



**Financial Crisis Inquiry Commission
Agenda Item 3 for Business Meeting of October 27, 2010
Minutes of Telephonic Business Meeting of
October 12, 2010**

Agenda Item 1: Call to Order

Chairman Angelides called the telephonic business meeting to order at 12:01pm EDT.

Agenda Item 2: Roll Call

Chairman Angelides asked Gretchen Newsom to call the roll of the Commissioners. Present were Phil Angelides, Bill Thomas, Brooksley Born, Byron Georgiou, Doug Holtz-Eakin, Heather Murren, John W. Thompson, and Peter Wallison. Commissioner Hennessey joined the call during Agenda Item 8. Commissioner Graham was absent.

Also participating in the meeting were: Wendy Edelberg, Executive Director; Gary Cohen, General Counsel; Gretchen Newsom, assistant to Chairman Angelides; and Scott Ganz, assistant to Vice Chairman Thomas. Chris Seefer joined the meeting during Agenda Item 8.

Agenda Item 3: Approval of Minutes of Meeting, September 14, 2010

Chairman Angelides introduced the minutes from the FCIC meeting of September 14, 2010.

MOTION: Born moved and Georgiou seconded a motion to adopt the meeting minutes (attached).

APPROVED: 8-0 (Commissioners Graham and Hennessey were absent.)

Agenda Item 4: Approval of Minutes of Meeting, September 29, 2010

Chairman Angelides introduced the minutes from the FCIC meeting of September 29, 2010.

MOTION: Georgiou moved and Born seconded a motion to adopt the meeting minutes (attached).

APPROVED: 8-0 (Commissioners Graham and Hennessey were absent.)

Agenda Item 5: Chairman's and Vice Chairman's Report

Chairman Angelides and Vice Chairman Thomas informed the Commission that our next meeting would take place on October 26th and 27th – an agenda will be forthcoming shortly and members should expect to have substantial amounts of draft text of the report for their review. Commissioners were asked by the Chairman to keep their schedules flexible during the week of November 15th and leading up to Thanksgiving, in case additional deliberations are needed. The Chairman also informed the Commission that at a subsequent meeting, amendments to Commission rules may be introduced to ensure a realistic timeline and production of the report.

Agenda Item 6: Executive Director's Report

Executive Director Wendy Edelberg updated the Commission on research and investigative work products that are wrapping up and that will be forthcoming for Commissioner review.

Agenda Item 7: Update on the Report

Edelberg reported to the Commission that a draft of Section 3 of the report should be anticipated in advance of the October meetings. Other sections of the report are well underway and in development and will be sent forth to the Commission on a rolling basis.

Agenda Item 8: Referrals to Justice

General Counsel Gary Cohen provided an update on the status of previous referrals to the Department of Justice (DOJ) and introduced the new referrals for consideration by the Commission (attached). Chris Seefer provided the Commission an overview of the staff memos regarding Merrill Lynch and Fannie Mae (attached), and answered Commissioner questions. The Commission discussed criteria for sending referrals to DOJ.

MOTION: Born moved that the Commission finds that the persons described in item 1 and 2 of the Merrill Lynch memo may have violated the laws of the United States and that the Commission refers these matters to the Attorney General of the United States.
MOTION failed for lack of a second.

MOTION: Wallison moved and Thomas seconded a motion that the Commission finds that the persons described within the Fannie Mae memo may have violated the laws of the United States and that the Commission refers this matter to the Attorney General of the United States.

MOTION: Georgiou moved and Murren seconded a substitute motion wherein the Commission finds that the persons described within the Merrill Lynch memo and the Fannie Mae memo may have violated the laws of the United States and that the Commission refers these matters to the Attorney General of the United States.

The Chairman divided the motion into two motions – to make the finding and referral to Justice of the persons cited in the Merrill Lynch memo and to make the finding and referral to Justice for the persons cited in the Fannie Mae memo. The Chairman called for a roll call vote on each motion.

APPROVED: First Motion – Merrill Lynch Memo: 6-1-1-1-1 (ROLL CALL VOTE)

AYE: 6- *Angelides; Thomas; Born; Georgiou; Murren; Thompson*
NAY: 1 - *Hennessey*
PRESENT: 1- *Wallison*
NOT PRESENT: 1- *Holtz-Eakin*
ABSENT: 1- *Graham*

APPROVED: Second Motion – Fannie Mae Memo: 7-1-1-1 (ROLL CALL VOTE)

AYE: 7 - *Angelides; Thomas; Born; Georgiou; Murren; Thompson; Wallison*
NAY: 1 - *Hennessey*
NOT PRESENT: 1- *Holtz-Eakin*
ABSENT: 1- *Graham*

Agenda Item 9: Clayton and Moody's Letters

Chairman Angelides introduced the Clayton and Moody's letters as well as the staff analysis of this correspondence and noted that Vice Chairman Thomas asked that these items be added to the agenda. The Chairman and the Vice Chairman agreed to enter the Clayton letter into the public hearing record of the Sacramento field hearing. The Moody's letter will be included in the archived Commission records.

