively, Fannie Mae responded by providing OFHEO with information on mortgage loan purchases and mortgage-backed securities under the EA program, describing the EA program as, "our most significant initiative to serve credit-impaired borrowers." SEC Cmpl ¶70; Fannie NPA ¶12.

291. In anticipation of communications with investors in March, 2004, Fannie Mae's then—CEO received a document listing questions and answers ("Q&A") relating to Fannie Mae's business. That document stated in part: "Delinquencies in the subprime market have been rising. What is Fannie Mae's exposure to subprime loans? Does subprime include Alt-A loans? ANSWER [:] Our strong risk management tools and practices have enabled expansion of Fannie Mae's product offerings to include products targeted to borrowers with minor credit blemishes. The most notable product line for reaching these borrowers, Expanded Approval with Timely Payment Rewards, has grown in volume but represents less than two percent of Single Family credit portfolio." Further, in March of 2005, Fannie Mae's CEO was provided with a Q&A that stated in part: ".... Delinquencies in the subprime market have been rising. What is Fannie Mae's exposure to subprime loans? Does subprime include Alt-A loans? ANSWER[:] Fannie Mae's subprime exposure primarily consists of our own product line for serving credit-impaired borrowers-the Expanded Approval with Timely Payment Rewards product, and mortgage related securities backed by subprime loans that we hold in our mortgage portfolio ..." Fannie NPA ¶11.

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

D. Fannie's Subprime Disclosure Fraud

1. Fannie Excluded EA and MCM Loans from its Subprime Disclosures

293. When Fannie Mae first reported its quantitative exposure to subprime loans in a filing with the Commission on February 27, 2007, the Company broadly defined subprime as loans to "borrowers with weaker credit histories." EA and MCM loans fell squarely within this definition, but were not included in the accompanying quantification of Fannie Mae's subprime exposure. SEC Cmpl ¶72; Fannie NPA ¶¶7-8, 13.

294. Instead, the quantification consisted primarily of private label securities it held that were marketed as being backed by subprime loans, certain "A-" loans that the company acquired prior to 2005, and certain loans that had been acquired through a limited new business initiative beginning in 2006. Fannie Mae's subprime quantification did not include significant numbers of other loans that fell within its published subprime definition of loans to "borrowers with weaker credit histories." SEC Cmpl ¶73.

295. Throughout the Class Period, EA loans had, on average, higher SDQ rates than the loans Fannie Mae used in calculating its disclosed subprime exposure. Senior management at Fannie Mae, including the Defendants, were aware of this fact, as SDQ rates were tracked and regularly included in reports and other internal presentations. SEC Cmpl ¶74; *e.g.*, FMCIV-NY-02_00006413, at 6445 (presentation dated Oct. 15, 2007 titled "Risk Policy and Capital Committee Chief Risk Officer Report" with graph showing EA SDQ rate as higher than Subprime); FMCIV-NY-02_00009036 at 9037-38 (presentation dated Feb. 29, 2008 titled

"Single Family Book of Business and Update on Loss Mitigation" listing SDQ rate of EA as higher than Subprime and stating that primary drivers of forecasted increase in credit losses "are loans acquired in 2006 and 2007 to . . . . meet housing goals (My Community Mortgage and Expanded Approval."); FMCIV-NY-02_00047024, at 7026 (presentation dated May 22, 2008 titled "Credit Review & Initiatives" stating, "Key products appear to be the source of the problem (Alt-A, MCM, and EA/TPR)"); FMCIV-NY-02_00057668, at 7689 (email dated Oct. 26, 2007 regarding "Disclosure Committee Meeting – Review of Q3 2007 10-Q" sent to Mudd, Dallavecchia, and others and attaching draft presentation slide showing credit losses by product year-to-date, including EA, Alt-A, and subprime loans, among others); FMCIV-NY-02_00098250 (email dated July 27, 2008 from Dallavecchia to Mudd stating that EA/MCM "is probably going to generate losses of about $5bn, or 20% of our credit losses."). Fannie Mae tracked the SDQ rates of its mortgage loan products in order to measure the credit risk of its loan portfolio. Fannie Mae defined SDQ as a loan that is 90 days or more past due and loans that are in the process of foreclosure. Generally, the higher the SDQ Rate of loans, the higher the credit risk of those loans. As Fannie Mae stated in its 2004 Form 10-K: "The SDQ is an indicator of potential future foreclosures, although most loan that become seriously delinquent do not result in foreclosure. The rate at which new loans become seriously delinquent and the rate at which existing seriously delinquent loans are resolved significantly affect the level of future credit losses." Fannie NPA ¶15.

296. For example, internal reports show that Fannie Mae's publicly disclosed subprime loans had an SDQ rate of 4.72% as of December 31, 2006, and Fannie Mae's EA loans had an SDQ rate of 5.57% as of December 31, 2006. Fannie NPA ¶16. In a meeting of the Risk Policy and Capital Committee ("RPCC") of Fannie Mae's Board, the CRO reported that as of July 2007

Fannie Mae's SDQ rates for EA were 5.57% (the highest on its book); by contrast, the SDQ rate of its disclosed subprime loans were 4.95 %. SEC Cmpl ¶74; FMCIV-NY-02 00006413, at 6445 (presentation dated Oct. 15, 2007 titled "Risk Policy and Capital Committee Chief Risk Officer Report" with slide titled "Select Single Family Risk Segments"). According to the Single Family Credit Risk Analytics & Monitoring Delinquency Report for September/October 2007, which was sent to Dallavecchia by email on November 7, 2007, by October 2007, Fannie's SDQ rate for EA was 6.117% and the SDQ rate for subprime loans was 4.805%. FMCIV-NY-02_00349972, at 9992.

297. Throughout the Class Period, the credit risk associated with Fannie Mae's EA and MCM acquisitions was reported to and tracked by senior management, including Defendants, in terms of acquisition volume, delinquencies, and credit losses–alongside those loans that were included when quantifying its disclosed "subprime" exposure in its public filings. *E.g.*, FMCIV-NY-02_00009036, at 9038 (presentation dated Feb. 29, 2008 titled "Single Family Book of Business and Update on Loss Mitigation"); FMCIV-NY-02_00047024, at 7026 (presentation dated May 22, 2008 titled "Credit Review & Initiatives"); FMCIV-NY-02_00098250 (email dated July 27, 2008 from Dallavecchia to Mudd); FMCIV-NY-02_00461394 (emails dated Feb. 11-12, 2008 listing Alt-A, subprime, and EA loan volume and distribution by largest 5-7 states). EA and MCM loans were routinely included in reports tracking Fannie Mae's high risk loan products (which ranged from three to five or more loan types during the Class Period) that were received by the Defendants. *Id.*; SEC Cmpl ¶75; Fannie NPA ¶17.

298. Also during the Class Period, senior executives, including the Defendants, were provided with credit loss data that showed that the greatest amount of credit losses attributable to any one loan type or product on Fannie Mae's Single Family book were attributable to

the EA product. For instance, in an October 26, 2007 Disclosure Committee report, a document found in Dallavecchia's files, it is noted that EA loans were responsible for $188.9 million in year-to-date losses and MCM loans were responsible for $16 million in year –to date losses—compared to only $5.5 million in year-to-date losses for the loan population Fannie Mae disclosed as its subprime exposure. SEC Cmpl ¶76; FMCIV-NY-02_00057668 (email dated Oct. 26, 2007 regarding "Disclosure Committee Meeting — Review of Q3 2007 10-Q" sent to Mudd, Dallavecchia, and others and attaching draft presentation with slide showing credit losses by product, including EA, MCM, Alt-A, and subprime loans).

299. As a portion of Fannie Mae's book of business, EA loans increased in volume between 2006 and 2008 from approximately $43 billion to approximately $58.3-59.6 billion, totaling approximately 2% of the company's book of business during the Class Period. MCM loans, which were intended for low-to-moderate income borrowers, accounted for between 0.3% and 1.5% of Fannie Mae's book of business over the same period. FMCIV-NY-02_00404976, at 5129 (report titled "March 2007 Book Profile" stating Fannie's EA/TPR exposure was $43.7 billion as of March 2007); FMCIV-NY-02_00407166, at 7187 (report titled "2008 Q1 Consolidated Control Plans" stating EA loan exposure was $59.6 billion, representing 2.3% of Single Family book as of Q1 2008). None of these loans were included in Fannie Mae's calculation of its publicly disclosed subprime exposure. SEC Cmpl ¶77; Fannie NPA ¶13.

2. Defendants' False and Misleading Statements Regarding Fannie's Exposure to Subprime Mortgages

300. Lead Plaintiffs repeat and reallege each of the allegations above as if fully set forth herein. The false and misleading statements further detailed below were made with scienter during the Class Period. The defendants made these statements in, among other things,

Fannie's SEC filings, public conference calls, press releases, statements to the media and Congressional testimony.

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

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

303. During part of the Class Period, Fannie Mae also filed supplemental Form 8-Ks filed simultaneously with various Forms 10-K and Forms 10-Q that contained credit characteristic information concerning its Single Family book of business, along with a purported tabular description of Fannie Mae's subprime and Alt-A holdings. None of the information contained in those supplement Form 8-Ks provided investors with an accurate description of the Company's subprime or Alt-A holdings. Although Fannie Mae claimed to provide additional information to investors, labeling a portion of loans "subprime" and "Alt-A" in a disclosure table, those tables included only a fraction of the loans that met Fannie Mae's own public definition of "subprime" or "Alt-A" in the quantification under each category. These supplemental disclosures deliberately gave investors false comfort that the Company's exposure

to subprime and Alt-A loans was dramatically smaller than it, in fact, was. *See also* SEC Cmpl ¶80.

(a) Fannie Mae's Initial Quantification of Subprime Exposure Was False and Misleading

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

305. In a February 6, 2007 memo to the Board of Directors of Fannie Mae, Mudd wrote that investors and analysts were "focused on our market share, subprime risk and our portfolio strategy." With this backdrop, Fannie Mae's Disclosure Committee, which included Dallavecchia as a members, decided to include a quantitative disclosure of Fannie Mae's exposure to subprime loans in the Company's public filings. SEC Cmpl ¶82; Fannie NPA ¶7.

306. According to an internal e-mail sent to Dallavecchia, "Enrico [Dallavecchia]'s team has been tasked with developing a definition of 'sub-prime,' as well as providing the numbers for the 12b-25." SEC Cmpl ¶83. As of February 22-23, 2007, Dallavecchia knew that Fannie did not have a definition of subprime. FMCIV-NY-02_00341436 (emails dated Feb. 22-23, 2007 between Dallavecchia and Brenda Nettles, Michael A. Shaw, Pamela Johnson and Eileen O'Malley regarding "Subprime Definition" in which Dallavecchia stated on Feb. 22 that "[t]he way I read it we have no definition at FNM," and on Feb. 23 that "[w]e have a whole morning to create definition.").

307. Also on February 23, 2007, in a call with investors Mudd stated: "Subprime mortgages are those offered to borrowers with damaged credit" and Fannie Mae's "subprime

investment constitutes well below 2 percent of our book." SEC Cmpl ¶84. Also on February 23, 2007, Mudd represented in an interview with *Reuters* that Fannie's subprime investment was "well below 2 percent of our book."

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

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

See also SEC Cmpl ¶85; Fannie NPA ¶8.

309. On the Feb. 27 Conference Call, Mudd stated "Our exposures to some of the high-risk segments are extremely low for subprime, and estimated 2.2% of our total single-family credit book of business at the end of '06." Further, when asked about Alt-A loans, Mudd responded that "we don't have so much that this is a major, significant exposure on our books."

310. The percentage of subprime loans disclosed by Fannie Mae did not include a material number of subprime-quality loans in the Fannie Mae Single Family mortgage credit book of business as of December 31, 2006, made to "borrowers with weaker credit histories." In particular, the percentage of subprime loans disclosed by Fannie Mae did not include the EA and MCM loans, which were the very types of loans that investors (and analysts) believed were the company's primary subprime exposure. SEC Cmpl ¶86; Fannie NPA ¶13.

311. Fannie Mae's exposure to EA loans in its Single Family mortgage credit book of business was approximately $43 billion as of December 31, 2006—approximately 10 times

greater than the 0.2% ($4.8 billion) disclosed as "sub-prime mortgage loans or structured Fannie Mae MBS back by subprime loans" as of December 31, 2006. SEC Cmpl ¶87; Fannie NPA ¶¶10, 14; FMCIV-NY-02_00404976, at 5129 (report titled "March 2007 Book Profile"). This information was provided and/or available to Mudd and Dallavecchia through internal reports, presentations, and briefings. Fannie NPA ¶17.

312. The February 27, 2007 disclosure falsely stated that Fannie Mae's total exposure to loans made to borrowers with weaker credit histories (subprime) was 2.2% of its total mortgage credit book of business, when in fact its exposure was at least 4.64% (as of December 31, 2006). SEC Cmpl ¶88; Fannie NPA ¶14.

313. Nothing in Fannie Mae's public disclosures alerted investors that it held a much larger volume of loans that matched the Company's description of subprime loans but were not included in the reported subprime number. SEC Cmpl ¶89. EA loans were not included in Fannie Mae's calculation or quantification of its subprime mortgage loans or other subprime exposure set forth in Fannie Mae's February 2007 12b- 25 Filing. Fannie NPA ¶13.

314. Although Fannie Mae excluded EA from its subprime reporting, Fannie Mae's EA loans had, on average throughout the Class Period, SDQ rates higher than those loans Fannie Mae actually included in calculating its disclosed exposure to subprime loans. SEC Cmpl ¶90; *e.g.*, FMCIV-NY-02 00009036, at 9038 (presentation dated Feb. 29, 2008 titled "Single Family Book of Business and Update on Loss Mitigation" identifying SDQ rate of EA as higher than subprime). Internal reports show that Fannie Mae's publicly disclosed subprime loans had an SDQ rate of 4.72% as of December 31, 2006, and Fannie Mae's EA loans had an SDQ rate of 5.57% as of December 31, 2006. Fannie NPA ¶16. As of January 2007, EA loans had an SDQ rate of 5.69%; disclosed Subprime loans (as-quantified in Fannie Mae's filings) had an SDQ rate

of 4.82%. SEC Cmpl ¶90; FMCIV-NY-02_00296008, at 6026 (report dated Feb./Mar. 2007 titled "Single Family Credit Risk Analytics & Monitoring Delinquency Report" stating that EA/TPR loans had an SDQ rate of 5.455% as of February 2007 compared to an SDQ of 4.68% and 0.579% for subprime and "subprime-New Business Initiative," respectively, for the same period).

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

316. Mudd and Dallavecchia each reviewed and approved the February 27, 2007, Form 12b-25 statement before it was released by the Company, knowing its quantified subprime disclosure excluded EA and MCM loans. SEC Cmpl ¶92; Fannie NPA ¶18.

(b) Mudd's and Dallavecchia's False and Misleading Statements

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

> In our filing today, we also indicate that we have increased our participation in subprime product in 2006. Our purchases have been prudent and have been made when we concluded that they would contribute to our mission objectives or they would general a profitable return. Given our view of the subprime market generally, let me offers [sic] some insight into our approach to this segment and the exposure to the risk. <u>The first point, as per our filing, is that our exposure is modest</u>. <u>Approximately 0.2% of our single-family credit book of business consisted of subprime loans or Fannie Mae MBS backed by subprime loans</u> ... to conclude my thoughts on credit risk, I anticipate our credit losses will trend upward as a result of the general softening of the housing market ... At the same time, I would advise that you consider our exposure in light of the strength of the risk characteristics I have described <u>and the immaterial size of our participation in</u> the subprime market. (Emphasis added.)

SEC Cmpl ¶93.

318. Despite knowledge that the Company had exposure to approximately $43 billion worth of EA loans and $13.8 billion in MCM loans as of December 31, 2006, which fell squarely within Fannie Mae's publicly stated definition of subprime, Dallavecchia falsely represented that only "0.2% of [Fannie Mae's] Single Family credit book of business consisted of subprime loans." SEC Cmpl ¶94; FMCIV-NY-02_00404976, at 5111, 5129 (report titled "March 2007 Book Profile" stating that as of December 31, 2006, Fannie's EA/TPR exposure was $43.2 billion and Fannie's exposure to MCM loans were $13.8 billion). Dallavecchia's representations were false and misleading for the additional reasons that i) he failed to disclose and quantify Fannie's exposure to EA and MCM loans; and ii) he failed to disclose the increasing delinquencies and credit losses associated with EA and MCM loans, a trend that was known to him and that had already had negative material effects on the Company's financial condition or results of operations.

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

320. On February 27, 2007, Prudential Equity Group LLC analysts Matthew Park and Tony Hill issued an analyst report which stated that:

> [W]e expect Fannie Mae to perform better relative to the overall industry due to the statutory requirements for conforming mortgages and the relatively limited exposure to riskier non-traditional mortgage products.

> Fannie Mae's exposure to the subprime mortgage credit risks appears limited. First, Fannie Mae estimates that that approximately 0.2% of its single-family mortgage credit book of business as of December 31, 2006 consisted of subprime mortgage loans or structured Fannie Mae MBS backed by sub-prime mortgage loans. Fannie Mae generally employs credit enhancement (such as mortgage insurance) which should reduce its credit exposure to the potential credit quality deterioration of these loans.
>
> Second, Fannie Mae estimates that private-label mortgage securities backed by subprime mortgage loans accounted for approximately 2% of its single-family mortgage credit book of business as of December 31, 2006. The fact that the company has focused on purchasing highly-rated tranches of these MBS should limit FNM's exposure.

321. Further, on February 28, 2007, Bear Stearns issued a research report that stated, in part: "To date the company has limited its exposures to sub-prime and Alt A loans . . . . [Fannie] believes its credit performance will remain significantly better than most other market participants . . . ."

(c) Mudd's False and Misleading Testimony Before Congress

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

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

See also SEC Cmpl ¶96.

323. At the time that Mudd gave this testimony, he knew that Fannie Mae EA loans were designed to provide loans to borrowers with weaker credit histories, *i.e.*, "credit

blemish[ed]" borrowers, and that the quantification of Fannie Mae's subprime holding as "less than 2 percent of our book" did not include EA or MCM loans.

324. Mudd's representations were false and misleading for the additional reasons that i) he failed to disclose and quantify Fannie's exposure to EA and MCM loans; and ii) he failed to disclose the increasing delinquencies and credit losses associated with EA and MCM loans, a trend that was known to him and that had already had negative material effects on the Company's financial condition or results of operations.

325. The following month, on April 17, 2007, Mudd again appeared before the Committee on Financial Services to provide testimony in a hearing on solutions to the subprime market turmoil. Mudd again testified: '"Subprime' is, after all, simply the description of a borrower who doesn't have perfect credit." He provided a broad description of Fannie Mae's efforts to reach "borrower[s] who do[n't] have perfect credit":

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

See also SEC Cmpl ¶97.

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

327. Mudd knew EA loans were loans specifically designed for "people who don't have perfect credit" —his own definition for subprime—and that the 2.5 percent figure he used did not include billions of dollars of EA and MCM loans. As such, his statement was knowingly false and misleading when made. SEC Cmpl ¶99. Mudd's representations were false and misleading for the additional reasons that i) he failed to disclose and quantify Fannie's exposure to EA and MCM loans; and ii) he failed to disclose the increasing delinquencies and credit losses associated with EA and MCM loans, a trend that was known to him and that had already had negative material effects on the Company's financial condition or results of operations.

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

328. In May 2007, Fannie Mae filed its 2005 Form 10-K, in which it supplemented its prior public definition of subprime. In addition to asserting that "subprime" generally refers to loans made to borrowers "with a weaker credit profile" and "borrowers [who] have a higher likelihood of default," Fannie Mae now disclosed that it classified loans as subprime if the loans were originated from a specialty subprime lender. *See also* SEC Cmpl ¶100; Fannie NPA ¶19.

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

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

resecuritizations of private-label mortgage-related securities backed by subprime mortgage loans.

See also SEC Cmpl ¶101; Fannie NPA ¶¶19-20.

330. Fannie Mae's reporting of its subprime exposure omitted approximately $43.3 billion worth of EA loans and $13.8 billion in MCM loans in Fannie Mae's Single Family mortgage credit book of business as of December 31, 2006-approximately 12 times greater than the 0.2% ($4.8 billion) disclosed as "subprime mortgage loans or structured Fannie Mae MBS back by subprime loans" as of December 31, 2006. Cmpl ¶102; Fannie NPA ¶¶20-21. This information was provided and/or available to Mudd and Dallavecchia through internal reports, presentations, and briefings. Fannie NPA ¶31.

331. Nothing in Fannie Mae's public disclosures alerted investors that this much larger volume of loans matched the Company's description of subprime loans but were not included in the reported quantitative number. *See also* SEC Cmpl ¶103; Fannie NPA ¶21. Fannie's representations in the 2005 Form 10-K were false and misleading for the additional reasons that i) the Company failed to disclose and quantify its exposure to EA and MCM loans; and ii) the Company failed to disclose the increasing delinquencies and credit losses associated with EA and MCM loans, a trend that was known to senior Fannie executives, including Mudd and Dallavecchia, and that had already had negative material effects on the Company's financial condition or results of operations.

332. In addition, while Fannie Mae stated that it classified loans as subprime if those loans were originated by specialty subprime lenders, that statement was materially false and misleading as well. Since 1993, the HUD posted a publicly available HUD Subprime Lender list based on loan data and interviews with lenders themselves. Companies in the mortgage industry rely on the HUD Subprime Lender list as a proxy for identifying subprime lenders. Internal

Fannie Mae documents reflect that its personnel were aware of the HUD Subprime Lender list as an accepted source for subprime-lender identification. During the Class Period, the HUD Subprime Lender list included approximately 210 lenders. SEC Cmpl ¶104; Fannie NPA ¶22; FMCIV-NY-02_00433558, at 3559 (email dated Apr. 2, 2007 attaching spreadsheet with tab listing names of 210 HUD subprime lenders).

333. The Company failed to disclose, however, that, when calculating Fannie Mae's subprime exposure only certain loans that had been originated by 15 lenders were included. Fannie Mae purchased and guaranteed loans from many other lenders on the HUD list, but they were not included when calculating the Company's subprime exposure. Fannie Mae disclosed neither that it was restricting its definition of "specialty lender" to 15 lenders on the HUD list, nor the names of those lenders on the HUD list that it included in its calculations. In fact, Fannie Mae acquired loans from many other specialty lenders on the HUD Subprime Lender list, and EA loans were originated by lenders on the HUD list. SEC Cmpl ¶105; Fannie NPA ¶¶23-24.

334. Although EA was left out of Fannie Mae's subprime reporting, it was well-known within Fannie Mae that EA was generally considered subprime in the marketplace. For example, on April 5, 2007, the SVP of business and strategic development sent an email to a group of Fannie Mae executives including Dallavecchia, stating "mcm and ea are much deeper risks that we take and many (if not all) in the market call EA subprime. They are growing very fast." Within a month, Fannie Mae filed its next public statement concerning its subprime exposure, and again omitted its exposure to EA and MCM loans. *See also* SEC Cmpl ¶106.

335. On May 2, 2007, Mudd certified the May 2, 2007 10-K Filing. The certification stated, among other things:

> a. [T]his report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light

of the circumstances under which such statements were made, not misleading with respect to the period covered by this report; and

b. [T]he financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report.

See also Fannie NPA ¶25.

336. Dallavecchia signed a sub-certification for the May 2, 2007 10-K Filing that stated, among other things:

a. [T]he Report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the periods covered by the Report.

b. [T]he financial statements, and other financial information included in the Report, fairly present in all material respects the financial condition, results of operations and cash flows of the business segments for which I am responsible as of, and for, the periods presented in the Report.

Fannie NPA ¶26.

337. On May 9, 2007, Fannie Mae filed a Form 12b-25 with the Commission, which repeated the disclosure contained in the May 2, 2007 filing. *See also* SEC Cmpl ¶107.

338. As it had previously, Fannie Mae's reporting of its subprime disclosure in this May 9, 2007 filing omitted approximately $43 billion worth of EA loans and $13.8 billion in MCM loans in Fannie Mae's Single Family mortgage credit book of business as of December 31, 2006. SEC Cmpl ¶108; FMCIV-NY-02_00404976, at 5111, 5129 (report titled "March 2007 Book Profile" stating as of December 31, 2006, Fannie's EA/TPR exposure was $43.2 billion and Fannie's exposure to MCM loans were $13.8 billion). That undisclosed subprime exposure was approximately 12 times greater than the 0.2% ($4.8 billion) disclosed as "subprime mortgage loans or structured Fannie Mae MBS back by subprime loans" as of December 31, 2006. SEC Cmpl ¶108. Fannie's representations were false and misleading for the additional

reasons that i) the Company failed to disclose and quantify its exposure to EA and MCM loans; and ii) the Company failed to disclose the increasing delinquencies and credit losses associated with EA and MCM loans, a trend that was known to senior executives and that had already had negative material effects on the Company's financial condition or results of operations.

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

(e) Fannie Mae's False and Misleading Subprime Disclosures for Year-End 2006

340. In early August 2007, as Fannie Mae prepared a draft Form 8-K Credit Supplement to be filed simultaneous with its upcoming 2006 Form 10-K, Mudd personally requested additional basic data concerning the Company's credit book in a draft version of the Form 8-K. On August 5, 2007, Mudd and Dallavecchia received an email with a Credit Supplement attached from the CRO office. FMCIV-NY-02_00023054. The Credit Supplement included details on the total volume of EA, MCM, and disclosed subprime and Alt-A loans Fannie Mae had on its book of business. *Id.* at 3060, 3063. This draft included SDQ data that clearly showed EA loans had a higher rate of delinquency (5.38%) than the Company's disclosed subprime loans (4.8%). *Id.*; SEC Cmpl ¶110.

341. The data provided to Mudd also included data on FICO scores that demonstrated that the credit quality of EA loans was worse than the credit quality of the loans that Fannie Mae disclosed as its subprime exposure. Specifically, the document disclosed that 53% of EA loans had FICO scores below 620; whereas 47% of Fannie Mae's disclosed subprime had FICO scores below 620. FMCIV-NY-02_00023054, at 3062. Further, 26% of EA had FICO scores below 580 while 23% of disclosed subprime loans had FICO scores that low. *Id.*; SEC Cmpl ¶111.

342. As of June 30, 2007, only 15.5% of the EA loans had both a FICO score below 620 and an OLTV greater than 90%. Fannie NPA ¶30. During the Class Period, information described in ¶¶19-30 of Fannie's NPA was provided and/or available to the CEO, the Single Family EVP and the CRO through internal reports, presentations, and briefings. Fannie NPA ¶31.

343. On August 3, 2007, as a member of the Disclosure Committee, Dallavecchia received the same draft credit supplement sent to Mudd. This information concerning EA and MCM was not ultimately made public. SEC Cmpl ¶112.

344. Fannie Mae issued its 2006 Form 10-K less than two weeks after each of the Defendants received the draft 8-K disclosure comparing EA and disclosed subprime, and documenting that EA loans had a higher serious delinquency rate than disclosed subprime and that EA loans had a weaker credit profile than disclosed subprime. The public filing again defined "subprime" as "loans to borrowers with riskier credit profiles." Nevertheless, EA and MCM loans were not included when quantifying Fannie Mae's subprime exposure; nor was it disclosed that there were "loans to borrowers with riskier credit profiles" that were excluded from Fannie Mae's subprime reporting. SEC Cmpl ¶113. Fannie's 2006 Form 10-K was false and misleading for the additional reasons that i) the Company failed to disclose and quantify Fannie's exposure to EA and MCM loans; and ii) the Company failed to disclose the increasing delinquencies and credit losses associated with EA and MCM loans, a trend that was known to Fannie's senior executives, including Mudd and Dallavecchia, and that had already had negative material effects on the Company's financial condition or results of operations.

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

> In recent years, we have increased our acquisitions of loans to borrowers with riskier credit profiles, referred to as subprime loans by the industry. Subprime mortgage loans that we acquire are generally originated by lenders specializing in this type of business, using processes unique to subprime loans. Based on data published by National Mortgage News and our internal economic analysis of the mortgage market, subprime mortgage loan originations have increased sharply in recent years, rising to a record high of approximately 24% of single-family mortgage loan originations in the first quarter of 2006 ... Our acquisitions of subprime mortgage loans have been significantly less than the overall market's share. We estimate that approximately 0.2% of our total single-family mortgage credit book of business as of December 31, 2006 consisted of subprime mortgage loans or structured Fannie Mae MBS backed by subprime mortgage loans. We have also invested in highly rated private-label mortgage-related securities that are backed by ... subprime mortgage loans ... We estimate that ... private-label mortgage-related securities backed by subprime mortgage loans, including resecuritizations, accounted for approximately ... 2% ... of our single-family mortgage credit book of business as of June 30, 2007.

See also SEC Cmpl ¶114.

346. Fannie Mae's Single Family mortgage credit book of business consisted of approximately $43.3 billion worth of EA loans and $13.8 billion worth of MCM loans as of December 31, 2006 – more than 12 times greater than the 0.2% ($4.8 billion) disclosed as "subprime mortgage loans or structured Fannie Mae MBS backed by subprime loans" as of December 31, 2006. SEC Cmpl ¶115; FMCIV-NY-02_00404976, at 5111, 5129 (report titled "March 2007 Book Profile" stating that as of December 31, 2006, Fannie's EA/TPR exposure was $43.2 billion and Fannie's MCM exposure was $13.8 billion).

347. Nothing in Fannie Mae's public disclosures alerted investors that this much larger volume of loans matched the Company's description of subprime loans but were not included in the reported quantitative number. SEC Cmpl ¶116. Further, nothing in Fannie's public representations i) disclosed or quantified Fannie's exposure to EA and MCM loans; or ii) disclosed the increasing delinquencies and credit losses associated with EA and MCM loans, a trend that was known to Fannie's senior executives, including Mudd and Dallavecchia and that

had already had negative material effects on the Company's financial condition or results of operations.

348. Mudd certified and Dallavecchia sub-certified the 2006 Form 10-K in the same manner they did as alleged in ¶¶335-336, above, even though they knew that the statements regarding the Company's subprime exposure were materially misleading SEC Cmpl ¶117; Fannie NPA ¶¶32-33.

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

349. On October 15, 2007, both Mudd and Dallavecchia attended a meeting of Fannie's Risk Policy and Capital Committee, during which Dallavecchia reported that the SDQ rate for EA loans was 5.57%, compared with an SDQ rate of 4.95% for Fannie's subprime loans. FMCIV-NY-02_00006413, at 6445 (presentation dated Oct. 15, 2007 titled "Risk Policy and Capital Committee Chief Risk Officer Report").

350. In preparing to review the upcoming Fannie Mae filing, a draft Disclosure Committee Analytical Report was sent via email on October 26, 2007, to several individuals, including Mudd and Dallavecchia. SEC Cmpl ¶118; FMCIV-NY-02_00057668. The report presented data on Single Family's "[h]igher risk products," including EA, MCM, and disclosed subprime. SEC Cmpl ¶118; FMCIV-NY-02_00057668, at 7689. The data documented that, in the two periods addressed in the document, year-to-date as of September 2006 and year-to-date as of September 2007, Fannie Mae's credit losses from EA and MCM far outweighed losses compared to the loans reported as the company's subprime exposure. SEC Cmpl ¶118; FMCIV-NY-02_00057668, at 7689. As of September 2006, Fannie Mae had $80.6 million in losses from EA and $1.7 million in losses from MCM, compared to no losses from loans disclosed as subprime. SEC Cmpl ¶118; FMCIV-NY-02_00057668, at 7689. As of September 2007, Fannie

Mae had $188.9 million in losses from EA, and $16 million in losses from MCM, compared to $5.5 million in losses from loans disclosed as subprime. SEC Cmpl ¶118; FMCIV-NY-02_00057668, at 7689. Fannie Mae's credit losses from EA in 2006 and 2007 were overwhelmingly greater than any losses it experienced related to its disclosed subprime holdings during the same period. SEC Cmpl ¶118; FMCIV-NY-02_00057668, at 7689. A key observation in the Report showed that the Company's highest risk products (which included EA and MCM loans) "comprise less than 15% of the S[ingle] F[amily] book but accounted for 57% of the $440MM" increase in credit losses. SEC Cmpl ¶118; FMCIV-NY-02_00057668, at 7689.

351. Within two weeks, on November 9, 2007, Fannie Mae filed its Forms 10-Q for the first, second and third quarters of 2007. Even though each of the Defendants knew that EA and MCM loans fit Fannie Mae's public definition of subprime loans and were a source of credit losses far greater than losses triggered by the loans that were disclosed as subprime, EA or MCM loans were not included in the quantification of subprime. Fannie's Form 10-Q for the first, second and third quarters of 2007 were false and misleading for the additional reasons that i) the Company failed to disclose and quantify Fannie's exposure to EA and MCM loans; and ii) the Company failed to disclose the increasing delinquencies and credit losses associated with EA and MCM loans, a trend that was known to Fannie's senior executives, including Mudd and Dallavecchia, and that had already had negative material effects on the Company's financial condition or results of operations.

352. The Company stated in its first quarter Form 10-Q:

> A subprime mortgage loan generally refers to a mortgage loan made to a borrower with a weaker credit profile than that of a prime borrower. As a result of the weaker credit profile, subprime borrowers have a higher likelihood of default than prime borrowers. Subprime mortgage loans are typically originated by lenders specializing in this type of business <u>or by subprime divisions of large lenders,</u> using processes unique to subprime loans. In

> reporting our subprime exposure, we have classified mortgage loans as subprime if the mortgage loans are originated by one of these specialty lenders or a subprime division of a large lender. ... Approximately 0.2% of our total single-family mortgage credit book of business as of March 31, 2007 consisted of subprime mortgage loans or Fannie Mae MBS backed by subprime mortgage loans. This percentage increased to approximately 0.3% as of September 30, 2007. Less than 1% of our single-family business volume for the nine months ended September 30, 2007 consisted of subprime mortgage loans or Fannie Mae MBS backed by subprime mortgage loans. (Emphasis added.)

See also SEC Cmpl ¶119; Fannie NPA ¶35.

353. The Company's subprime disclosures in its second and third quarter Forms 10-Q were comparable. *See also* SEC Cmpl ¶120; Fannie NPA ¶35.

354. The quantified subprime exposure omitted at least $43 billion worth of EA loans that were part of Fannie Mae's Single Family mortgage credit book of business and $17.6 billion in MCM loans as of March 31, 2007—approximately 12 times greater than the 0.2% ($4.8 billion) disclosed as "subprime mortgage loans or structured Fannie Mae MBS back by subprime loans" as of March 31, 2007. SEC Cmpl ¶121; Fannie NPA ¶42; FMCIV-NY-02_00404976, at 5111, 5129 (report titled "March 2007 Book Profile" stating that as of December 31, 2006, Fannie's EA/TPR exposure was $43.2 billion and Fannie's exposure to MCM loans were $13.8 billion and as of March 31, 2007, EA was $43.7 billion and MCM was $17.6 billion). By November 2007, Fannie's "EA book" grew over 25% from March 2007 to approximately $54 billion. FMCIV-NY-02_00461394 (emails dated Feb. 11-12, 2008 stating exposure).

355. Nothing in Fannie Mae's public disclosures alerted investors to this much larger volume of loans that matched the Company's description of subprime loans but were not included in the reported subprime exposure. SEC Cmpl ¶122. Further, nothing in Fannie's public representations in its Form 10-Qs for the first, second and third quarters of 2007 i) disclosed or quantified Fannie's exposure to EA and MCM loans; or ii) disclosed the increasing

delinquencies and credit losses associated with EA and MCM loans, a trend that was known to Fannie's senior executives, including Mudd and Dallavecchia and that had already had negative material effects on the Company's financial condition or results of operations.