Agenda Item 10: Comments and Questions from Commissioners

No comments were brought up or questions asked by the Commissioners.

Agenda Item 11: Other Items of Business

No other items of business were brought up by the Commissioners.

Agenda Item 12: Adjournment

Chairman Angelides requested a motion to adjourn the meeting.

MOTION: Murren moved and Thompson seconded a motion to adjourn the meeting at 1:10pm.

APPROVED: 8-0 (Commissioners Graham and Holtz-Eakin absent)



**Financial Crisis Inquiry Commission
Agenda Item 3 for Business Meeting of October 27, 2010
Minutes of Telephonic Business Meeting of
October 12, 2010**

**ATTACHMENT
Approved Minutes of Telephonic Business Meeting of
September 14, 2010**

Agenda Item 1: Call to Order

Chairman Angelides called the telephonic business meeting to order at 12:04pm EDT.

Agenda Item 2: Roll Call

Chairman Angelides asked Gretchen Newsom to call the roll of the Commissioners. Present were Phil Angelides, Bill Thomas, Brooksley Born, Byron Georgiou, Heather Murren, John W. Thompson, and Peter Wallison. Commissioner Hennessey joined the call midway into Agenda Item 10. Commissioner Graham and Holtz-Eakin were absent.

Also participating in the meeting were: Wendy Edelberg, Executive Director; Gary Cohen, General Counsel; Gretchen Newsom, assistant to Chairman Angelides; Scott Ganz, assistant to Vice Chairman Thomas, and Shaista Ahmed, assistant to Wendy Edelberg. Mina Simhai joined the meeting during Agenda Item 10

Agenda Item 3: Approval of Minutes of Meeting, August 17, 2010

Chairman Angelides introduced the minutes from the FCIC meeting of August 17, 2010.

MOTION: Born moved and Wallison seconded a motion to adopt the meeting minutes (attached).

APPROVED: 7-0 (Commissioners Graham, Holtz-Eakin, and Hennessey absent)

Agenda Item 4: Chairman's and Vice Chairman's Report

Chairman Angelides provided the Commission a general update on Commission matters, including a brief update on the initial draft sections of the report; an overview of the field hearings, and staff efforts to wrap up investigations and research. Chairman Angelides and Vice Chairman Thomas emphasized the importance of time tables and the need for continued discussions to inform the Commission where there are agreements and disagreements on report material.

Agenda Item 5: Executive Director's Report and Agenda Item 6: Update on the Report

Executive Director Wendy Edelberg combined her report with Agenda Item 6 – an update on the report. She apprised the Commission of the selection of a senior editor (Mike Bryan) and a website design firm. Edelberg gave an overview of the various sections of the report and which writers are assigned to each section as well as when Commissioners can expect to review material. She noted production toward the final Commission products is moving forward, including the archiving of materials. Edelberg will provide the Commission an estimated schedule of production for draft sections and Commissioner review of these materials.

Agenda Item 7: Upcoming September 28-29 Meeting

Chairman Angelides and Vice Chairman Thomas will flesh out an agenda for the upcoming retreat soon and inquired if Commissioners had thoughts on the most productive way to make progress on coming together on a report. Vice Chairman Thomas raised concerns about the staff's desire to receive input from outside experts, academics and economists and share the document on a confidential basis for the purposes of fact checking and to ensure that seminal events were not missed. Chairman Angelides said there would be value in this to make sure there are not glaring errors, omissions, or mistakes – and asked that staff limit this to only checking facts and not garnering broad opinions.

Agenda Item 8: Field Hearings – Overview of Bakersfield and Las Vegas; and upcoming hearings in Miami and Sacramento

Vice Chairman Thomas informed the Commission that he thought the first two field hearings (Bakersfield and Las Vegas) were interesting and useful and noted the outrageous behavior of lenders as heard from testimony at the local level. Commissioner Murren also noted the value in the field hearings in illuminating the issue of stalled mortgage modifications and resolutions and recommended that the Commission take action on this matter. Chairman Angelides recommended that this topic be covered in Section 4 and Section 2 of the report. Commissioner Georgiou commented on the testimony received in Las Vegas on the impact of the financial crisis on local governments and community services.