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

357. This statement in the November 9, 2007 Form 10-Q was false. In reality, Fannie Mae never tracked loans from the subprime divisions of large lenders and, accordingly, the Company never included any of those subprime loans in its reported subprime exposure-despite its explicit claim that it did so. SEC Cmpl ¶124. Fannie Mae did not keep separate statistical reports or otherwise track loans made by the subprime division of originators. It therefore could not quantify the number of loans it acquired or securitized that were originated by the subprime division of a large lender. Fannie NPA ¶36.

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

359. Members of Fannie Mae's senior management were provided with information indicating that Fannie Mae purchased and securitized loans from subprime divisions of large lenders such as Countrywide's Full Spectrum Lending. Fannie NPA ¶45. In February 2007, Mudd traveled to meet with Fannie Mae's then-largest customer, Countrywide. Countrywide's retail subprime lending division was known as Full Spectrum Lending. At the meeting, Mudd

was briefed by the President and COO of Countrywide Home Loans about the volume of loans Fannie Mae acquired from that customer's Subprime lending division (Full Spectrum Lending), which between 2004 and 2006 totaled $14.23 billion worth of loans. The presentation explicitly referred to Countrywide's subprime lending division customers as subprime "Fallen Angels." SEC Cmpl ¶126; Fannie NPA ¶37.

360. Records indicate that Fannie Mae purchased or securitized $7.7 billion worth of loans originated by Full Spectrum Lending in 2006, $13.2 billion in 2007, and $7.6 billion in 2008. Fannie NPA ¶38.

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

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

363. During the Class Period, Fannie Mae purchased or securitized loans from subprime divisions of other large lenders including Citigroup, JPMorgan and GMAC. SEC Cmpl ¶129; Fannie NPA ¶39.

364. In Fannie Mae's single family mortgage credit book of business, the dollar amount of the subprime loans and other subprime exposure as disclosed in each of Fannie

Mae's February 2007 12b-25 Filing, May 2, 2007 10-K Filing, August 2007 10-K Filing or November 2007 10-Q Filings did not exceed $8.3 billion. Fannie NPA ¶41.

365. On November 9, 2007, for the quarter ended September 30, 2007, Fannie Mae also filed a "credit supplement" on Form 8-K with the Commission. The document contained a summary description of certain credit risk characteristics of its Single Family book of business in chart form. Included in this chart were separate columns identifying Fannie Mae's subprime holdings and designating that 0.3% of its Single Family holdings were subprime loans. This supplemental disclosure did not inform investors of the additional subprime exposure from EA and MCM loans, or loans originated by the subprime divisions of large lenders. Fannie Mae continued to issue credit supplements that were similarly false and misleading throughout the Class Period. SEC Cmpl ¶131; Fannie NPA ¶¶40, 42. The supplemental disclosure was false and misleading for the additional reasons that i) the Company failed to disclose and quantify Fannie's exposure to EA and MCM loans; and ii) the Company failed to disclose the increasing delinquencies and credit losses associated with EA and MCM loans, a trend that was known to Fannie's senior executives, including Mudd and Dallavecchia, and that had already had negative material effects on the Company's financial condition or results of operations.

366. On November 9, 2007, Fannie Mae provided disclosure of its exposure to loans that were both Low FICO/High OLTV in its Form 8-K Credit Supplement that it filed concurrent with its November 2007 10-Q Filings with the Commission (the "November 2007 8-K Filings"). Fannie NPA ¶43. Fannie Mae's calculation and quantification of its exposure to loans that were both Low FICO/High OLTV in the November 2007 8-K Filings did not include all of its EA loans. Fannie NPA ¶44. The November 2007 8-K Filings were false and misleading for the additional reasons that i) the Company failed to disclose and quantify Fannie's exposure to EA

and MCM loans; and ii) the Company failed to disclose the increasing delinquencies and credit losses associated with EA and MCM loans, a trend that was known to Fannie's senior executives, including Mudd and Dallavecchia, and that had already had negative material effects on the Company's financial condition or results of operations.

367. Mudd certified the November 2007 10-Q Filings and reviewed and approved the November 2007 8-K Filings in substantially the same from that he did as alleged in ¶335, above. Dallavecchia sub-certified the November 2007 10-Q Filings and reviewed and approved the November 2007 8-K Filings in substantially the same form that he did as alleged in ¶336, above. Fannie NPA ¶46.

(g) Mudd's False and Misleading Subprime Statements to the Media

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

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

See also SEC Cmpl ¶132.

369. Mudd made these claims when he knew they were false and misleading. At the time that he made this statement, Mudd knew that the "2 percent" figure did not include billions of dollars in EA or MCM loans held by Fannie Mae. Mudd also knew that those undisclosed loans were specifically designed for "credit blemish[ed]" borrowers and that the figure could not reflect loans originated by the subprime division of large lenders, which by then the Company claimed to include in its reported subprime exposure. SEC Cmpl ¶133. Mudd's representations were false and misleading for the additional reasons that i) he failed to disclose and quantify Fannie's exposure to EA and MCM loans; and ii) he failed to disclose the increasing delinquencies and credit losses associated with EA and MCM loans, a trend that was known to Fannie's senior executives, including Mudd and Dallavecchia, and that had already had negative material effects on the Company's financial condition or results of operations.

(h) Fannie Mae's False and Misleading Subprime Disclosures for Year-End 2007

370. On January 30, 2008, Dallavecchia's CRO office circulated a report titled "Expanded Approval/Subprime Analysis," which concluded that "EA products look like and largely perform like Subprime collateral," and "[i]n Key Risk Areas, EA and Subprime Underwriting are similar." FMCIV-NY-02_00299696, at 9701, 9705. The report also included a chart showing that for loans purchased between September 2007 through November 2007 the average credit profiles of Fannie's three EA levels were similar to—and in some ways worse—than the credit profile of Fannie's subprime mortgages. *Id.* at 9703. Specifically, the chart (an image of which is below) shows that the weighted average loan-to-value ratio ("WA LTV") and debt-to-income ratio ("WA DTI") of each of the EA levels were worse than those of Fannie's subprime loans, while the weighted average FICO scores were similar.

- **Expanded Approval purchases are similar in credit attributes, however, represent more debt-encumbered homeowners at a higher loan-to-value.** [1]

	EA-I	EA-II	EA-III	Subprime
WA LTV	89.22	91.03	81.01	77.23
% > 90 LTV	47.55	53.29	28.68	6.09
WA FICO [2]	636	622	579	620
% < 620 FICO	60.32	73.51	92.38	70.60
WA DTI	45.08	47.57	45.93	41.02
% > 50 DTI	33.17	42.49	38.83	13.79
Net Charge Fee	59.38	85.48	125.66	229.29

Notes:

[1] Characteristics reflect loans purchased between September 2007 thru November 2007.

[2] Subprime WA FICO and % under 620 has been normalized to reflect lesser of borrower 1 and borrower 2 credit score. Industry convention in subprime is Primary Wage Earner.

371. On February 29, 2008, Mudd and Dallavecchia both attended a meeting of the Risk Policy and Capital Committee, during which the committee discussed a report titled "Single Family Book of Business and Update on Loss Mitigation." The report stated that the SDQ rate of EA loans was 6.85%, compared to 5.68% for subprime loans. FMCIV-NY-02_00009036, at 9038. And although EA loans constituted 2% of Fannie's book of business, they accounted for 16% of the Company's SDQ loans and 15% of its 2007 credit losses. *Id.* Indeed, the report concluded that credit losses were "forecasted to increase to $3.6 billion in 2008, from $1.3 billion in 2007," and the "primary drivers" for these losses were Fannie's EA, MCM, and Alt-A loans acquired in 2006 and 2007. *Id.* at 9037.

372. Yet the Company continued to exclude EA loans from its subprime disclosures. On February 27, 2008, Fannie Mae issued its 2007 Form 10-K, which was identical to prior disclosures but further included the following statement:

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

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

SEC Cmpl ¶134.

373. As of November 2007, $54 billion worth of Fannie Mae's Single Family mortgage credit book of business consisted of EA loans and approximately $55.6 billion worth of Fannie Mae's Single Family mortgage credit book of business consisted of EA loans as of December 31, 2007, and $38.8 billion in MCM loans—approximately 11 times greater than the 0.3% ($8.3 billion) disclosed as "sub-prime mortgage loans held in our portfolio or subprime mortgage loans backing Fannie Mae MBS" as of December 31, 2007. SEC Cmpl ¶135; compare FMCIV-NY-02_00461394 (emails dated Feb. 11-12, 2008 with EA loan volume from Credit Risk Analytics Group reporting for the November book).

374. Nothing in Fannie Mae's public disclosures alerted investors that this much larger volume of loans matched the Company's description of subprime loans but were not included in the reported quantitative number. SEC Cmpl ¶136. Further, nothing in Fannie's public representations in its 2007 Form 10-K i) disclosed or quantified Fannie's exposure to EA and MCM loans; or ii) disclosed the increasing delinquencies and credit losses associated with EA and MCM loans, a trend that was known to Fannie's senior executives, including Mudd and Dallavecchia and that had already had negative material effects on the Company's financial condition or results of operations.

375. Mudd certified and Dallavecchia sub-certified the 2007 form 10-K in substantially the same form that they did as alleged in ¶¶335-36, above. SEC Cmpl ¶¶ 45, 55; Fannie NPA ¶¶61-62.

376. As of January 31, 2008, the serious delinquency rate of EA was 7.14%—performance that was worse than the disclosed subprime serious delinquency rate of 6.21% for the same period. By February 2008, it was clear from reports provided to Mudd and Dallavecchia that credit losses from EA loans were "disproportionate to the amount of the book they constitute." SEC Cmpl ¶137; *see also* FMCIV-NY-02_00350890, at 0909 (Report dated Feb./Mar. 2008 titled "Single Family Credit Risk and Analytics & Monitoring Delinquency Report" stating that as of January 2008 EA/TPR loans had an SDQ rate of 7.093% compared to an SDQ rate of 6.175% for subprime and an SDQ rate of 4.333% for "subprime-New Business Initiative" for the same period).

377. On February 7, 2008, during testimony before the Senate Banking Committee, Mudd represented that the Company carefully managed its subprime exposure and that "Subprime represents... Less than 1 percent of our book." Mudd's representation was materially false and misleading for the reasons set forth in ¶369.

(i) Fannie Mae's False and Misleading first and second quarter 2008 filings

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

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

See also SEC Cmpl ¶138.

379. Approximately $101 billion worth of Fannie Mae's Single Family mortgage credit book of business of March 31, 2008, consisted of undisclosed loans that fell within the company's description of subprime, and approximately $94.4 billion worth of Fannie Mae's

Single Family mortgage credit book of business consisted of undisclosed loans as of December 31, 2007-approximately 12 times greater than the 0.3% ($8 billion as of March 31, 2008 and $8.3 billion as of December 31, 2007) disclosed as "subprime mortgage loans held in our portfolio or subprime mortgage loans backing Fannie Mae MBS" as of December 31, 2007. SEC Cmpl ¶139.

380. Nothing in Fannie Mae's public disclosures alerted investors that this much larger volume of loans matched the Company's description of subprime loans, but were not included in the reported quantitative number. SEC Cmpl ¶140. Further, nothing in Fannie's first quarter 2008 Form 10-Q i) disclosed or quantified Fannie's exposure to EA and MCM loans or ii) disclosed the increasing delinquencies and credit losses associated with EA and MCM loans, a trend that was known to Fannie's senior executives, including Mudd and Dallavecchia and that had already had negative material effects on the Company's financial condition or results of operations.

381. Mudd certified and Dallavecchia sub-certified the Form 10-Q first quarter 2008 in substantially the same form that they did as alleged in ¶¶335-36, above. SEC Cmpl ¶¶45, 55; Fannie NPA ¶¶61-62.

382. By July 2008, Dallavecchia was emailing Mudd directly to highlight that EA and MCM were generating approximately 20% of the Company's credit losses. SEC Cmpl ¶141; FMCIV-NY-02_00098250 (email dated July 27, 2008 from Dallavecchia to Mudd stating, "The EA/MCM . . . is probably going to generate losses of about $5bn, or 20% of our credit losses.").

383. As of the beginning of August 2008, EA and MCM were classified in internal Fannie Mae documents as two of Fannie Mae's top three highest-risk loan products and Fannie

Mae made plans to eliminate the EA loan program as part of an attempt to improve the overall credit quality of its Single Family book of business. SEC Cmpl ¶142.

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

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

SEC Cmpl ¶143.

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

386. Nothing in Fannie Mae's public disclosures alerted investors to the fact this much larger volume of loans matched the Company's description of subprime loans but were not included in the reported quantitative number. SEC Cmpl ¶145. Further, nothing in Fannie's public representations in its second quarter 2007 Form 10-Q i) disclosed and quantified Fannie's exposure to EA and MCM loans or ii) disclosed the increasing delinquencies and credit losses associated with EA and MCM loans, a trend that was known to Fannie's senior executives, including Mudd and Dallavecchia and that had already had negative material effects on the Company's financial condition or results of operations.

387. Mudd certified the Form 10-Q second quarter 2008 in substantially the same from that he did as alleged in ¶334, above. SEC Cmpl ¶45; Fannie NPA ¶61.

(j) Mudd Publicly Declares that Fannie Mae has Zero Subprime

388. On August 20, 2008, Mudd falsely stated in a radio interview: Fannie Mae has "about zero percent" exposure to subprime loans, and "[s]ubprime to Fannie Mae means a loan to a borrower that has had a credit problem in the past." When Mudd made this statement, he knew that Fannie Mae had substantial exposure to loans made to borrowers who have had a credit problem in the past. SEC Cmpl ¶146. Mudd's representation was false and misleading for the additional reasons that i) he failed to quantify Fannie's exposure to EA and MCM loans; and ii) he failed to disclose the increasing delinquencies and credit losses associated with EA and MCM loans, a trend that was known to Fannie's senior executives, including Mudd and Dallavecchia, and that had already had negative material effects on the Company's financial condition or results of operations.

E. Fannie's Alt-A Disclosure Fraud

1. Fannie Increases Market Share by Acquiring Reduced Documentation Alt-A Loans

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

390. Traditionally, Fannie Mae's MBS dominated the nationwide mortgage-related securities market. However, by 2005, private label competition for mortgage-backed securities

overtook Fannie Mae's MBS market dominance; as a result, Fannie Mae's nationwide share of mortgage loan originations fell from 40% in 2004 to 20% in 2005. SEC Cmpl ¶152.

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

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

2. Fannie Mae Internally Tracked Its Loans with Low Or Alternative Documentation Requirements As Reduced Documentation Loans

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

394. Mudd, for example, was well aware of the Company's increased acquisition of reduced documentation loans. On April 20, 2006, Mudd received the CEO Credit Risk Briefing,

a PowerPoint presentation, in preparation for the CEO Credit Risk Briefing on April 26, 2006. FMCIV-NY-02_00021643 (email attaching CEO Credit Risk Briefing presentation and memo). The CEO Credit Risk Briefing stated that of all loans acquired by Fannie Mae's Single Family business, 20.2% were reduced documentation loans at year-end 2005, and this number increased to 23.5% of acquisitions by February 2006. *Id.* at 1651 (slide titled "Select Book and Acquisition Trends"). Of the 23.5% of reduced documentation loans acquired year-to-date by February 2006, 10.4% of were Select Lender Program loans. *Id.* As of February 2006, Fannie's Conventional Book of Business was comprised of 7.6% or $157 billion of Select Lender Program loans, and 6.5% or $135 billion of "Other Low/No Doc" loans. *Id.*

395. The CEO Credit Risk Briefing noted that credit risks (such as reduced documentation) are a strong predictor of serious delinquency within the first year of a loan's acquisition and therefore present significant credit risk. *Id.* at 1652; SEC Cmpl ¶156.

396. Similarly, at the beginning of his tenure as CRO of Fannie Mae in June 2006, Dallavecchia was briefed on Fannie Mae's increasing stake in reduced documentation loans in a credit risk briefing that explained: Fannie Mae's Single Family business has seen :an increase in potentially riskier products like ... low documentation loans. . . . Alt-A loans as a percent of total acquisitions increased from 11.5% in 2002 to 20.2% in 2005." FMCIV-NY-02_000252241, at 2244 (presentation titled "Credit Risk Briefing for Enrico Dallavecchia"). That same presentation described this increase as an acquisition "trend" and noted Fannie Mae's Single Family plan for an "Alt-A push. Goal of $60B in 2006." *Id.* at 2245, 2247; SEC Cmpl ¶157.

397. As a member of the Disclosure Committee, throughout the fall of 2006, Dallavecchia received draft versions of Fannie Mae's 2004 Form 10-K, which contained detailed acquisition data concerning reduced documentation mortgages, including quantitative exposure

data that showed reduced documentation mortgages "represented approximately 18%, 20% and 24% of our single-family acquisitions in 2004, 2005, and the first half of 2006." SEC Cmpl ¶158; FMCIV-NY-02_00045482, at 5566 (Confidential—Highly Restricted 2004 10-K Draft D2 distributed on Aug. 31, 2006).

398. In its February 2007 12b-25 Filing, Fannie Mae stated that Alt-A loans "are generally defined as loans with lower or alternative documentation requirements." *See also* Fannie NPA ¶49.

399. Prior to May 2, 2007, Fannie Mae did not quantify its exposure to Alt-A loans in its public filings with the SEC or in other disclosures provided to investors. *See also* Fannie NPA ¶50.

400. Fannie Mae increased its acquisition of reduced documentation loans in its conventional single family mortgage guarantee business from at least 17.8% percent of new acquisitions in 2004 to at least 27.8% of new acquisitions in 2006. Fannie NPA ¶51.

401. From December 6, 2006 through May 31, 2008, according to internal Fannie Mae loan acquisition data reports, at least 25% of Fannie Mae's loan acquisitions in its conventional single family mortgage guarantee business were reduced documentation loans. Fannie NPA ¶52.

3. Fannie Failed to Report All the Reduced Documentation Loans that It Tracked Internally for Credit Risk Monitoring Purposes

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

403. Each of the Defendants knew that approximately half of the reduced documentation loans in the Single Family book were not included when the Company reported its Alt-A loans. SEC Cmpl ¶162. Fannie had both an "Internal" Alt-A definition and other

reduced-documentation loans that it simultaneously tracked. *E.g.*, FMCIV-NY-02_00529408 (document dividing loan programs into "Internal Fannie Mae Definition of Alt-A" and "Other Non-Alt A Documentation Variances"); FMCIV-NY-02_00459555, at 9555, 9558 (email dated Nov. 27, 2006 attaching "latest definition of Alt-A" titled "ALT-A and Reduced Documentation" and explaining that there are types of low documentation loans that Fannie categorizes as outside "Alt-A"). When the Company internally tracked its reduced documentation loans it included loans that it referred to as "Special Lender Programs" or Lender-Selected loans. FMCIV-NY-02_00021643, at 1651 (email dated Apr. 20, 2006 attaching presentation titled "CEO Credit Risk Briefing" with slide listing "Select Lender Programs" and "Other Low/No Doc" under "Non-Full Doc"); FMCIV-NY-02_00132544, at 2559 (presentation dated Mar. 12, 2008 titled "Single Family 4Q 2007 Credit Risk Report" with similar slide, found in Dallavecchia's files). These were loans in which the lender ostensibly initiated the reduced documentation option for processing the loan. The Company also tracked "Other Low/No Doc loans," which are Borrower-Selected loans or loans in which borrowers specifically requested loans for which minimal documentation was required. SEC Cmpl ¶163; FMCIV-NY-02_00132544; FMCIV-NY-02_00021643; FMCIV-NY-02_00459555 (email dated Nov. 27, 2006 attaching preliminary definition of Alt-A as separate from other reduced documentation loans).

404. When the Company reported its Alt-A holdings it failed to disclose all its reduced documentation loans: it disclosed Borrower-Selected loans but did not report its Lender-Selected loans. This limited disclosure misrepresented the extent of Fannie Mae's total exposure to reduced documentation loans. SEC Cmpl ¶164; Publicly available letter dated Sept. 4, 2008 from FHFA to Mudd on "critical concerns" ("The reporting of the Alt-A book was altered in 2006 when Fannie Mae redefined Alt-A and moved an estimated $10 billion (UPB) in mortgages into the prime book. Additionally, management has not included special lender programs in the Alt-A metrics

despite the mortgages in these programs lacking full documentation. ***This issue results in inaccurate or incomplete reporting.*** This does not meet the requirements of FHFA's directive communicated letter dated April 10, 2007.") (emphasis added).

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

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

407. In internal documents, Fannie divided reduced documentation loan programs by Special Feature Codes or SFCs into "Internal Fannie Mae Definition of Alt-A" and "Other Non-Alt A Documentation Variances." FMCIV-NY-02_00529408. The SFCs under the Internal Fannie Mae Definition of Alt-A included SFC 404 for the "Washington Mutual Low-Doc Program," while those under the Other Non-Alt A Documentation Variances included SFC 373 for the "Countrywide Internet Program," also known as Fast and Easy, SFC 371 for "Alt A

outside of DU - Countrywide CLUES," and numerous other Lender-Selected reduced documentation loan programs. *Id.*

408. On November 22, 2006, Mark Winer, Senior Vice President of Fannie's Business Analysis and Decisions division, asked by email, "What is the definition of alt-a [sic]? is [sic]this being used corporate wide?" FMCIV-NY-02_00459555. He received a response stating: "Attached is the latest definition of Alt-A." *Id.* The attachment, titled ALT-A and Reduced Documentation, divided loan programs by Special Feature Codes and stated with regard to the preliminary definition, "There are two primary sources in the definition: Alt-A low doc Special Feature Codes, and Process Efficient loans that are priced as low doc." *Id.* at 9558. The document listed "Countrywide Fast and Easy Program" as SFC 373 under Process Efficient Loans. *Id.*[14]

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

4. Fannie Failed to Disclose that the Company Directed Lenders When to Classify Loans as Alt-A

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

[14] *See also* FMCIV-NY-02_00542474, at 2477, 2481 (emails dated Aug. 28-29, 2008 regarding "Morgan Stanley Follow-up—low doc codes and percentages—Final Matrix," separating Borrower-Selected as Reduced Documentation Alt-A from Lender-Selected as Reduced Documentation Non Alt-A); FMCIV-NY-02_00542506, at 2506-2507 (version of previous document, with additional chart on first page listing Countrywide Fast & Easy as an example of a typical Lender-Selected—or Non Alt-A—product).

411. Fannie Mae did not disclose that the Company directed lenders that delivered the mortgage loans to Fannie Mae's lender channel whether to label reduced documentation loans as Alt-A or not. The Alt-A classification, in practice, came from Fannie Mae and was executed by the originating lenders; the lenders did not make the coding determination. SEC Cmpl ¶169.[15]

412. Fannie Mae had contractual agreements with lenders that included instructions on when to code reduced documentation loans for delivery through its Lender Channel as Alt-A. Occasionally, when a customer delivered loans to Fannie Mae's Lender channel with an Alt-A code that Fannie Mae had not prescribed for delivery for that loan type, Fannie Mae would instruct the customer to re-code its loans to remove the Alt-A code prior to accepting delivery. SEC Cmpl ¶170.

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

5. Defendants' False and Misleading Statements Regarding Fannie's Exposure to Alt-A Mortgages

414. Lead Plaintiffs repeat and reallege each of the materially false and misleading statements set forth above in ¶¶389-413, as if fully set forth herein. The false and misleading statements further detailed below were made with scienter during the Class Period. The Defendants made these statements in, among other things, Fannie's SEC filings, public conference calls, press releases, statements to the media and Congressional testimony.

(a) Fannie's 2004 Form 10-K

[15] Fannie Mae made similar determinations for loans coming in through the Investor Channel. *E.g.*, FMCIV-NY-02_00543606, at 3608, 3611 (emails dated July 2008 regarding determination going forward to code certain loans as "SFC 276 and not with Alt-A SFCs."); FMCIV-NY-02_00529408 (document listing SFC 276 outside of the "Internal Fannie Mae Definition of Alt-A"); FMCIV-NY-02_00543682 (emails dated July 30, 2008 regarding no longer automatically classifying Investor Channel reduced documentation loans as Alt-A).

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

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

See also SEC Cmpl ¶172.

416. The market believed the Defendants' false statements. On February 7, 2007, Bear Stearns issued an analyst report stating that "[t]he [C]ompany made a strategic decision in 2005 NOT to participate in the market for exotic mortgage products, particularly those in the subprime segment because pricing did not adequately reflect the risk. Fannie Mae did not want to support a market that it believed was unsound."

417. In its discussion of Alt-A, Fannie Mae did not disclose that the amount of "loans that are underwritten with lower or alternative documentation" in the Single Family mortgage credit book of business was $390 billion as of September 30, 2006, or the fact that by June 30, 2006, approximately 24% of Fannie Mae's Single Family loan acquisitions were reduced documentation loans. SEC Cmpl ¶173. As of October 2006, 16.3% of Fannie's Single Family mortgage credit book of business, and 30.4% of its Single Family loan acquisitions, were loans underwritten with lower or alternative documentation. FMCIV-NY-02_00135179, at 5192 (presentation dated Dec. 18, 2007 titled "Single Family 3Q 2007 Credit Risk Report" with slide titled "Portfolio and Acquisition Detail"). Fannie's representations were false and misleading for the additional reasons that i) the Company failed to disclose and quantify Fannie's exposure

to Select-Lender and other reduced documentation loans; and ii) the Company failed to disclose the increasing delinquencies and credit losses associated with Select-Lender and other reduced documentation, a trend that was known to Fannie's senior executives, including Mudd and Dallavecchia, and that had already had negative material effects on the Company's financial condition or results of operations.

418. Mudd certified and Dallavecchia sub-certified the 2004 Form 10-K (filed on December 6, 2006) in substantially the same form that they did as alleged in ¶¶335-336, above.

419. As Fannie Mae prepared to file its 2005 Form 10-K in February 2007, Single Family officers working on the credit risk disclosures voiced concern: "Given Alt-A is an increasing as a part [sic] of our business strategy and volume and this is the 2005 disclosure it seems to warrant more than a fairly benign reference, as is the case in the 2004 disclosure. It also appears we are reporting other specific segments in dollars such as neg am and interest only so not reporting on volume for reduced doc feels a little inconsistent . . . The decision now may very well be not to include numbers for this segment and just disclose an increasing trend in words, but by the time we are done with 2006 we need to reflect the reality of the business . . ." SEC Cmpl ¶174; FMCIV-NY-02_00341009 (emails dated Feb. 12, 2007 regarding "URGENT – 10-K Feedback").

420. On a February 27, 2007 conference call, Mudd was asked about Alt-A loans. He responded that "we don't have so much that this is a major, significant exposure on our books."

421. During this time period, senior management at Fannie Mae recognized that investors wanted to know the Company's Alt-A exposure. In April 2007, the Director of Investor Relations at Fannie Mae wrote an email acknowledging: "In anticipation of IR's 2005 10-K briefing with Dan and Bob tomorrow, we would like to get your direction on how management

should address questions related to FNMs exposure to Alt-A product ... we expect the question to be asked and need to plan for it." (Emphasis added). SEC Cmpl ¶175.

(b) Fannie Mae's False and Misleading Alt-Disclosures in Its May 9, 2007 Form 12b-25 Filing

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

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

See also SEC Cmpl ¶176; Fannie NPA ¶¶53-54.

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

Fannie's representations were false and misleading for the additional reasons that i) the Company failed to disclose and quantify Fannie's exposure to Select-Lender and other reduced documentation loans; and ii) the Company failed to disclose the increasing delinquencies and credit losses associated with Select-Lender and other reduced documentation, a trend that was known to Fannie's senior executives, including Mudd and Dallavecchia, and that had already had negative material effects on the Company's financial condition or results of operations.

424. On May 9, 2007, for the first time in a public filing, Fannie Mae quantified its exposure to Alt-A loans in a 12b-25 filed with the Commission (the "May 9, 2007 12b-25 Filing"). *See also* Fannie NPA ¶53.

425. In the May 9, 2007 12b-25 Filing, Fannie Mae stated that in reporting "Alt-A exposure, we have classified mortgage loans as Alt-A if the lenders that deliver the mortgage loans to us have classified the loans as Alt-A based on documentation or other product features, or, for the original or resecuritized private-label, mortgage-related securities that we hold in our portfolio, if the securities were labeled as Alt-A when sold. We estimate that approximately 11% of our total single-family mortgage credit book of business as of both March 31, 2007 and December 31, 2006 consisted of Alt-A mortgage loans or structured Fannie Mae MBS backed by Alt-A mortgage loans." *See also* Fannie NPA ¶54.

426. Fannie Mae had a coding system to identify the loan characteristics for certain mortgages ("Special Feature Codes"). Loan sellers in the lender channel were instructed by Fannie Mae to use certain Special Feature Codes in delivering loans to Fannie Mae. Thus, Fannie Mae's coding system determined those loans that such sellers classified as Alt-A. Fannie NPA ¶55.

427. In calculating its Alt-A exposure, Fannie Mae excluded what it classified as Lender-Selected Loans ("Lender-Selected Reduced Documentation Loans"). Fannie NPA ¶56.

428. During the Class Period, Fannie Mae did not publicly disclose that it excluded Lender-Selected Reduced Documentation Loans from its reported Alt-A exposure. Fannie NPA ¶57.

429. At times during the Class Period, Lender-Selected Reduced Documentation Loans had an SDQ Rate that was on average 1.4 times higher than Fannie Mae's full documentation loans with a similar credit risk profile. Fannie NPA ¶58.

430. Fannie Mae's total exposure to loans with "lower or alternative documentation" (Alt-A) was actually 20.7% and 20.1% of its total Single Family mortgage credit book of business at March 31, 2007, and December 31, 2006, respectively, not 11% as disclosed. Fannie Mae's reporting of its Alt-A mortgage loans omitted approximately $219 billion and $201 billion worth of Fannie Mae's Single Family mortgage credit book of business which consisted of reduced documentation loans as of March 31, 2007, and December 31, 2006, almost equal to the volume of Single Family loans ($263 billion and $257 billion) that were disclosed as Alt-A. SEC Cmpl ¶178. As of March 31, 2007, at least 17.9% of Fannie Mae's total conventional single-family mortgage guarantee business consisted of reduced documentation mortgage loans or structured Fannie Mae MBS backed by reduced documentation mortgage loans. Fannie NPA ¶59.

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

431. Even though senior management, including Mudd and Dallavecchia, recognized that Fannie Mae had an increasing volume of reduced documentation loans that performed as

poorly as some loans disclosed as Alt-A, none of these loans were disclosed. On August 16, 2007, in its 2006 Form 10-K, the Company stated:

> *"Alt-A mortgage"* generally refers to a loan that can be underwritten with lower or alternative documentation than a full documentation mortgage loan but may also include other alternative product features. As a result, Alt-A mortgage loans generally have a higher risk of default than non-Alt-A mortgage loans. In reporting our Alt-A exposure, we have classified mortgage loans as Alt-A if the lenders that deliver the mortgage loans to us have classified the loans as Alt-A based on documentation or other product features, or, for the original or resecuritized private-label, mortgage-related securities that we hold in our portfolio, if the securities were labeled as Alt-A when sold ...We estimate that approximately 11% of our total single-family mortgage credit book of business as of December 31, 2006 consisted of Alt-A mortgage loans or structured Fannie Mae MBS backed by Alt-A mortgage loans. This percentage increased to approximately 12% as of June 30, 2007 ... We estimate that private label mortgage-related securities backed by Alt-A loans ... accounted for approximately 1% (and 2% respectively) ... of our single-family mortgage credit book of business as of June 30, 2007. (Emphasis added.)

SEC Cmpl ¶180.

432. Also on August 16, 2007, Fannie issued a press release that stated, in part, that "as of June 30, 2007, we have purchased or guaranteed approximately $310 billion of Alt-A loans, or 12 percent of our single-family mortgage credit book of business . . . ."

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

434. Fannie's representations in the 2006 Form 10-K and August 16, 2008 press release were false and misleading for the additional reasons that i) the Company failed to disclose and quantify Fannie's exposure to Select-Lender and other reduced documentation

loans; and ii) the Company failed to disclose the increasing delinquencies and credit losses associated with Select-Lender and other reduced documentation, a trend that was known to Fannie's senior executives, including Mudd and Dallavecchia, and that had already had negative material effects on the Company's financial condition or results of operations.

435. Mudd certified and Dallavecchia sub-certified the 2006 Form 10-K in substantially the same from that they did as alleged in ¶¶335-336, above.

436. Also on August 16, 2007, the Company conducted a conference call with investors (the "Aug. 16 Conference Call") in which the following statements were made:

> [Dallavecchia]: [W]e have or guaranteed approximately $310 billion in Alt-A loans at June 30. That is about 12% of our total book. Importantly we generally acquire loans originated at Alt-A from our traditional lender partners. We will review then approve of lenders underwriting guidelines, and I'm very familiar with your [sic] origination practices. The Alt-A mortgages originated by these lenders will typically follow an origination path similar to that used for originating [prime] mortgages. So we believe that the Alt-A loans we guarantee have more favorable credit characteristics than the overall market of Alt-A loans, including a weighted average FICO score of 720 and low exposure to high LTVs. . . . We also hold $34.5 billion in private-label securities backed by Alt-A loans. These securities have a weighted average subordination of nearly 20%. An important point for both our [subprime] and Alt-A backed securities is our use of stress tests to assess potential losses under multiple scenarios. We include the scenarios as severe as two consecutive years of 10% declines in home prices, coupled with the two consecutive years of 2% increase in interest rates. And the outcome of these scenarios project better (inaudible) loss and cash flow even under the direst scenario.

(Alteration added).

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

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

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

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

See also SEC Cmpl ¶183.

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

440. Fannie Mae's total exposure to loans with "lower or alternative documentation" (Alt-A) was actually 22% of its total Single Family mortgage credit book of business, not 12% as disclosed. Fannie Mae's reporting of its Alt-A omitted approximately $267 billion worth of Fannie Mae's Single Family mortgage credit book of business which consisted of reduced document loans as of September 30, 2007-almost equal to the $306 billion that was disclosed as Alt-A. SEC Cmpl ¶185. Fannie's representations in the first, second and third quarter Form 10-Qs were false and misleading for the additional reasons that i) the Company failed to disclose and quantify Fannie's exposure to Select-Lender and other reduced documentation loans; and ii) the Company failed to disclose the increasing delinquencies and credit losses associated with Select-Lender and other reduced documentation, a trend that was known to Fannie's senior executives, including Mudd and Dallavecchia, and that had already had negative material effects on the Company's financial condition or results of operations.

441. Mudd certified and Dallavecchia sub-certified the 2007 Form 10-Qs for the first, second, and third quarters in substantially the same from that they did as alleged in ¶¶335-336, above.

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

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

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

> Alt-A mortgage loans, whether held in our portfolio or backing Fannie Mae MBS, represented approximately 16% of our single-family business volume in 2007, compared with approximately 22% and 16% in 2006 and 2005, respectively . . . We estimate that Alt-A mortgage loans held in our portfolio or Alt-A mortgage loans backing Fannie Mae MBS, excluding resecuritized private-label mortgage-related securities backed by Alt-A mortgage loans, represented approximately 12% of our total single-family mortgage credit book of business as of December 31, 2007, compared with approximately 11% and 8% as of December 31, 2006 and 2005, respectively.

See also SEC Cmpl ¶187.

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

¶188. Loans with "lower or alternative documentation" (Alt-A) were approximately 20.4% of its Single Family book of business as of December 2007. FMCIV-NY-02_00132544, at 559 (presentation dated Mar. 12, 2008 titled "Single Family 4Q 2007 Credit Risk Report" found in Dallavecchia's files). Fannie's representations in the 2007 10-K were false and misleading for the additional reasons that i) the Company failed to disclose and quantify Fannie's exposure to Select-Lender and other reduced documentation loans; and ii) the Company failed to disclose the increasing delinquencies and credit losses associated with Select-Lender and other reduced documentation, a trend that was known to Fannie's senior executives, including Mudd and Dallavecchia, and that had already had negative material effects on the Company's financial condition or results of operations.