Agenda Item 9: Approval of Extension to Execute Agreements and Contracts on behalf of the Financial Crisis Inquiry Commission

General Counsel Gary Cohen introduced the extension to execute agreements and contracts on behalf of the Commission and noted that this would be the last extension.

MOTION: Murren moved and Born seconded a motion to adopt the extension (attached).

APPROVED: 7-0 (Commissioners Graham, Holtz-Eakin, and Hennessey absent)

Agenda Item 10: Referral to Justice Memo

Gary Cohen introduced the referral to justice memo to the Commission and noted that as stated in the memo, if the Commission comes across any potential violations of the law, we are directed to refer these matters to the Attorney General. He noted that some of the seven items outlined in the memo are currently being investigated by other entities, but we have a responsibility to share the information we have with the Department of Justice. Cohen emphasized that this is a referral not a recommendation for prosecution and that if staff are directed to proceed, staff would compile documents in our possession. It was also noted that this referral is strictly confidential during the course of the Commission and after the Commission concludes.

Vice Chairman Thomas expressed concerns about the timing of the referral memo. Commissioner Wallison asked staff to also look into the matter of Fannie and Freddie and mortgage quality reporting and requested that the cover letter does not specify that we are recommending legal action be taken. Vice Chairman Thomas asked that the Commission wait to take action on this matter until at least the upcoming retreat on September 28th and 29th. Commissioner Hennessey asked that the referrals be considered individually rather than as a block.

MOTION: Georgiou moved and Thompson seconded a motion to hold this item over until the retreat of September 28th and 29th.

APPROVED: 8-0 (Commissioners Graham and Holtz-Eakin absent)

Edelberg requested that Commissioners forward preliminary questions via email to Cohen and will organize a separate informational conference call for Commissioners that have questions and concerns on this matter.

Agenda Item 11: Comments and Questions from Commissioners

No comments were brought up or questions asked by the Commissioners.

Agenda Item 12: Other Items of Business

No other items of business were brought up by the Commissioners.

Agenda Item 13: Adjournment

Chairman Angelides requested a motion to adjourn the meeting at 1:30pm.

MOTION: Georgiou moved and Murren seconded a motion to adjourn the meeting.

APPROVED: 8-0 (Commissioners Graham and Holtz-Eakin absent)



**Financial Crisis Inquiry Commission
Agenda Item 3 for Business Meeting of October 27, 2010
Minutes of Telephonic Business Meeting of
October 12, 2010**

**ATTACHMENT
Approved Minutes of Business/Retreat Meeting of
September 29, 2010**

Agenda Item 1: Call to Order

Chairman Angelides called the business meeting to order at 9:20am EDT.

Agenda Item 2: Roll Call

Chairman Angelides asked Gretchen Newsom to call the roll of the Commissioners. Present were Phil Angelides, Bill Thomas, Brooksley Born, Byron Georgiou, Bob Graham, Heather Murren, John W. Thompson, and Peter Wallison. Commissioner Hennessey and Holtz-Eakin were absent.

Also participating in the meeting were: Wendy Edelberg, Executive Director; Gary Cohen, General Counsel; Gretchen Newsom, assistant to Chairman Angelides; Scott Ganz, assistant to Vice Chairman Thomas, Rob Bachmann, assistant to Chairman Angelides, and Courtney Mayo, Assistant to Vice Chairman Thomas. Chris Seefer joined the meeting during Agenda Item 3.

Agenda Item 3: Commissioner Deliberations and Vote on FCIC Memo of Referrals to the Department of Justice

Chairman Angelides introduced the referral to justice memo as distributed for the previous business meeting and the supplemental memo distributed on September 28th by Gary Cohen. Mr. Cohen noted that an informational call open to all Commissioners occurred wherein Commissioners Wallison and Born participated and asked questions pertaining to this matter of FCIC staff, including Mr. Chris Seefer. Commissioner Wallison asked that each referral be considered individually and one at a time by the

Commission. Mr. Cohen informed the Commission that staff may have 1-3 additional referrals and that the memo before the Commission is current and up to date.

MOTION: Born moved and Murren seconded the adoption of the recommendation i.e. that the Commission should find that in these matters the persons or corporations indicated may have violated the law of the United States in relation to such crisis.

DISSCUSSION: The Commission discussed the referral memo and the timing of taking action today and the timing of sending materials to the Department of Justice.

Mr. Seefer advised the Commission of 1-3 additional referrals that may be forthcoming.

The Chairman divided the motion into two motions – whether to move forward today or wait until a later time and then the consideration of each referral item individually.

MOTION: The Chairman called the vote on the motion to act in favor of moving the referral memo forward today with a ROLL CALL VOTE.

APPROVED: 6-2 (ROLL CALL VOTE)
AYE: 6 - *Angelides; Born; Georgiou; Graham; Murren; Thompson*
NAY: 2 - *Thomas; Wallison*
(*Hennessey and Holtz-Eakin absent*)).

The Chairman called for individual votes on each referral referenced in the referral memo.

MOTION: Graham moved and Born seconded the recommendation to make the finding and transmit Item Number 1 of the referral memo to the Department of Justice: “Potential Fraud: False and Misleading Representations about Loan Underwriting Standards by UBS and Other Issuers”

APPROVED: 6-0-1-1 (ROLL CALL VOTE)
AYE: 6- *Angelides; Born; Georgiou; Graham; Murren; Wallison*
NAY: 0
PRESENT: 1- *Thomas*
NOT PRESENT: 1- *Thompson*
(*Hennessey and Holtz-Eakin absent*)).

MOTION: Graham moved and Murren seconded the recommendation to make the finding and transmit Item Number 2 of the referral memo to the Department of Justice: “Potential Accounting Fraud and False Certifications: Fannie Mae”

APPROVED: 6-0-2 (ROLL CALL VOTE)
AYE: 6 - *Angelides; Born; Georgiou; Graham; Murren; Wallison*
NOT PRESENT: 2 - *Thomas, Thompson*

(Hennessey and Holtz-Eakin absent)).

MOTION: Born moved and Graham seconded the recommendation to make the finding and transmit Item Number 3 of the referral memo to the Department of Justice: “Moody’s Appears to Have Made Selective Disclosures of Imminent Ratings Downgrades; UBS and Possibly Other Recipients of this Information Fail to Disclose Upcoming Downgrades to Purchasers of Their Securities”

APPROVED: 5-1-2 (ROLL CALL VOTE)

AYE: 5- *Angelides; Born; Georgiou; Graham; Murren;*

NAY: 1- *Wallison*

NOT PRESENT: 2 - *Thomas; Thompson*

(Hennessey and Holtz-Eakin absent)).

MOTION: Born moved and Graham seconded the motion that the Commission finds that the persons described in Item 4 may have violated the laws of the United States in relation to the financial crisis and that the Commission refer this to the Attorney General of the United States: “Potential Fraud and False Certifications: Citigroup”.

APPROVED: 6-0-2 (ROLL CALL VOTE)

AYE: 6- *Angelides; Born; Georgiou; Graham; Murren; Wallison*

NAY: 0

NOT PRESENT: 2 - *Thomas; Thompson*

(Hennessey and Holtz-Eakin absent)).

MOTION: Georgiou moved and Born seconded the motion that the Commission continue Item 5 of the referral memo until the following meeting or when the Commission considers future referral items: “Potential Fraud by Goldman Sachs in Connection with Collateral Calls on AIG”.

APPROVED: 6-0-2 (Voice vote. Note Present: *Thomas and Thompson. (Hennessey and Holtz-Eakin absent)).*

MOTION: Born moved and Murren seconded the motion that the Commission finds that the persons described in item 6 may have violated the laws of the United States in relation to the financial crisis and that the Commission refer this to the Attorney General of the United States: “Potential Fraud in AIG Investor Calls”.

APPROVED: 6-0-2 (ROLL CALL VOTE)

AYE: 6- *Angelides; Born; Georgiou; Graham; Murren; Wallison*

NAY: 0

NOT PRESENT: 2 - *Thomas; Thompson*

(Hennessey and Holtz-Eakin absent)).

MOTION: Murren moved and Born seconded the motion that the Commission finds that the persons described in item 7 may have violated the laws of the United States in relation to the financial crisis and that the Commission refer this to the Attorney General of the United States: “Potential Fraud by Goldman Sachs in Connection with Abacus 2007-18 CDO”.

APPROVED: 5-1-2 (ROLL CALL VOTE)

AYE: 5- *Angelides; Born; Georgiou; Graham; Murren;*

NAY: 1- *Wallison*

NOT PRESENT: 2 - *Thomas; Thompson*

(Hennessey and Holtz-Eakin absent)).

Chairman Angelides asked for a motion to clarify that the Commission made the finding and refers the matter to the Attorney General for Items 1, 2, and 3 of the referral memo and requested that the motion be divided between Items 1 and 2 and Item 3.