445. Mudd certified and Dallavecchia sub-certified the 2007 Form 10-K in substantially the same from that they did as alleged in ¶¶335-336, above.

446. On May 6, 2008, Fannie issued a issued a press release reporting its financial results for the quarter ended March 31, 2008 that represented, among other things, that "Alt-A loans made up about 11.2 percent of the single-family conventional mortgage credit book of business and 42.7 percent of the credit losses."

447. Also on May 6, 2008, in its 2008 Form 10-Q for the first quarter, the Company stated:

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

See also SEC Cmpl ¶189.

448. Fannie Mae's total exposure to loans with "lower or alternative documentation" (Alt-A) was actually 22% of its total Single Family mortgage credit book of business, not 11% as disclosed. SEC Cmpl ¶190. A nonpublic draft of Fannie's May 6, 2008 Press Release that was contained within Fannie Board Meeting Materials stated "Loans identified by lenders as Alt-A loans, which have a variety of alternative characteristics that may include low documentation, comprised about 25 percent of its book, but accounted for more than 66 percent of the total credit-related expenses as of March 31, 2008." FMCIV-NY-02_00010002, at 0048 (press release draft dated May 2, 2008 contained in materials for May 5, 2008 Fannie Board Meeting). Fannie Mae's reporting of its Alt-A loans omitted approximately $323 billion worth of mortgage loans in Fannie Mae's Single Family mortgage credit book of business that consisted of reduced document loans as of March 31, 2008—more than the $300 billion that was disclosed as Alt-A. SEC Cmpl ¶190. Fannie's representations in the first quarter 2008 Form 10-Q were false and misleading for the additional reasons that i) the Company failed to disclose and quantify Fannie's exposure to Select-Lender and other reduced documentation loans; and ii) the Company failed to disclose the increasing delinquencies and credit losses associated with Select-Lender and other reduced documentation, a trend that was known to Fannie's senior executives, including Mudd and Dallavecchia, and that had already had negative material effects on the Company's financial condition or results of operations.

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

450. Mudd certified and Dallavecchia sub-certified the 2008 Form 10-Q for the first quarter in substantially the same from that they did as alleged in ¶¶335-36, above.

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

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

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

See also SEC Cmpl ¶193.

453. Fannie Mae's total exposure to loans with "lower or alternative documentation" (Alt-A) was actually 23% of its total Single Family mortgage credit book of business, not 11% as disclosed. Fannie Mae's reporting of its Alt-A omitted approximately $341 billion worth of Fannie Mae's Single Family mortgage credit book of business which consisted of reduced documentation loans as of June 30, 2008-more than the $306 billion that was disclosed as Alt- A to investors on August 8, 2008. SEC Cmpl ¶195. Fannie's representations in second quarter 2008 Form 10-Q were false and misleading for the additional reasons that i) the Company failed to disclose and quantify Fannie's exposure to Select-Lender and other reduced documentation loans; and ii) the Company failed to disclose the increasing delinquencies and credit losses associated with Select-Lender and other reduced documentation, a trend that was known to Fannie's senior executives, including Mudd and Dallavecchia, and that had already had negative material effects on the Company's financial condition or results of operations.

454. Mudd certified the 2008 Form 10-Q for the second quarter in substantially the same from that he did as alleged in ¶¶335-336, above.

VIII. THE GOVERNMENT PLACES FANNIE INTO CONSERVATORSHIP

455. On July 30, 2008, President Bush signed HERA. Under HERA, OFHEO was replaced by FHFA. In addition, the circumstances under which FHFA could exercise its discretion to impose a conservatorship on Fannie were broadened to include when Fannie is in "[a]n unsafe or unsound condition to transact business." The statute also gave FHFA discretion to downgrade Fannie's capital adequacy classification, if it determined that Fannie is in "an unsafe or unsound condition."

456. According to a July 14, 2008 *New York Times* article, even as Fannie insisted it had plenty of capital to weather the financial storm, the Bush administration asked Congress to approve a sweeping rescue package that would empower officials to inject billions of federal dollars into Fannie and Freddie through investments and loans.

457. On September 6, 2008, Fannie Mae's massive, ongoing fraud finally came to an abrupt halt. On that date, *MarketWatch* reported:

> The Treasury Department is expected to announce as early as this weekend a plan to bail out and recapitalize collapsing home mortgage giants Fannie Mae and Freddie Mac in one of the biggest government rescues in U.S. history. Such a plan would end a long downward spiral for the firms
>
> * * *
>
> Rep. Barney Frank (D. Mass.) confirmed in a statement Saturday that Treasury Secretary Henry Paulson is set to put the federal government in control of the two troubled mortgage owners . . . According to media reports citing unnamed sources close to the negotiations, the government is expected to take at least temporary control of [Fannie and Freddie Mac] and place the troubled firms under the umbrella of the Federal Housing Finance Agency. Fannie Mae Chief Executive Daniel Mudd and Freddie Mac CEO Richard Syron are expected to leave their positions soon after the federal bailout is complete.

458. On September 7, 2008, on the heels of the Defendants' Class Period-long assurances regarding Fannie Mae's subprime and Alt-A loan exposure and the adequacy of its capital, the government came to Fannie's financial rescue. On that date, the FHFA issued a statement announcing that it "will act as the conservator to operate [Fannie] until [it is] stabilized," and that "as the conservator, FHFA will assume the power of the Board and management." Under the conservatorship, in addition to taking over Fannie's management, the U.S. Government became the Company's majority owner and, potentially, its primary lender. As *The Wall Street Journal* reported on September 8, 2008, "[t]he Treasury will acquire $1 billion of preferred shares in each company [*i.e.*, Fannie and Freddie] without providing immediate cash, and has pledged to provide as much as $200 billion to the companies as they cope with heavy losses on mortgage defaults."

459. The federal government takeover was based upon Fannie's failure to manage its credit risk or to meet its capital requirements, despite Fannie's attempt to convince otherwise. As FHFA director Lockhart confirmed in a September 23, 2008 written statement to Congress, "the determination to appoint a conservator" was based on several concerns, of which the very first was "accelerating safety and soundness weaknesses, **especially with regard to credit risk, earnings outlook, and capitalization**." (Emphasis added.) Testifying that same day, as reported in the Washington Post on September 24, 2008, director Lockhart put the blame for Fannie's collapse squarely on non-prime and non-traditional loans:

> Fannie Mae and Freddie Mac purchased and guaranteed "many more low documentation, low-verification and non-standard" mortgages in 2006 and 2007 "than they had in the past." He said the companies increased their exposure to risks in 2006 and 2007 despite the regulator's warnings.
>
> Roughly 33 percent of the companies' business involved buying or guaranteeing these risky mortgages, compared with 14 percent in 2005. Those bad debts on mortgages led to billions of dollars in losses at the firms.

460. In his testimony at the December 9 Hearing, Mr. Pinto described Fannie as having "engaged in 'an orgy of junk mortgage development' that turned the two mortgage-finance giants into vast repositories of subprime and similarly risky loans...," as reported by *The New York Times* the next day.

461. Fannie's failure to timely report its undercapitalization, and to disclose other facts from which that undercapitalization could have been deduced, prevented the members of the Classes from adequately anticipating the government takeover and, in this way, among others, caused the members of the Classes to suffer damages. As *The New York Times* noted in its September 7, 2008 article, as a result of the conservatorship:

> [I]t appears that investors who own the companies' common stock will be virtually wiped out; preferred shareholders, who have priority over other shareholders, may also wind up with little.

In another September 7, 2008 article on the federal government takeover of Fannie Mae, *The New York Times* further reported that Fannie's shareholders "will suffer. [Fannie] would stop paying any dividends on [its] common shares, and any new capital provided by the Treasury Department would have financial priority over the existing preferred and common stock."

462. The prices of Fannie securities plunged as a result of the fraud alleged herein and have never recovered. The day after Fannie was placed into conservatorship—September 8, 2008, which was the next trading day—Fannie common stock plunged nearly **90%** from $7.04 to $0.73, on heavy trading volume of more than 585,000,000 shares—a massive increase over the previous days' trading volume of approximately 83,000,000.

463. Similarly, the preferred shares plummeted by between approximately 63% and 92%over the previous day's closing price.

464. As indicated above, as numerous partial revelations of Fannie's true financial condition and future business prospects were revealed to the market, the full extent of the fraud

and false and misleading financial reporting became known. The misrepresentations and omissions detailed herein which centered on the Company's exposure to non-traditional and non-prime mortgages and the adequacy of its capital, were connected by a common underlying purpose and pattern. The Defendants' motivation was to artificially inflate the price of Fannie's equity securities, thus misleading the market into believing Fannie continued to be a model of safety and stability and causing the market to expect and anticipate that Fannie would survive the mortgage market downturn with aplomb. But when the price of the Company's securities dropped upon revelation of Fannie's true financial condition concealed by the fraud, Lead Plaintiffs and the Classes suffered losses proximately caused by the fraud alleged herein.

A. Post-Conservatorship Fannie Acknowledges Additional Subprime Holdings

465. After Fannie Mae had been placed into conservatorship on September 6, 2008, the Company made a disclosure that highlights the misleading nature of the Company's prior subprime reports. At the time this disclosure was made, neither Mudd nor Dallavecchia were at Fannie Mae. SEC Cmpl ¶147.

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

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

See also SEC Cmpl ¶148; Fannie NPA ¶47.

467. In this statement, the Company, for the first time, publicly acknowledged what Mudd and Dallavecchia had known throughout the Class Period; namely, that Fannie Mae held

loans squarely within the public definition of subprime that it had not included in calculating its publicly disclosed exposure to subprime loans. SEC Cmpl ¶149.

468. On February 24, 2011, in its Form 10-K for the fiscal year 2010, Fannie Mae stated for the first time: "We exclude from the subprime classification loans originated by these lenders if we acquired the loans in accordance with our standard underwriting criteria, which typically require compliance by the seller with our Selling Guide (including standard representations and warranties) and/or evaluation of the loans through our Desktop Underwriter system." Fannie NPA ¶48.

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

B. Post-Conservatorship Fannie Mae Acknowledges Additional Alt-A Holdings

470. In its first periodic filing post-conservatorship, Fannie Mae made a disclosure that highlights the misleading nature of the Company's prior Alt-A disclosures. At the time this disclosure was made neither Mudd nor Dallavecchia were at Fannie Mae. The Company explained:

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

SEC Cmpl ¶196; Fannie NPA¶64.

471. In this statement for the first time the Company publicly acknowledged what Mudd and Dallavecchia had known throughout the Class Period, that it held loans that matched

its public definition of Alt-A, but had not included them when reporting its Alt-A exposure. SEC Cmpl ¶197.

472. Information described above concerning Fannie Mae's Alt-A exposure was provided and/or available to Mudd and Dallavecchia through internal reports, presentations, and/or briefings. *E.g.*, FMCIV-NY-02 00021643, at 1651 (email dated Apr. 20, 2006 attaching presentation titled "CEO Credit Risk Briefing"); FMCIV-NY-02 00252241, at 252244-45 (presentation titled "Credit Risk Briefing for Enrico Dallavecchia"); FMCIV-NY-02 00053610, at 3617, 3619 (presentation dated Dec. 20, 2006 titled "Single Family 3rd Quarter Credit Risk Report" with slide listing Non-Full Doc loans as percentage of acquisitions and single family book); Fannie NPA ¶60.

473. Mudd certified periodic filings during the Class Period that included Fannie Mae's Alt-A disclosures. Those certifications were substantially similar to the representations set forth above in ¶335. Fannie NPA ¶61. Dallavecchia sub-certified periodic filings during the Class Period that included Fannie Mae's Alt-A disclosures. Those sub-certifications were substantially similar to the representations set forth above in ¶336. Fannie NPA ¶62.

474. Mudd and Dallavecchia reviewed and approved Alt-A disclosures contained in Fannie Mae's 12b-25 filings during the Class Period. Fannie NPA ¶63.

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

IX. LOSS CAUSATION

476. During the Class Period, as detailed herein, Defendants engaged in a fraudulent scheme to deceive the market and members of the Classes by misrepresenting Fannie's risk

management and controls and its actual exposure to subprime and Alt-A mortgages. As a result of the Defendants' fraudulent conduct, Fannie securities were artificially inflated throughout the Class Period. When Lead Plaintiffs and other members of the Classes purchased their Fannie securities, the true value of such securities was substantially lower than the prices actually paid by Lead Plaintiffs and the other members of the Classes.

477. The false and misleading statements set forth above were widely disseminated to the securities markets, investment analysts, and to the investing public. Those statements caused and maintained the artificial inflation of the price of Fannie shares, which consequently traded at prices in excess of their true value. During the Class Period, the concealed risks associated with the Company's inadequate risk management and controls and its actual exposure to subprime and Alt-A mortgages materialized, causing the price of Fannie's shares to decline. That decline in value eliminated a portion of the inflation in the price of those securities, causing economic harm to Lead Plaintiffs and the Classes.

478. By misrepresenting the Company's ability to manage risk and its true exposure to subprime and Alt-A mortgages, the Defendants presented a misleading picture of Fannie's business and prospects, which caused and maintained the artificial inflation in the prices of Fannie's securities throughout the Class Period, even as negative news reached the market, until these concealed risks fully materialized by the close of the Class Period.

479. Lead Plaintiffs and other members of the Classes relied, to their detriment, on the Defendants' materially false and misleading statements and/or the integrity of the market, in purchasing their Fannie securities at artificially inflated prices during the Class Period. Had Lead Plaintiffs and the other members of the Classes known the truth, they would not have taken such actions.

480. As explained herein, these false statements directly or proximately caused, or were a substantial contributing cause of, the damages and economic loss suffered by Lead Plaintiffs and other members of the Classes, and maintained the artificial inflation in the prices of Fannie's equity securities throughout the Class Period.

A. Partial Disclosures Prior to the Government Take Over

1. February 27, 2008 Disclosure of a Larger than Expected Loss in the Fourth Quarter of 2007

481. On February 27, 2008, Defendants caused Fannie to file its 2007 Form 10-K, which reported a loss of $3.80 per share in the fourth quarter of 2007, much larger than the consensus estimate of a $1.24 loss, according to a *Wall Street Strategies* analyst report published on February 29, 2008. The analyst report noted that "[o]ur estimate did not take into account increased loss reserves."

482. The Company noted that in November 2007 it had announced and implemented price increases: "[W]e implemented pricing increases to reflect the higher credit risk posed by [Alt-A] mortgages," and that "[a]s a result of these eligibility restrictions and price increases, we believe that our volume of Alt-A mortgage loan acquisitions will decline in future periods."

483. As reported by *Bloomberg*, in early trading, Fannie's stock declined $1.87 per share, or approximately 7%, to $25.10 per share, though non-related positive news muted the immediate effect. As subsequently reported by *Wall Street Strategies*, "[Fannie's stock loss] was quickly reversed when the [OFHEO] announced that, in light of the Company's achievement in avoiding delinquency of its financial statements, it will remove the caps on Fannie's mortgage portfolio."

484. The size of Fannie's loss in the fourth quarter of 2007—which was more than three times the consensus estimate—was a partial materialization of the concealed risks

associated with Fannie's inadequate risk management and controls and its actual exposure to subprime and Alt-A mortgages. As contemporaneous internal non-public Fannie documents show, senior management had determined that the "primary drivers" of the Company's dramatically increasing credit losses were its EA, MCM, and Alt-A mortgages. FMCIV-NY-02_0009036, at 9037 (presentation dated Feb. 29, 2008 titled "Single Family Book of Business and Update on Loss Mitigation").

2. May 6, 2008 Disclosure of $2.2 Billion Loss in the First Quarter of 2008 Due to High Risk Loans

485. On May 6, 2008, before the market opened, Defendants caused Fannie to file its Form 10-Q for the first quarter of 2008, announcing a $2.2 billion loss and reporting that "our credit losses for the quarter were concentrated primarily in our Alt-A and other higher risk loan categories, in loans originated in 2005 through 2007, and in areas of the country experiencing steep declines in home prices (such as Florida, California, Nevada and Arizona)."

486. As reported by *Bloomberg*, on May 6, 2008, by 9:40 a.m., the price of Fannie's stock had fallen 5.1% to $26.85 per share.

487. Fannie's disastrous results in the first quarter of 2008 were a partial materialization of the concealed risks associated with Fannie's inadequate risk management and controls and its actual exposure to subprime and Alt-A mortgages. As contemporaneous internal non-public Fannie documents show, senior management had determined that the Company's EA, MCM, and Alt-A mortgages were the "source" of its rising serious delinquency rates and, therefore, high credit losses. FMCIV-NY-02_00047024, at 7026 (presentation dated May 22, 2008, titled "Credit Review & Initiatives").

3. July 10-11, 2008 Disclosure of Fannie's Potential Insolvency and Potential Government Takeover

488. On July 10, 2008, the first of a series of partial disclosures revealing Fannie's core capital inadequacy emerged. On Thursday, July 10, 2008, before the market opened, *Bloomberg* published an article titled, "Fannie, Freddie 'Insolvent After Losses, Poole Says (Update 1)." The article quoted former St. Louis Federal Reserve President, William Poole: "Congress ought to recognize that [Fannie Mae and Freddie Mac] are insolvent."

489. On July 10, 2008, the first day of trading after Poole's statement was made public, Fannie's stock price dropped 13.78%, from $15.31 per share to $13.20 per share. As a *New York Times* article published on July 11, 2008, noted: "On Thursday, the rapid sell-off of shares of Fannie and Freddie Mac came after a former central banker made comments that the companies might not be solvent. . . ."