MOTION: Born moved and Graham seconded the motion to clarify the motion pertaining to Items 1 and 2 of the referral memo, that the Commission finds that the persons described in Items 1 and 2 may have violated the laws of the United States in relation to the financial crisis and that the Commission refer this to the Attorney General of the United States: “Potential Fraud: False and Misleading Representations about Loan Underwriting Standards by UBS and Other Issuers” and “Potential Accounting Fraud and False Certifications: Fannie Mae”.

APPROVED: 6-0-2 (ROLL CALL VOTE)

AYE: 6- *Angelides; Born; Georgiou; Graham; Murren; Wallison*

NAY: 0

NOT PRESENT: 2 - *Thomas; Thompson*

(Hennessey and Holtz-Eakin absent)).

MOTION: Born moved and Murren seconded the motion to clarify the motion pertaining to Item 3 of the referral memo, that the Commission finds that the persons described in Item 3 may have violated the laws of the United States in relation to the financial crisis and that the Commission refer this to the Attorney General of the United States: “Moody’s Appears to Have Made Selective Disclosures of Imminent Ratings Downgrades; UBS and Possibly Other Recipients of this Information Fail to Disclose Upcoming Downgrades to Purchasers of Their Securities”.

APPROVED: 5-1-2 (ROLL CALL VOTE)

AYE: 5- *Angelides; Born; Georgiou; Graham; Murren;*
NAY: 1- *Wallison*
NOT PRESENT: 2 - *Thomas; Thompson*
(*Hennessey and Holtz-Eakin absent*)).

Commissioner Wallison asked staff to again look into the matter of Fannie and Freddie mortgage quality reporting. Chairman Angelides asked that this matter be brought back to the Commission for our next business meeting on October 12th.

Commissioner Wallison requested that staff share a copy of the final referral memo to the Department of Justice with the Commission before it is submitted. Staff expressed that extra security precautions will be taken for the review of this document due its highly confidential nature.

Agenda Item 4: Commission Comments on tone and approach of sample report section and timeline

The Commission provided staff general comments on the tone and approach of the draft section that was provided for their review, including how the “why” of the financial crisis will be incorporated into the report. Overall, the Commissioners were pleased with the tone and writing of the sample draft section.

Agenda Item 5: Adjournment

Chairman Angelides requested a motion to adjourn the meeting.

MOTION: Thompson moved and Georgiou seconded a motion to adjourn the meeting.

APPROVED: 8-0 (Commissioners Hennessey and Holtz-Eakin absent)



**Financial Crisis Inquiry Commission
Agenda Item 3 for Business Meeting of October 27, 2010
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October 12, 2010**

**ATTACHMENT
Confidential Referral Memorandum Supplement**

FROM: Financial Crisis Inquiry Commission Legal Staff
TO: Commissioners of the Financial Crisis Inquiry Commission
Cc: Wendy Edelberg
DATE: October 11, 2010
RE: Confidential Referral Memorandum Supplement

Pursuant to section 5(c) (4) of the Fraud Enforcement and Recovery Act of 2009, one function of the Financial Crisis Inquiry Commission is to:

refer to the Attorney General of the United States and any State attorney general any person that the Commission finds may have violated the laws of the United States in relation to such crisis.

This Confidential Referral Memorandum Supplement is further to our prior Memorandum of September 12, 2010, discussed at the Commission's Telephonic Business Meeting of September 14, 2010 .

Merrill Lynch & Co., Inc. Evidence discovered during the investigation of Merrill Lynch & Co., Inc. ("Merrill") indicates

(1) that former CEO Stanley O'Neal and former CFO Jeffrey Edwards may have violated the federal securities laws by making materially false and misleading representations and omissions

about (a) Merrill's exposures to retained CDO positions, (b) the value of those positions and (c) the firm's risk management.

(2) that Merrill may have made materially false and misleading representations in the offering documents related to the \$1.5 billion Norma CDO issued in March 2007.

(3) Merrill may have aided and abetted fraud or breaches of fiduciary duty by collateral managers to the investors in the CDOs they managed by purchasing CDO tranches from Merrill without performing sufficient due diligence because Merrill told the collateral managers that they would not be retained as collateral managers unless they purchased collateral from Merrill for the CDOs they managed.

Possible False and Misleading Statements and Omissions About Merrill's Risk Management, Retained CDO Positions and the Value of the Retained CDO Positions

Buildup of Retained CDO Positions. Documents produced by Merrill to the FCIC staff, including a 9/26/07 Market Risk Management Update show that Merrill's "net" exposures to ABS CDOs increased from \$7.2 billion as of 8/31/06 to \$32.2 billion as of 7/07.

Merrill ABS CDO Positions – Net (in millions)

Date	High Grade	Mezzazine	CDO^2	Total
8/06	5,580	1,610	0	7,190
9/06	7,210	2,075	0	9,285
1/07	12,810	4,524	0	17,334
2/07	15,175	4,737	370	20,282
3/07	18,620	6,109	700	25,429
4/07	23,220	6,192	1,340	30,752
5/07	22,310	6,117	440	28,867
6/07	22,310	6,423	1,620	30,353
7/07	24,120	6,438	1,505	32,158
8/07	18,286	6,228	1,201	25,715
9/07	18,158	6,173	1,201	25,532

A December 3, 2007 presentation to the Merrill Board of Directors showed that Merrill's "net" ABS CDO exposures varied from the amounts shown in the September 26, 2007 presentation and certain earnings calls: \$18.9 billion as of September 30, 2006 (not \$9.3 billion), \$28.5 billion as of December 31, 2006, \$31.5 billion as of March 31, 2007 (not \$25.4 billion), \$33.9 billion as of June 30, 2007 (not \$30.4 billion), \$15.8 billion as of September 30, 2007 (not \$25.5 billion), and \$14.6 billion as of October 31, 2007.

Dow Kim, the former co-president of Merrill's Global Markets and Investment Banking ("GMI") segment told FCIC staff that the buildup of the retained CDO positions was part of a strategy begun in late 2006 to reduce the firm's warehouse exposure to subprime.

In a 3/30/07 memo prepared by the SEC's Office of Prudential Supervision and Risk Analysis ("OPSRA"), it was reported that Merrill was "actively pushing their subprime mortgage inventory into several ABS CDO deals" because there was an increase in the demand for lower rated tranches of ABS CDOs, particularly from hedge funds. It was also reported that Merrill was "experiencing difficulty in placing the higher rated product, causing the desk to bump up against its limits."

An "ABS Warehouse/CDO Inventory Chronology" produced by Merrill reported deterioration in the ABS CDO market from 3/07 to 5/07 and further increases in ABS CDO inventory. Specifically, it was reported that from 3/07-5/07 (1) Merrill began an active risk-mitigation strategy, (2) Merrill's warehouse declined to \$3.5 billion while inventory increased to \$30.7 billion as the firm actively reduced the warehouse by printing deals, (3) Merrill was required to retain senior and mezzanine tranches to complete deals, (4) Merrill had to enhance mezzanine tranches to the detriment of senior tranches to complete deals, (5) there was a market for selling senior and mezzanine tranches but at a loss, and (6) \$10 billion of deals were completed with Merrill taking significant senior and mezzanine tranches into inventory.

During a July 22, 2007 Finance Committee Meeting and a July 23, 2007 Board of Directors meeting, it was reported that Merrill's retained CDO interests were approximately \$32 billion due to a risk transformation strategy begun in 12/06 that reduced substantial warehouse risk by securitizing and hedging the warehouse. Both meetings were attended by Mr. O'Neal and Mr. Edwards. Mr. O'Neal told FCIC staff this was the first time he learned of the retained CDO positions but the initiation of the risk transformation strategy in 12/06, the buildup of retained CDO positions shortly thereafter and other documents indicate he may have known earlier. For example, during an April 26, 2007 Board meeting, it was reported that Merrill was pursuing an active risk mitigation strategy that included (1) reducing warehouse loans, (2) discontinuing whole loan purchases, (3) reducing originations by First Franklin, and (4) limiting the level of retained residual interests which were \$1.5 billion as of 4/07 and projected to be \$1.6 billion in 6/07.¹ In addition, it was reported in a summary of a 11/29/07 meeting between Merrill executives (including CFO Edwards) and the Federal Reserve that "senior executives were involved in key determinations about the subprime-related businesses at Merrill *throughout 2007*" and that "senior executives get regular risk reports as a matter of course and were involved in discussions about the business, particularly focused on First Franklin in the first half of the year and later the CDO business."²

1Q07 Earnings Conference Call. On April 19, 2007, Merrill reported 1Q07 results - its second highest quarterly revenues ever and record net revenues from the FICC (Fixed Income, Currencies and Commodities) business (the business housing the increased retained ABS CDO positions) but Merrill failed to disclose the increase in the ABS CDO positions or the fact that the firm was only able to sell senior and mezzanine CDO tranches at a loss even though analysts asked about Merrill's exposure to subprime.