490. The disclosure of Fannie's potential insolvency was a partial materialization of the concealed risks associated with Fannie's inadequate risk management and controls and its actual exposure to subprime and Alt-A mortgages, which together caused the Company to incur gigantic credit losses. Because Fannie was thinly capitalized compared to other banking institutions, the credit losses from EA, MCM, and Alt-A mortgages had the potential to render Fannie insolvent. At the very least, the magnitude of the losses threatened the Company's ability to maintain its statutorily required capital base, raising the specter of a government takeover.

491. On July 11, 2008, *The New York Times* published an article warning that the federal government was weighing a takeover of Fannie, along with Freddie Mac:

> Alarmed by the growing financial stress at the nation's two largest mortgage finance companies, senior Bush administration officials are considering a plan to have the government take over one or both of the companies and place them in a conservatorship if their problems worsen, people briefed about the plan said on Thursday. . . . Under a conservatorship, the shares of Fannie and Freddie would be worth little or nothing.

> [¶] Under a 1992 law, Fannie or Freddie could be put into conservatorship if their top regulator found that either one is "critically undercapitalized."

492. On news that the federal government was considering a takeover of Fannie, the price of Fannie's stock plummeted 22% from $13.20 per share on July 10, 2008 to $10.25 per share at close on July 11, 2008.

493. Defendants attempted to mitigate the impact of the partial disclosures as to Fannie's capital inadequacy and the potential for a government takeover. On July 11, 2008, in a statement issued after the market close, Fannie misleadingly reassured the market that its capital was adequate: "Our capital level is substantially above our statutory minimum capital level and the OFHEO-required 15 percent surplus over minimum capital. In fact, we have more core capital, and a higher surplus over our regulatory requirements, than at any time in this company's history." Fannie's stock price nevertheless slid slightly lower the next trading day, from $10.25 per share at close on July 11, 2008 to $9.73 per share at close on July 14, 2008. Likewise, each series of Fannie's preferred stock encompassed by the Preferred Class definition declined substantially on July 10-11, 2008.

4. August 8, 2008 Disclosure of $2.3 Billion Loss in the Second Quarter of 2008 Due to High Risk Loans

494. On August 8, 2008, Defendants caused Fannie to file its Form 10-Q for the second quarter of 2008, which reported an unexpectedly high $2.3 billion net loss—according to the *Associated Press*, "more than triple what Wall Street expected." This second consecutive multi-billion-dollar quarterly loss was a partial materialization of the concealed risks associated with Fannie's inadequate risk management and controls and its actual exposure to subprime and Alt-A mortgages.

495. On this news, Fannie's stock price fell to $9.05 per share by the close of trading, which was a 9% drop from a closing price of $9.95 per share the day before.

5. August 19-20, 2008 Partial Disclosure of Fannie's Subprime and Alt-A Exposure

496. On August 19, 2008, *The Washington Post* published an article titled "Fannie's Perilous Pursuit of Subprime Loans," which disclosed that in early 2006 and 2007 Defendants aggressively expanded Fannie's subprime and Alt-A portfolio while giving "short shrift" to the risks they knew to be associated with such loans. *The Washington Post* quoted internal Fannie documents, including a memorandum dated January 3, 2007, from Defendant Mudd to Fannie's Board in which he trumpeted: "By entering new markets—especially Alt-A and subprime and guaranteeing more of our customers' products at market prices we met our goal of increasing market share from 22 to 25 percent."

497. In response to this disclosure, the stock price dropped 2.28%, from $6.15 per share at close on August 18, 2008, to $6.01 per share at close on August 19, 2008. Likewise, each series of Fannie's preferred stock included in the Preferred Class declined substantially on August 18, 2008.

498. On August 20, 2008, the *Washington Post*'s story was picked up and further distributed by the Dow Jones Newswire Services, which summarized the story and provided an internet link to where the original story appeared on the *Washington Post*'s website.

499. On this news, Fannie's stock price plummeted 26.8%, from $6.01 per share at close on August 19, 2008, to $4.40 per share at close on August 20, 2008. Disclosure of the subprime and Alt-A exposure caused this drop. Likewise, each series of Fannie's preferred stock encompassed by the Preferred Class definition declined substantially on August 19, 2008.

6. September 7, 2008 Announcement of FHFA Conservatorship

500. On September 7, 2008, the FHFA issued a statement announcing that it had placed Fannie into conservatorship. On September 8, 2008, the first day of trading after the government announced Fannie's conservatorship, the price of Fannie's common stock price plunged nearly **90%**, from $7.04 to $0.73. Likewise, each series of Fannie's preferred stock encompassed by the Preferred Class declined substantially on September 8, 2008.

501. The concealed risks associated with Fannie's inadequate risk management and controls and its actual exposure to subprime and Alt-A mortgages materialized in the form of enormous credit losses, which resulted in severe capital inadequacy and ultimately in federal conservatorship. The disclosure of the Company's conservatorship caused the price of Fannie's shares to decline, causing economic harm to Lead Plaintiffs and the Classes.

B. Post-Class Period Events

502. In the wake of the federal government's announcement that it was imposing a conservatorship on Fannie, details continued to emerge confirming that Defendants fraudulently misled investors about Fannie's risk management and controls and its actual exposure to subprime and Alt-A mortgages.

503. On October 9, 2008, the FHFA announced that it was "classifying Fannie Mae and Freddie Mac as of June 30, 2008, **prior to the conservatorship**, as undercapitalized using FHFA's discretionary authority provided in the statute." (Emphasis added.)

504. On November 10, 2008, Fannie filed its Form 10-Q for the third quarter of 2008, its first financial statement filed under the government conservatorship and reported a net loss of $29 billion for the quarter—a loss three times larger than the total of all the losses reported by Fannie for the four previous quarters combined.

505. At the December 9, 2008 Congressional Hearing, it was disclosed that, on October 28, 2006, Fannie's chief risk officer had sent CEO Mudd an e-mail warning about a "serious problem" at the company. [*See* ¶¶82-83, above.] He wrote "There is a pattern emerging of inadequate regard for the control process." During the hearing it also was disclosed that, on July 16, 2007, the same Chief Risk Officer wrote yet another email to Mudd stating that the board of directors had been told falsely that "we have the will and the money to change our culture and support taking more credit risk. . . . I have been saying that we are not even close to having proper control processes for credit, market, and operational risk. I get a 16 percent budget cut. Do I look so stupid?" [*See* ¶¶92-93, above.]

506. On February 26, 2009, Fannie filed its Form 10-K for the year 2008, the first audited financial statement filed under the government conservatorship, and reported a net loss for the fourth quarter of $25.2 billion, bringing the total losses reported in the first two quarters under the government conservatorship to $54.2 billion, more than five times the total losses reported during the four quarters before the government takeover.

507. On February 26, 2009, Fannie also disclosed that it would need $15.2 billion from the government to cover a net worth deficit.

508. On May 9, 2009, Fannie disclosed that it would need another $19 billion from the government, bringing to $34.2 billion the total amount required from the government to cover Fannie's net worth deficit to $34.2 billion.

X. APPLICABILITY OF THE PRESUMPTION OF RELIANCE: FRAUD ON THE MARKET DOCTRINE

509. In bringing these claims, with regard to claims under the Exchange Act, Lead Plaintiffs and the members of the Classes are entitled to the presumption of reliance established

by the fraud-on-the-market doctrine. At all times relevant to this Complaint, the market for Fannie shares was an efficient market for the following reasons, among others:

a. Fannie's equity securities—both common and preferred—met the requirements for listing and were listed and actively traded on the NYSE, a highly efficient and automated market;

b. As a regulated issuer, Fannie filed periodic public reports with the SEC;

c. Fannie shares were followed by numerous securities analysts employed by leading brokerage firms and investment banks who wrote reports about the Company and the value of its shares that were publicly available and entered the public marketplace; and

d. Fannie regularly issued press releases, which were carried by national and international news wires, and which were publicly available and entered into the public marketplace.

510. As a result, the market for Fannie equity securities promptly digested current information regarding Fannie from all publicly-available sources and reflected such information in Fannie's equity securities prices. Under these circumstances, all purchasers of Fannie equity securities during the Class Period suffered similar injury through their purchase of Fannie equity securities at artificially inflated prices, and a presumption of reliance applies.

XI. INAPPLICABILITY OF THE STATUTORY SAFE HARBOR

511. The statutory safe harbor provided for forward looking statements under certain circumstances does not apply to any of the allegedly false statements pleaded in this complaint. The statements alleged to be false and misleading concerned statements of existing or historical

fact or conditions. Additionally, to the extent that any of the statements alleged to be false and misleading may be deemed to be forward looking statements, the Defendants are nevertheless liable for those statements because they were not identified as forward looking statements or, even if so identified, the statements were material, they were not accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the purportedly forward looking statements and, at the time each of those statements was made, the Defendants had actual knowledge that the particular forward looking statement was false or the forward looking statement was authorized and/or approved by an officer of Fannie who knew that the statement was false when made. In addition, to the extent that any of the statements set forth above were accurate when made, they became inaccurate or misleading because of subsequent events, and the Defendants failed to update those statements that later became inaccurate and/or did not disclose information that undermined the validity of those statements.

XII. CLASS ACTION ALLEGATIONS

512. Lead Plaintiffs bring this action as a class action pursuant to Rule 23 of the Federal Rules of Civil Procedure on behalf of all persons who, during the Class Period, purchased or acquired, either on the secondary market or through an original offering pursuant to a registration statement or prospectus: (a) Fannie common stock and options (the "Common Stock Class"); and (b) Fannie preferred stock during the Class Period (the "Preferred Class") (together, the "Classes"). The Massachusetts Public Pension Funds bring this action on behalf of the Common Stock Class, and TCRS brings this action on behalf of the Preferred Class. Excluded from the Classes are (i) Defendants; (ii) members of the immediate family of any defendant; (iii) any person who was an officer or director of Fannie during the Class Period; (iv) any firm, trust, corporation, officer, or other entity in which any defendant has or had a

controlling interest; and (v) the legal representatives, agents, affiliates, heirs, successors-in-interest, or assigns of any such excluded party.

513. The members of the Common Stock Class are so numerous that joinder of all members is impracticable. The disposition of their claims in a class action will provide substantial benefits to the parties and the Court. As of October 30, 2006, there were 975,052,687 shares of Fannie common stock outstanding, and as of September 30, 2008, there were 1,076,207,174 shares of Fannie common stock outstanding.

514. The members of the Preferred Class are so numerous that joinder of all members is impracticable. The disposition of their claims in a class action will provide substantial benefits to the parties and the Court. 110,175,000 shares of preferred stock that were issued prior to the Class Period were outstanding during that timeframe.[16] 496,950,000 shares of preferred stock were issued during the Class Period and then had shares outstanding.[17]

[16] Those shares are attributed to the specific series of offerings, as follows:

- 3,000,000 outstanding shares of 5.25% Non-Cumulative Preferred Stock, Series D ("Series D Preferred Stock");
- 3,000,000 outstanding shares of 5.10% Non-Cumulative Preferred Stock, Series E ("Series E Preferred Stock");
- 13,800,000 outstanding shares of Variable Rate Non-Cumulative Preferred Stock, Series F ("Series F Preferred Stock");
- 5,750,000 outstanding shares of Variable Rate Non-Cumulative Preferred Stock, Series G ("Series G Preferred Stock");
- 8,000,000 outstanding shares of 5.81% Non-Cumulative Preferred Stock, Series H ("Series H Preferred Stock");
- 6,000,000 outstanding shares of 5.375% Non-Cumulative Preferred Stock, Series I ("Series I Preferred Stock");
- 6,900,000 outstanding shares of 5.125% Non-Cumulative Preferred Stock, Series L ("Series L Preferred Stock");
- 9,200,000 outstanding shares of 4.75% Non-Cumulative Preferred Stock, Series M ("Series M Preferred Stock");
- 4,500,000 outstanding shares of 5.50% Non-Cumulative Preferred Stock, Series N ("Series N Preferred Stock");
- 50,000,000 outstanding shares of Non-Cumulative Preferred Stock, Series O ("Series O Preferred Stock"); and
- 25,000 outstanding shares of Non-Cumulative Convertible Series 2004-1 Preferred Stock ("Series 2004-1 Preferred Stock").

[17] Those shares are attributed to the specific series of offerings, as follows:

515. During the Class Period, the common stock, Series F Preferred Stock, Series G Preferred Stock, Series H Preferred Stock, Series I Preferred Stock, Series L Preferred Stock, Series M Preferred Stock, Series N Preferred Stock, Series P Preferred Stock, Series Q Preferred Stock, Series R Preferred Stock, Series S Preferred Stock, Series T Preferred Stock, and Series 2008-1 Preferred Stock actively traded on the New York Stock Exchange; Series D, Series E, Series 2004-1 and Series O traded over the counter. These constitute efficient markets. During the Class Period, Fannie was one of the largest companies in the world, with a market capitalization surpassing $40 billion. Fannie was followed by securities analysts employed by major brokerage firms who wrote reports that were disseminated to the sales force and to certain customers of their respective brokerage firms. Each of these reports was publicly available and entered the public marketplace.

516. Lead Plaintiffs' claims are typical of the claims of other members of the respective Classes. Plaintiffs and the Classes purchased their securities through the offerings at issue, or on the open market, and they sustained damages from the Defendants' wrongful conduct.

517. Lead Plaintiffs will adequately protect the interests of the Classes, and they have retained counsel who are experienced in class action securities litigation. Lead Plaintiffs have no

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- 40,000,000 outstanding shares of Variable Rate Non-Cumulative Preferred Stock, Series P ("Series P Preferred Stock");
- 15,000,000 outstanding shares of 6.75% Rate Non-Cumulative Preferred Stock, Series Q ("Series Q Preferred Stock");
- 21,200,000 outstanding shares of 7.625% Non-Cumulative Preferred Stock, Series R ("Series R Preferred Stock");
- 280,000,000 outstanding shares of Fixed-to-Floating Rate Non-Cumulative Preferred Stock, Series S ("Series S Preferred Stock");
- 89,000,000 outstanding shares of 8.25% Non-Cumulative Preferred Stock, Series T ("Series T Preferred Stock"); and
- 51,750,000 outstanding shares of 8.75% Non-Cumulative Mandatory Convertible Preferred Stock, Series 2008-1 ("Series 2008-1 Preferred Stock").

interests that are contrary to or in conflict with those of the members of the Classes that Lead Plaintiffs seek to represent.

518. A class action is superior to other available methods for the fair and efficient adjudication of this controversy. Because the damages suffered by individual members of the Classes may be relatively small, the expense and burden of individual litigation make it virtually impossible for the members of the classes individually to seek redress for the wrongful conduct alleged herein.

519. There is a well-defined community of interest in the questions of law and fact involved in this case. Questions of law and fact common to the members of the Classes which predominate over questions which may affect individual members of either the Common Stock Class or the Preferred Class include:

a. whether the Exchange Act was violated by Defendants;

b. whether Defendants omitted and/or misrepresented material facts;

c. whether Defendants' statements omitted material facts necessary to make the statements made, in light of the circumstances under which they were made, not misleading;

d. whether the Defendants acted with the requisite state of mind;

e. whether the prices of Fannie securities were artificially inflated; and

f. whether members of the Classes have sustained damages, and if so, the appropriate measure thereof.

520. Plaintiffs know of no difficulty that will be encountered in the management of this litigation that would preclude its maintenance as a class action.

521. The names and addresses of record owners of Fannie common and preferred shares who are members of the Classes are available from records maintained by Fannie or its transfer agent. Notice may be provided to such record owners via first class mail, using techniques and a form of notice similar to that customarily used in securities class actions.

522. As a direct and proximate result of the Defendants' violations of the Exchange Act, Lead Plaintiffs and the other members of the Classes suffered damages in connection with their purchases of Fannie common and preferred shares. Had Lead Plaintiffs and the other members of the Classes known of the material adverse information not disclosed by Defendants, or been aware of the truth behind the material misstatements of the Defendants, they would not have purchased Fannie shares at artificially inflated prices, if at all.

XIII. COUNTS

COUNT I

Violations of Section 10(b) of the Exchange Act, and Rule 10b-5 Promulgated Thereunder, by Defendants for Fraud Regarding Fannie's Risk Management and Controls

523. Lead Plaintiffs repeat and reallege each of the allegations set forth above as if fully set forth herein. This Count is asserted against Defendants Fannie Mae, Mudd and Dallavecchia for violations of Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b), and SEC Rule 10b-5, 17 C.F.R. § 240.10b-5, promulgated thereunder.

524. Fannie Mae and each of the Officer Defendants individually and in concert, directly and indirectly, by the use, means or instrumentalities of interstate commerce and/or of the mails, engaged and participated in a continuous course of conduct to conceal adverse material information about the business, business practices, performance, operations and future prospects of Fannie Mae, as specified herein.

525. The Defendants: (i) employed devices, schemes, and artifices to defraud; (ii) made untrue statements of material fact and/or omitted to state material facts necessary to make

the statements not misleading; and (iii) engaged in acts, practices, and a course of business which operated as a fraud and deceit upon the purchasers of the Company's securities in an effort to maintain artificially high market prices for Fannie Mae's securities in violation of Section 10(b) of the Exchange Act and Rule 10b-5. The Defendants are sued as primary participants in the wrongful and illegal conduct charged herein. The Officer Defendants are also sued as controlling persons of Fannie Mae, as alleged below.

526. During the Class Period, the Defendants named in this Count: (a) deceived the investing public, including Lead Plaintiffs and members of the Classes, as alleged herein; (b) artificially inflated and maintained the market price of Fannie's common stock and preferred stock; and (c) caused members of the Classes to purchase Fannie's common stock and preferred stock at artificially inflated prices.

527. Each of the Officer Defendants' primary liability, and controlling person liability, arises from the following facts: (a) each of the Officer Defendants was a high-level executive and/or director at the Company during the Class Period; (b) each of the Officer Defendants, by virtue of his/her responsibilities and activities as a senior executive officer and/or director of the Company, was privy to and participated in the creation, development and reporting of the Company's financial performance, projections and/or reports; and (c) each of the Officer Defendants was aware of the Company's dissemination of information to the investing public, which each knew or disregarded with severe recklessness was materially false and misleading.