During the conference call, then CFO Edwards indicated that Merrill's results would not be adversely affected by the dislocation in the subprime market because "revenues from subprime mortgage-related activities comprise[d] less than 1% of our net revenues" over the last five quarters, and because Merrill's "risk management capabilities are better than ever, and crucial to our success in navigating turbulent

¹ 4/27/07 U.S. Residential Mortgage Update, BAC-ML-CDO-000076828-6861, at 6847-54.

² 11/29/07 Senior Supervisors Meetings, Merrill Lynch, November 29, 2007; FCIC-125522-527 at 125523 and 125525.

markets.” He provided further assurances, stating, “we believe the issues in this narrow slice of the market remain contained and have not negatively impacted other sectors.”

Analysts indicated that they understood the message to be that the dislocation in the subprime market had not adversely impacted Merrill but asked Edwards if Merrill was changing its risk appetite. Edwards said nothing about the increase in retained ABS CDO positions or the fact that Merrill was selling ABS CDOs at a loss, repeated the importance of Merrill’s risk management and said the FICC business “powered right through” the dislocation in the subprime market.

Well, let me make a couple of points about that. Certainly risk management, as I said in the prepared remarks, is a crucial aspect of our business. I think we have done a very good job in negotiating these markets as a result of that. So how are we approaching that? We are certainly looking at new ways to do business where there are opportunities for us to either share risk or pre-sell some of the risk and still do good business. So I think we are approaching it in a prudent way given the environment.

But let me just reiterate that in these markets, in these asset classes, it is important to recognize that there are going to be periods of dislocation. This particular quarter, there was one in the U.S. subprime business and it’s, as you point out, it is important to react to that. But it is going to – as part of a broader portfolio of businesses, you are able to deal with those types of markets. As you can see, the fixed income business just powered right through that.

Edwards responded to a question about CDO trends that Merrill was able to price 28 CDO transactions during the quarter but said nothing about the increase in retained ABS CDO positions or the fact that ABS CDO tranches were being sold at a loss.

In response to a question about whether there were “any big shifts since the beginning of the year” in “the level of [] overall retained interest for mortgage securitizations,” Edwards failed to disclose the increase and stated that the majority of retained interests were “investment grade rated securities that are either part of our CDO warehouse or the result of securitizations that are effectively in inventory, that we intend to sell on to investors” and that there was “only a small part that reflects the sub-prime residuals.”

2Q07 Earnings Conference Call. On July 17, 2007, Merrill reported 2Q07 results including “very strong net revenues, net earnings and earnings per diluted share for the second quarter of 2007, which enabled the company to achieve record net revenues, net earnings and net earnings per diluted share for the first half of 2007.” During the conference call, CFO Edwards repeated the results reported in the press release and after completing his prepared remarks, UBS analyst Glenn Schorr asked Edwards to provide some color on Merrill’s exposure to retained ABS CDO positions. Similar to the 1Q07 earnings conference call, Edwards stressed Merrill’s risk management and the fact that the CDO business was a small part of Merrill’s overall business. He also said that there were significant reductions in Merrill’s exposures to lower-rated segments of the market. However, the “net” exposure of Merrill’s ABS CDO retained interests had increased from \$17.3 billion in January 2007 to \$25.4 billion in March 2007 and to \$30.4 billion in June 2007. Edwards failure to disclose the increase in CDO exposure could be construed as material information that made his statements about reductions in exposures to lower-rated segments of the market misleading.

Deutsche Bank analyst Mike Mayo asked Edwards to disclose the level of assets related to subprime mortgages, CDOs and warehouse lines so he would know how much of the firm's capital was at risk from these asset classes but Edwards responded that "we don't disclose our capital allocations against any specific or even broader group."

3Q07 Earnings Call and Disclosure of CDO Losses but Refusal to Provide Gross Exposures. On 10/24/07, Merrill reported 3Q07 results including a net loss from continuing operations of \$2.3 billion, or \$2.85 per diluted share. The results included write-downs of \$7.9 billion related to the retained CDOs (\$6.9 billion) and U.S. sub-prime mortgages (\$1.0 billion). Merrill also reported for the first time its net exposures to retained CDO positions, which were \$15.2 billion. The disclosure of the retained CDO exposures and related write-downs indicate that the statements made by Edwards during the 1Q07 and 2Q07 earnings calls may have been materially false and misleading. In addition, O'Neal and Edwards may have made materially false and misleading representations or omissions during the 10/24/07 conference call. First, the amount of subsequent write-downs indicates that it is possible Edwards and O'Neal knew that the reported 3Q07 write-downs were insufficient. As shown below, Merrill reported more than \$20 billion of additional CDO-related write-downs over the next 5 quarters.