528. As a result of the dissemination of the materially false and misleading information and failure to disclose material facts, as set forth above, the market prices of Fannie's securities and options were artificially inflated, at varying levels, throughout the Class Period. In ignorance of the fact that market prices of Fannie securities were artificially inflated, and relying

directly or indirectly on the false and misleading statements made by the Defendants, or upon the integrity of the market in which such securities trade, and on the truth of any misrepresentations made to appropriate agencies and to the investing public, at the time when such statements were made, and/or on the absence of material adverse information that was known or, with recklessness, disregarded by the Officer Defendants during the Class Period, Lead Plaintiffs and the other members of the Classes acquired Fannie securities during the Class Period at artificially high prices and were damaged thereby, as evidenced by, among others, the stock price declines identified herein that released the artificial inflation from Fannie's securities.

529. At the time of said misrepresentations and omissions, Lead Plaintiffs and the other members of the Classes were unaware of their falsity, and believed the false statements to be true. Had Lead Plaintiffs, the other members of the Classes and the marketplace known the true nature of the operations of Fannie and the noncompliance with federal law, which was not disclosed by the Defendants, Lead Plaintiffs and other members of the Classes would not have purchased or otherwise acquired their Fannie securities during the Class Period, or they would not have done so at artificially inflated prices which they paid.

530. As a result of their making affirmative statements and reports to the investing public, the Defendants had a duty to promptly disseminate truthful information that would be material to investors in compliance with the integrated disclosure provisions of the SEC, as embodied in SEC Regulation S-K (17 C.F.R. § 229.10, et seq.) and other SEC regulations, including accurate and truthful information with respect to the Company's operations and performance, so that the market prices of Fannie's securities would be based on truthful, complete and accurate information.

531. In addition, the false and misleading statements made in the Company's published documents (including but not limited to its press releases and SEC filings) constitute "group published information," which Defendants Mudd and Dallavecchia were responsible for creating. During their respective terms of employment at Fannie, the other Officer Defendants had direct involvement in the daily business of the Company and participated in the preparation and dissemination of Fannie's "group published information." As such, they are personally liable for the false and misleading statements contained in the "group published information."

532. More particularly, Defendant Mudd signed the Company's SEC filings attributed to each of him, below, and is personally liable for the following false and misleading statements that were contained in the "group published information:" the false and misleading statements in the 2004 Form 10-K filed on December 6, 2006; the 2005 Form10-K filed on May 2, 2007; the 2006 Form 10-K filed on August 16, 2007; the 2007 Form 10-K filed on February 27, 2008; and the Forms 10-Q for the first, second and third quarters of 2007 (all filed on November 9, 2007); and the first and second quarters of 2008, filed on May 6, 2008 and August 8, 2008, respectively.

533. In addition to their personal liability for the false and misleading statements that were contained within the "group published information," Defendants Mudd and Dallavecchia each are also liable for the false and misleading statements that they personally made during the Class Period, as follows:

a. Defendant Mudd: his false and misleading statements in (1) the press releases issued on August 16, 2007; November 9, 2007; February 27, 2008; May 6, 2008; August 8, 2008; and (2) news reports on February 23, 2007; August 17, 2007; February 23, 2008; July 11, 2008; July 17, 2008; and August 8, 2008; (3) conference calls held on February 27, 2007; May 2, 2007; August 16, 2007; November 9, 2007; February 27, 2008; May 6, 2008; and August 8, 2008; and (4) Congressional testimony given on March 15, 2007; September 20, 2007; and February 7, 2008; and

b. Defendant Dallavecchia: his false and misleading statements in the calls held on February 27, 2007; August 16, 2007; and November 9, 2007.

534. Each of the Defendants had actual knowledge of the misrepresentations and omissions of material facts set forth herein, or acted with severely reckless disregard for the truth in that each failed to ascertain and to disclose such facts, even though such facts were available to each of them. Such defendants' material misrepresentations and/or omissions were done knowingly or with severe recklessness and for the purpose and effect of concealing Fannie Mae's operating condition and future business prospects from the investing public and supporting the artificially inflated price of its equity securities. As demonstrated by the Defendants' misstatements of the Company's financial condition and performance throughout the Class Period, each of the Officer Defendants, if he did not have actual knowledge of the misrepresentations and omissions alleged, was reckless in failing to obtain such knowledge by deliberately refraining from taking those steps necessary to discover whether those statements were false and misleading. Further evidence of scienter is detailed herein.

A. The Officer Defendants Acted With Scienter

535. The allegations set forth above in ¶¶53-128 establish a strong inference that the Officer Defendants acted with scienter in misrepresenting the adequacy of the Company's risk management and controls during the Class Period. As officers in the Company, the Officer Defendants were in a unique position to understand Fannie's increased exposure to risk due to its

increased investment in subprime and Alt-A loans, failure to manage credit risk through tools such as higher guaranty fees and underwriting requirements. For example, as Chief Risk Officer of Fannie Mae during the Class Period, Defendant Dallavecchia had an intimate understanding of the risk management tools and processes in place at the Company and made it clear that those tools and processes were woefully inadequate, if not completely absent.

536. The Officer Defendants were privy to a number of internal documents and emails produced during the Class Period that discussed the Company's worsening credit profile. For example, as set forth above in ¶¶11-12, and 128, as members of senior management, the Officer Defendants received copies of internal Risk Reports by early 2007 forecasting a surge in loan delinquencies, as well as a home price model forecast predicting a 50% drop in home prices.

537. Accordingly, the Officer Defendants knew or recklessly disregarded that Fannie misrepresented its risk exposure and risk controls.

1. Additional Facts Establishing That Defendants Mudd and Dallavecchia Acted with Scienter with Regard To Fannie's Risk Controls

538. As set forth above in ¶¶127-256, the Officer Defendants repeatedly reassured the investing public during the Class Period that Fannie had the ability to successfully manage its credit risk. Yet, according to Confidential Witness 2, who worked as a Director of Risk Management in the Business Analytics division overseen by Defendant Dallavecchia's Risk Office, Fannie did not evaluate the risk of the subprime mortgage pools it bought, did not have the ability to analyze pools in-house, and did not have a model to evaluate subprime loans and indeed was still building such models as late as August 2007.

539. As set forth above in ¶¶82-83, 92-93, Defendant Dallavecchia, Fannie's Chief Risk Officer, specifically warned Defendant Mudd about the lack of internal controls in emails sent to Mudd on October 28, 2006 and July 16, 2007. In Mudd's later testimony to Congress on

December 9, 2008, he confirmed that he understood Dallavecchia to mean "that [Fannie was] rushing into billions of dollars worth of subprime loan purchases without really knowing what [it was] doing." Indeed, Dallavecchia warned Mudd again, in a second email on July 16, 2007, that "I have been saying that we are not even close to have [sic] proper control processes for credit, market and operational risk. I get a 16pct budget cut. Do I look stupid?"

540. Defendant Dallavecchia specifically stated in an internal email that "[Fannie] has one of the weakest control processes I [have] ever witnessed in my career."

541. Accordingly, Defendants Mudd and Dallavecchia knew that Fannie's risk controls were defective and thus incapable of adequately managing the risks related to the subprime and Alt-A market.

542. Nonetheless, Mudd and Fannie cut Dallavecchia's budget two years in a row by a material amount.

543. On September 20, 2007, notwithstanding Defendant Dallavecchia's July 2007 warnings and the budget reductions—which explicitly placed Defendant Mudd on notice of Fannie's nonexistent controls—Mudd testified before Congress that Fannie could "provide more liquidity help to the home finance market today without taking risks we are not capable of managing" and that Fannie had "vastly reduced [its] material control weaknesses." These facts establish Defendant Mudd's conscious or reckless disregard for the truth in affirming to the investing public the sufficiency of Fannie's ability to manage its credit risk.

2. Additional Facts Establishing That the Officer Defendants Acted With Scienter With Regard To Fannie's Guaranty Fee Pricing

544. The fees Fannie charged for guaranteeing MBS backed by risky subprime and Alt-A loans were crucial to the safety and soundness of Fannie's business model. By charging sufficiently high fees, Fannie could mitigate its exposure to potentially massive losses.

545. Fannie's officers who were responsible for the overall financial health of the Company and for allocating the funding for the purchases made by Fannie, could not have been ignorant of the foregoing described facts regarding allocation and pricing, without having been reckless in their ignorance.

546. Moreover, at all relevant times, confidential pricing sheets showing the guarantee fees that Fannie intended to obtain from lenders were created on a regular basis and circulated internally, including to Fannie's most senior officers. As members of Fannie's senior management, the Officer Defendants knew or recklessly disregarded that Fannie's guaranty fees were inadequate to mitigate the risk of the subprime and Alt-A backing the MBS Fannie guaranteed.

3. Additional Facts Establishing That The Officer Defendants Acted With Scienter With Regard To Fannie's Enforcement Of Underwriting Guidelines

547. The underwriting guidelines to which the Company mandated its lender-customers adhere, and the enforcement of those rules, which defined the Company's risk profile, were of critical importance to Fannie's business and operations. In particular, the quality of the loans Fannie purchased and guaranteed directly impacted the Company's risk exposure.

548. The Defendants knew or were reckless in not knowing that the lenders' underwriting was weak and failed to screen out high-risk loans, because, as the Officer Defendants repeatedly represented to the public, the Company closely monitored the level of quality of that underwriting. As members of Fannie's senior management, the Officer Defendants were privy to this information and therefore knew or recklessly disregarded that Fannie's guaranty fees were inadequate and did not mitigate the risk of the subprime and Alt-A backing the MBS Fannie guaranteed.

4. The Termination of Fannie's Senior Officers' Employment and Fannie's Stock Offerings Create An Inference of Scienter

549. When the U.S. government learned that Fannie had misrepresented its capital position to the public, it instituted a conservatorship over the Company and fired senior management. The government decision to fire senior management lends further support to the inference that the Officer Defendants acted with scienter. The Officer Defendants were motivated to keep Fannie's stock price artificially inflated and its credit rating inflated throughout the Class Period so that Fannie could issue over $14 billion of Preferred Stock and common stock at artificially inflated prices. Fannie's proceeds from its securities issuances during the Class Period included:

Security	**Date**	**Proceeds**
Preferred Series R	November 16, 2007	$500 million
Preferred Series S	December 6, 2007	$7 billion
Common Stock	May 8, 2008	$2.255 billion
Preferred Series 2008-1	May 8, 2008	$2.25 billion
Preferred Series T	May 13, 2008	$2 billion

550. Each of these securities was a direct or indirect obligation of Fannie and each was valued in material part on the basis of Fannie's financial statements and perceived financial strength, perceived ability to manage risks and reported capital. Moreover, these shares all traded at prices closely correlated to the price of Fannie's common stock.

551. These transactions would not have been consummated at the price set, had Fannie fully disclosed its true financial condition.

5. Executive Compensation

552. The Officer Defendants were also motivated to provide materially misleading disclosures in order to conceal Fannie's true financial condition and to maximize their own compensation, particularly during the fiscal years 2006 and 2007.

553. Absent misrepresentations regarding Fannie's true performance and risk management practices, the Officer Defendants would have received materially less compensation in terms of not only cash bonuses, but also overall compensation.

554. In particular, during the Class Period, Defendant Mudd was highly motivated to increase dramatically Fannie's subprime and Alt-A purchases in order to inflate his own personal compensation. Fannie's executive compensation plan included incentives that encouraged excessive risk-taking by Fannie's executives. Fannie's compensation plan offered Fannie executives go-for-broke incentives that motivated them to ignore risk. Faced with such skewed incentives, Fannie executives were motivated to place big bets on risky non-traditional mortgages and securities backed by Alt-A and subprime mortgages.

555. Specifically, Defendant Mudd was granted substantial cash bonuses in 2006 and 2007 for meeting certain performance goals. These performance-based cash bonuses were approximately two to three times these executives' annual salaries. For example, in 2006 Defendant Mudd received $950,000 as his base salary, but $3,500,000 in cash bonuses, or over three times the amount of his base salary.

556. The performance-based cash bonuses were awarded, in part, for successfully launching major strategic business initiatives. Specifically, in 2006, the Board established several performance goals used to determine the amount of cash bonuses it should award executives. One of these goals was expanding Fannie's market share and ramping up the Company's exposure to subprime and Alt-A loans.

557. For 2006, the Compensation Committee determined that the Company had met 110 percent of its corporate performance targets—including "successfully launch[ing] several major strategic business initiatives." The Board therefore determined that Company executives, including Defendant Mudd should receive substantial cash bonuses at 110 percent of target bonus levels.

558. In 2007, the Compensation Committee again made recommendations to the Board regarding the amount of cash bonuses to be paid to senior executives, including Defendant Mudd, based on whether the Company had met performance goals including: "*Business Goals.* Our business goals were to optimize our performance through the achievement of targets for new business, book growth, and economic returns."

559. The Compensation Committee determined that despite Fannie's net loss and falling stock price in 2007, the Company had met or exceeded overall expectations for its performance goals in the aggregate, and therefore Company executives should be awarded cash bonuses at 80% of target levels. Hence, Defendant Mudd was granted substantial cash bonuses in 2007.

560. In 2006 and into 2007, the key business initiative for the Company was the substantial expansion of Fannie's investment in subprime and Alt-A loans. Indeed, according to an August 19, 2008 article in the *Washington Post*, on January 3, 2007, Mudd wrote a confidential memo to Fannie's Board in which he stated that one of Fannie's "achievements" in 2006 was "expanding its involvement in the market for subprime and other nontraditional mortgages," which Mudd called a step "toward optimizing [Fannie's] business." According to this article, a month later, another internal Fannie document outlined the Company's plan to

expand further into the subprime market by buying $11 billion more in "subprime/non-prime mortgages" in 2007, despite recognizing "the already weak performance of subprime loans."

561. The Company had "approached its expansion of this business cognizant of the relatively weak credit performance of recent subprime originations, which were affected by issues relating to underwriting quality, home price de-appreciation . . . and risk layering," one February 2007 document said, referring to loans with multiple risky characteristics. "However, management expects improvement in the quality and credit performance of subprime mortgages originated this year."

562. By March 2007, however, when Mudd sent the Board an update, he had to acknowledge that the subprime sector was "in partial meltdown" and reported to directors that Fannie Mae's investment in subprime mortgage assets totaled about $55 billion.

563. The article further stated that other internal Fannie documents show that "even late in the housing bubble, Fannie Mae was drawn to risky loans by a variety of temptations, including the desire to increase its market share ...." The Fannie documents obtained by *The Washington Post* "paint[ed] a picture of a company ... caught between the imperatives of increasing its market share while avoiding excessive risk. In a bid to juggle these demands, the company's executives took on risks they either misunderstood or unduly minimized."

564. The facts alleged above in ¶¶53-128 establish that the Officer Defendants did not misunderstand the risks but rather, were well aware of them and chose to forge ahead, knowingly or recklessly disregarding the consequences.

565. According to that same *Washington Post* article, "'[b]y entering new markets—especially Alt-A and subprime—and guaranteeing more of [the Company's] customers' products at market prices, [Fannie] met [its] goal of increasing market share from 22 to 25 percent,'"

Mudd wrote in a 2006 year-end report to the Fannie Board dated January 3, 2007. "In other internal documents, there was a common refrain: one of Fannie Mae's objectives for 2006 was to "increase our penetration into subprime." In an interview, Lund said "the company pursued the purchase of subprime loans in 2006 and 2007 at the request of lenders, who wanted Fannie Mae to take the loans off their books." Yet as early as Spring 2005, Lund mused at a conference about the danger to borrowers, asking, "Are we setting them up for failure?" Fannie Mae spokesman Brian Faith acknowledged to the Washington Post that in 2006 and 2007 Fannie Mae broadened its entry into the subprime market.

566. As Defendant Mudd confirmed at a December 9, 2008 hearing before Congress, revenues were a component of the overall consideration for bonuses. Hence, Defendant Mudd was motivated to increase substantially Fannie's subprime and Alt-A purchases—despite, as set forth above, *e.g.*, ¶¶82-83 and 92-93— several warnings that Fannie's risk controls were inadequate—in order to generate revenue and artificially pump up the stock price. By so doing, Mudd was personally able to reap huge cash bonuses. By sharply increasing holdings of Fannie Mae's subprime and Alt-A purchases, Mudd inflated the Company's revenues, thus ensuring large cash bonuses for themselves.

567. In 2006 and 2007, Fannie also gave senior executives restricted stock awards with values of up to ten times the amount of the executive's base salary. For example, in 2006 Defendant Mudd received a restricted stock award worth nearly $10 million, compared to a base salary of $950,000.

568. Fannie's policies in 2006 and 2007 were to have a higher proportion of senior management's compensation be in the form of equity compensation than at comparable companies. Fannie Mae's policy was for the CEO to hold Fannie common stock with value

equal to five times his or her base salary. For the other senior executives, the policy required them to hold Fannie Mae common stock with value equal to three times their base salary.

569. Fannie's policy of having senior executives receive a high percentage of their compensation in the form of equity compensation meant that Officer Defendants were motivated to prop up Fannie's stock price by concealing the true extent of the Company's exposure to high-risk Alt-A and subprime loans, the Company's materially defective risk controls, and the fact that the Company was undercapitalized. Notably, upon announcement of the U.S. government's takeover of Fannie, the Secretary of the Treasury stated that Fannie would "no longer be managed with a strategy to maximize common shareholder returns."

570. The following table depicts the compensation of CEO Mudd in 2006:

Executive	**Base Salary ($)**	**2006 Bonus ($)**	**2006 Long-Term Incentive Award ($)**	**Total Compensation ($)**
Daniel Mudd (CEO)	950,000	3,500,000	9,999,947	14,449,947

571. The following table depicts the compensation of CEO Mudd in 2007:

Executive	**Base Salary ($)**	**2007 Bonus ($)**	**2007 Long-Term Incentive Award ($)**	**Total Compensation ($)**
Daniel Mudd (CEO)	990,000	2,227,500	9,000,000	12,217,500

6. The Investigations by Law Enforcement Authorities and the SEC Suggest Wrongdoing

572. In separate articles by *The New York Times* on September 26, 2008 and *The Washington Post* on September 30, 2008, it was reported that the United States Department of Justice and the SEC had opened investigations into potential accounting, disclosure and

governance problems at Fannie, that the U.S. Attorney had convened a federal grand jury to issue subpoenas to Fannie, and that the SEC had directed Fannie to preserve its records.

573. The investigations and issuance of subpoenas by the U.S. Department of Justice and the SEC as well as the convening of a grand jury further support the inference that the Officer Defendants acted with scienter.

7. Corporate Scienter

574. The cumulative knowledge of all Fannie's agents is imputed to the Company. The facts alleged herein create a strong inference that one or more officers of the Company acted knowingly or recklessly in violating the securities laws.

575. By virtue of the foregoing, Fannie Mae and the Officer Defendants have each violated Section 10(b) of the Exchange Act, and Rule 10b-5 promulgated thereunder.

COUNT II
Violations of Section 10(b) of the Exchange Act, and Rule 10b-5 Promulgated Thereunder, by Defendants for Fraud Regarding Fannie's Risk Exposure to Subprime and Alt-A Mortgages

576. Lead Plaintiffs repeat and reallege each of the allegations set forth above as if fully set forth herein. This Count is asserted against Defendant Fannie Mae and the Officer Defendants for violations of Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b), and SEC Rule 10b-5, 17 C.F.R. § 240.10b-5, promulgated thereunder.

577. Fannie Mae and each of the Officer Defendants individually and in concert, directly and indirectly, by the use, means or instrumentalities of interstate commerce and/or of the mails, engaged and participated in a continuous course of conduct to conceal adverse material information about the business, business practices, performance, operations and future prospects of Fannie Mae, as specified herein.

578. The Defendants: (i) employed devices, schemes, and artifices to defraud; (ii) made untrue statements of material fact and/or omitted to state material facts necessary to make the statements not misleading; and (iii) engaged in acts, practices, and a course of business which operated as a fraud and deceit upon the purchasers of the Company's equity securities in an effort to maintain artificially high market prices for Fannie Mae's equity securities in violation of Section 10(b) of the Exchange Act and Rule 10b-5. The Defendants are sued as primary participants in the wrongful and illegal conduct charged herein. The Officer Defendants are also sued as controlling persons of Fannie Mae, as alleged below.

579. During the Class Period, the Defendants named in this Count: (a) deceived the investing public, including Lead Plaintiffs and members of the Classes, as alleged herein; (b) artificially inflated and maintained the market price of Fannie's common stock and preferred stock; and (c) caused members of the Classes to purchase Fannie's common stock and preferred stock at artificially inflated prices.

580. Each of the Officer Defendants' primary liability, and controlling person liability, arises from the following facts: (a) each of the Officer Defendants was a high-level executive and/or director at the Company during the Class Period; (b) each of the Officer Defendants, by virtue of his/her responsibilities and activities as a senior executive officer and/or director of the Company, was privy to and participated in the creation, development and reporting of the Company's financial performance, projections and/or reports; and (c) each of the Officer Defendants was aware of the Company's dissemination of information to the investing public, which each knew or disregarded with severe recklessness was materially false and misleading.

581. As a result of the dissemination of the materially false and misleading information and failure to disclose material facts, as set forth above, the market prices of Fannie's securities

and options were artificially inflated, at varying levels, throughout the Class Period. In ignorance of the fact that market prices of Fannie securities were artificially inflated, and relying directly or indirectly on the false and misleading statements made by the Defendants, or upon the integrity of the market in which such securities trade, and on the truth of any misrepresentations made to appropriate agencies and to the investing public, at the time when such statements were made, and/or on the absence of material adverse information that was known or, with recklessness, disregarded by the Officer Defendants during the Class Period, Lead Plaintiffs and the other members of the Classes acquired Fannie securities during the Class Period at artificially high prices and were damaged thereby, as evidenced by, among others, the stock price declines identified herein that released the artificial inflation from Fannie's securities.

582. At the time of said misrepresentations and omissions, Lead Plaintiffs and the other members of the Classes were unaware of their falsity, and believed the false statements to be true. Had Lead Plaintiffs, the other members of the Classes and the marketplace known the true nature of the operations of Fannie and the noncompliance with federal law, which was not disclosed by the Defendants, Lead Plaintiffs and other members of the Classes would not have purchased or otherwise acquired their Fannie securities during the Class Period, or they would not have done so at artificially inflated prices which they paid.

583. As a result of their making affirmative statements and reports to the investing public, the Defendants had a duty to promptly disseminate truthful information that would be material to investors in compliance with the integrated disclosure provisions of the SEC, as embodied in SEC Regulation S-K (17 C.F.R. § 229.10, et seq.) and other SEC regulations, including accurate and truthful information with respect to the Company's operations and

performance, so that the market prices of Fannie's securities would be based on truthful, complete and accurate information.

584. In addition, the false and misleading statements made in the Company's published documents (including but not limited to its press releases and SEC filings) constitute "group published information," which Defendants Mudd and Dallavecchia were responsible for creating. As such, they are personally liable for the false and misleading statements contained in the "group published information."

585. In particular, Defendant Mudd is personally liable for the false and misleading statements in the "group published information" in the following Fannie SEC filings that he signed: the 2004 Form 10-K filed on December 6, 2006; the 2005 Form 10-K filed on May 2, 2007; the 2006 Form 10-K filed on August 16, 2007; the 2007 Form 10-K filed on February 27, 2008; and the Forms 10-Q for the first, second and third quarters of 2007 (all filed on November 9, 2007); and the Forms 10-Q for the first and second quarters of 2008, filed on May 6, 2008 and August 8, 2008, respectively.

586. Defendants Mudd and Dallavecchia are also each liable for the false and misleading statements they personally made during the Class Period, as follows:

a. Defendant Mudd's false and misleading statements in (1) conference calls held on February 23, 2007 and February 27, 2007; (2) congressional testimony given on March 15, 2007; and April 17, 2007; and February 7, 2008; and (3) statements to the media on December 2, 2007 and August 20, 2008; and

b. Defendant Dallavecchia's false and misleading statements in a conference call held on February 27, 2007; May 2, 2007; and August 16, 2007.

587. Each of the Defendants had actual knowledge of the misrepresentations and omissions of material facts set forth herein, or acted with severely reckless disregard for the truth in that each failed to ascertain and to disclose such facts, even though such facts were available to each of them. Such defendants' material misrepresentations and/or omissions were done knowingly or with severe recklessness and for the purpose and effect of concealing Fannie's operating condition and future business prospects from the investing public and supporting the artificially inflated price of its equity securities. As demonstrated by the Defendants' misstatements of the Company's financial condition and performance throughout the Class Period, each of the Officer Defendants, if he did not have actual knowledge of the misrepresentations and omissions alleged, was severely reckless in failing to obtain such knowledge by deliberately refraining from taking those steps necessary to discover whether those statements were false and misleading. Further evidence of scienter is detailed herein.

A. The Officer Defendants Acted With Scienter

588. The allegations set forth above in ¶¶257-454 establish a strong inference that the Officer Defendants acted with scienter in misrepresenting the full extent of Fannie's risk exposure to subprime and Alt-A mortgages during the Class Period. As officers in the Company, the Officer Defendants were in a unique position to understand Fannie's heightened risk exposure due to its increased investment in mortgages that should have been publicly disclosed as subprime and Alt-A.

1. Additional Facts Establishing that Defendants Mudd and Dallavecchia Acted with Scienter

589. During the Class Period, the Officer Defendants repeatedly reassured the investing public that Fannie's risk exposure to subprime mortgages was minimal and its exposure to Alt-A mortgages was limited. *See* ¶¶300-388 and 414-454. At the same time, however, the Officer Defendants were privy to a number of internal documents and emails created during the Class Period informing them that Fannie's actual risk exposure to subprime and Alt-A mortgages was significant and increasing, placing the Company's operating results at risk and threatening its ability to maintain its required capital base. For example:

a. As set forth in ¶¶273, 295-296, 349, 394-396 and 471, Defendants Mudd and Dallavecchia regularly received "Credit Risk Briefings" (*e.g.*, FMCIV-NY-02_00021643, at 1651) and "Chief Risk Officer Reports" (*e.g.*, FMCIV-NY-02_00005445, at 5463) showing that Fannie's low-documentation mortgages (loans that should have been included as part of Fannie's Alt-A disclosure) had reached alarming levels during the Class Period.

b. As set forth in ¶¶273, 288, 295-96, 340-343, and 349, Defendants Mudd and Dallavecchia regularly received draft "Credit Supplements" (*e.g.*, FMCIV-NY-02_00023054, at 3060) and "Chief Risk Officer Reports" (*e.g.*, FMCIV-NY-02_00006413, at 6445) showing that the serious delinquency rates of EA mortgages were greater than that of Fannie's subprime loans.

c. As set forth in ¶¶287, 370, a report titled "Expanded Approval/Subprime Analysis," dated January 2008, was prepared by Dallavecchia's CRO office. The report concluded that "EA products look like and largely perform like Subprime collateral," and "[i]n Key Risk Areas, EA and Subprime Underwriting are similar." FMCIV-NY-02_00299696, at 9701, 9705. The report also included a chart showing that the average credit profiles of Fannie's three EA programs were similar to—and in some ways worse—than the credit profile of Fannie's subprime mortgages. *Id.* at 9703.

d. As set forth in ¶¶287, 295, 297, and 371, a report titled "Single Family Book of Business and Update on Loss Mitigation," dated February 29, 2008, was prepared for a Board meeting of the Risk Policy and Capital Committee that both Mudd and Dallavecchia attended. The report concluded that the "primary drivers" of an almost 300% increase in credit losses were Fannie's EA, MCM, and Alt-A mortgages. FMCIV-NY-02_00009036, at 9037. The report also included a chart showing that the credit profile and performance of the EA program overall was worse than the credit profile of Fannie's subprime mortgages. *Id.* at 9038.

e. As set forth in ¶¶295, 297, and 487, on May 22, 2008, Defendant Dallavecchia received a report titled "Credit Review & Initiatives," stating that EA, MCM, and Alt-A mortgages were the "source" of Fannie's increasing serious delinquency rates. FMCIV-NY-02_00047024 at 7026.

f. As set forth in ¶¶295, 297, and 382, on July 17, 2008, Defendant Dallavecchia sent an email to Defendant Mudd stating that EA and

MCM mortgages were "probably going to generate losses of about $5bn, or 20% of our credit losses." FMCIV-NY-02_00098250.

590. Accordingly, the Officer Defendants knew or recklessly disregarded that Fannie misrepresented its risk exposure to subprime and Alt-A mortgages.

2. Executive Compensation

591. The Officer Defendants were motivated to provide materially misleading disclosures to maximize their own compensation. By concealing the full extent of Fannie's risk exposure to subprime and Alt-A mortgages, the Officer Defendants were able to gain market share, and thus enhance their compensation, without alarming investors and driving down Fannie's stock price. Absent these misrepresentations, the Officer Defendants would have received materially less overall compensation.

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

593. Throughout the Class Period, Mudd received an Annual Incentive Plan ("AIP") bonus that was tied to two things: (i) Company performance, measured by attaining corporate year-end goals; and, (ii) personal performance, measured by attaining individual year-end goals. The AIP program was designed to "put part of the participants' total compensation package at risk, based on the achievement of one-year goals for both the participant and the corporation" with individual performance driving the AIP payout each year, adjusted for corporate goal

performance. The AIP bonus for a given year's performance was paid out in the following fiscal year such that an AIP bonus for performance in 2006 was received in 2007. SEC Cmpl ¶41.

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

Mudd served as CEO for only eight full months in 2008 before he was ousted, but his taxable compensation in 2008 was $7.4 million, with more than $2.2 million from his AIP bonus based on his personal performance in 2007. SEC Cmpl ¶42.

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

596. Throughout the Class Period, Dallavecchia also received an AIP bonus tied to attaining corporate and personal goals. When Dallavecchia began as Fannie Mae's CRO, the then-Chairman of the Board of Directors noted in an address to Senior Management, "We have to think differently and creatively about risk... Enrico Dallavecchia was not brought on-board to

be a business dampener." In 2006, Fannie Mae's corporate goals included filing its 2004 Form 10-K, increasing its earnings per share, profitability, and subprime penetration while building a CRO function and implementing business unit risk officers. In his year-end 2006 self-assessment, Dallavecchia noted that the most significant achievement was his office playing a role "from both a risk perspective and also from a business perspective." SEC Cmpl ¶59.

597. In 2007, Fannie Mae's corporate goals included growing revenue and timely periodic filings with the Commission. In large part because Fannie Mae met most of its 2007 corporate goals with respect to growing revenue, Dallavecchia's 2007 taxable compensation was more than $2.6 million with $1.04 million from his AIP bonus. SEC Cmpl ¶60. One month prior to conservatorship, in August 2008, Dallavecchia was terminated as CRO. Accordingly, Dallavecchia served as CRO for only seven full months in 2008; his 2008 taxable compensation was $2.3 million with $923,780 from his AIP bonus. SEC Cmpl ¶61.

3. The Termination of Fannie's Senior Officers' Employment and Investigations by Law Enforcement Authorities and the SEC Suggest Wrongdoing

598. When the U.S. government learned that Fannie had misrepresented its capital position to the public, it instituted a conservatorship over the Company and fired senior management. The government's decision to fire senior management lends further support to the inference that the Officer Defendants acted with scienter.

599. Further, in articles by *The New York Times* on September 26, 2008 and *The Washington Post* on September 30, 2008, it was reported that the United States Department of Justice and the SEC had opened investigations into potential accounting, disclosure and governance problems at Fannie, that the U.S. Attorney had convened a federal grand jury to issue subpoenas to Fannie, and that the SEC had directed Fannie to preserve its records.

600. Thus far, these government investigations have led the SEC to file a civil enforcement action against Defendants Mudd and Dallavecchia and Tom Lund, Executive Vice President in charge of Fannie's Single Family Mortgage Business. In addition, the SEC entered into a non-prosecution agreement with Fannie, which accepted responsibility for its conduct and agreed to cooperate with the SEC in its prosecution of the civil enforcement action against the Officer Defendants.

601. The investigations and issuance of subpoenas by the U.S. Department of Justice and the SEC, the convening of a grand jury, the SEC's civil enforcement action, and the SEC's non-prosecution agreement with Fannie all further support the inference that the Officer Defendants acted with scienter.

B. Corporate Scienter

602. The cumulative knowledge of all Fannie's agents is imputed to the Company. The facts alleged herein create a strong inference that one or more officers of the Company acted knowingly or recklessly in violating the securities laws.

603. By virtue of the foregoing, Fannie Mae and the Officer Defendants have each violated Section 10(b) of the Exchange Act, and Rule 10b-5 promulgated thereunder.

COUNT III
Violations of Section 20(a) of the Exchange Act by the Officer Defendants for the Frauds Regarding Fannie's Risk Management and Controls and Exposure to Subprime and Alt-A Mortgages

604. Lead Plaintiffs repeat and reallege each of the allegations set forth above as if fully set forth herein. This Count is asserted against the Officer Defendants for violations of Section 20(a) of the Exchange Act, 15 U.S.C. § 78t(a).

605. Fannie Mae is a primary violator of Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b), and Rule 10b-5, 17 C.F.R. § 240.10b-5, promulgated thereunder, for the frauds alleged in Count I and Count II, above.

606. The Officer Defendants acted as controlling persons of Fannie Mae within the meaning of Section 20(a) of the Exchange Act, as alleged herein, by reason of their respective positions as officers of Fannie Mae and specific acts alleged above, their ability to approve the issuance of statements, their ownership of Fannie Mae securities and/or by contract. Each of the Officer Defendants had direct control and/or supervisory involvement in the day-to-day operations of the Company during the Class Period, and therefore had the power and authority to control or influence the particular transactions giving rise to the violations of the Exchange Act by the Company as alleged herein, and exercised the same.

607. By reason of their positions and/or status as officers of Fannie Mae during the Class Period, the Officer Defendants are "controlling persons" of Fannie within the meaning of Section 20(a) of the Exchange Act because they had the power and influence to cause the Company to engage in the unlawful conduct complained of herein. Because of their positions of control, the Officer Defendants were able to, and did, directly or indirectly, control the conduct of Fannie's business, the information contained in its filings with the SEC, the public statements about its business, and/or the decision-making of Fannie Mae as set forth herein.

608. Each of the Officer Defendants was provided with or had access to copies of the Company's reports, press releases, public filings and other statements alleged by Lead Plaintiffs to be false or misleading prior to and/or shortly after these statements were issued and had the ability to prevent the issuance of the statements or cause the statements to be corrected. The Officer Defendants also had access to the internal Fannie Mae documents identified herein.

609. The Officer Defendants culpably participated in the fraudulent conduct described herein.

610. As set forth herein, because of their positions at Fannie Mae and their access to material non-public information, the Officer Defendants knew or recklessly disregarded that the statements and representations being made were materially false and misleading and that the adverse facts specified herein had not been disclosed to, and were being concealed from, the public. Thus, each of the Officer Defendants is legally responsible for the falsification of Fannie's public reports, financial statements, press releases and other statements as alleged herein.

611. By virtue of their positions as controlling persons, these Officer Defendants are liable pursuant to Section 20(a) of the Exchange Act for controlling a primary violator of the federal securities laws. As a direct and proximate result of the Officer Defendants' wrongful conduct, Lead Plaintiffs and other members of the Classes suffered damages in connection with their purchases of the Company's securities during the Class Period.

PRAYER FOR RELIEF

WHEREFORE, Lead Plaintiffs pray for judgment as follows:

A. Declaring the action to be a proper class action pursuant to Fed. R. Civ. P. 23;

B. Awarding Lead Plaintiffs and the members of the Classes monetary damages, including interest;

C. Awarding Lead Plaintiffs' counsel reasonable costs and attorneys' fees; and

D. Awarding such equitable/injunctive relief or other relief as the Court may deem just and proper.

JURY DEMAND

Lead Plaintiffs demand a trial by jury.

DATED: March 2, 2012

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