Write-Downs and Credit Valuation Allowances (in billions)

	3Q07	4Q07	1Q08	2Q08	3Q08	4Q08	Total
ABS CDO Writedowns	5.80	8.70	1.80	3.50	6.40	0.40	26.60
Other Retained & Warehouse Exposures	1.10	1.10	(0.30)	0.20	0.20	(0.10)	2.20
Credit Valuation Allowances	0.00	2.60	3.00	2.90	1.30	3.20	13.00
Subprime Writedowns	1.00	1.60	0.30	0.50	0.40	0.10	3.90
Alt-A	N/R	0.40	0.40	0.50	0.50	0.00	1.80
USB Subprime	N/R	0.90	0.70	0.30	0.10	0.20	2.20
USB Alt-A	N/R	0.70	0.20	1.40	0.60	0.80	3.70
USB CRE	N/R	0.30	0.70	(0.30)	0.40	0.10	1.20
Non U.S.		0.50	0.10	0.20	1.30	0.20	2.30
Total	7.90	16.80	6.90	9.20	11.20	4.90	56.90

Merrill Lynch Net Income/(Loss) (in billions)

3Q07	4Q07	1Q08	2Q08	3Q08	4Q08	Total
(\$2.30)	(\$9.90)	(\$2.10)	(\$4.90)	(\$7.50)	(\$16.00)	(\$42.70)

Further, O'Neal and Edwards may have made misleading statements about Merrill's exposures to CDOs. During the 10/24/07 conference call, CEO O'Neal and CFO Edwards refused to disclose Merrill's gross exposures despite repeated requests from analysts. In response to a request to breakdown what was sold and what was hedged, CFO Edwards stated "I just don't want to get into the details behind that." When pressed for more information on the exposures, CFO Edwards stated "let me just say that what we have provided again we think is extraordinarily high level of disclosure and it should be sufficient." Deutsche

Bank analyst Mike Mayo disagreed and asked management to provide additional information but his request was rejected.

Documents obtained from Merrill and the SEC, and subsequent disclosures by Merrill after O’Neal and Edwards left the firm indicate that O’Neal and Edwards representations about Merrill’s CDO net exposures may have been materially false and misleading because they failed to disclose that there were billions of dollars of hedges that they knew might not be effective.

Merrill hedged its long exposures of U.S. super senior ABS CDOs with the monolines, either through a guarantee or through a credit default swap. Documents produced by the SEC to the FCIC reveal that Merrill began to increase the amount of credit default protection purchased from financial guarantors in July 2007 to offset its long exposure to the super senior ABS CDO positions. The SEC became concerned with the viability of the financial guarantors in early Fall 2007 as rating agencies began to downgrade them and the SEC raised those concerns with Merrill because it had purchased \$95.9 billion of notional credit default protection from the financial guarantors. Indeed, the SEC told Merrill that it would impose a punitive capital charge on the firm if it purchased additional credit default protection from the financial guarantors. The SEC’s threat of a capital charge resulted in Merrill ceasing any further purchases.

The SEC also reported that Merrill recognized there was uncertainty about the value of the credit default protection purchased from the financial guarantors. The 11/6/07 SEC Office of Prudential Supervision and Risk Analysis memo reported that Merrill had purchased CDS protection from several financial guarantors but that Merrill was beginning to question their ability to perform under all scenarios since the financial guarantors had recently reported GAAP-based losses. As shown in the chart above, beginning in 4Q07, Merrill recorded \$13.0 billion of credit valuation allowances (“CVAs”) because of the deteriorating financial condition of the monolines and their inability to comply with the terms of the guarantees.

During Merrill’s January 17, 2008 conference call, newly hired CFO Nelson Chai reported that Merrill’s net exposure to super-senior ABS CDOs was \$4.8 billion as of December 31, 2007, but was \$30 billion when excluding the impact of hedges and short positions. On April 17, 2008, Merrill reported that its super senior ABS CDO exposure was \$26 billion as of March 31, 2008. On July 17, 2008, Merrill reported that at the end of 2Q08 it had \$20 billion of long ABS CDO positions and \$16 billion of short positions, but \$9.6 billion of the short positions were hedges with the monolines which were valued at just \$2.9 billion. Eleven days later, Merrill reported that it had sold \$30.6 billion of ABS CDOs (with a carrying value of \$11.6 billion) to Lone Star Funds for \$6.7 billion. Merrill’s ABS CDO exposures caused Merrill to record tens of billions of dollars in write-downs and related charges (e.g., CVAs on monoline hedges) in 2007 and 2008. These facts indicate that the gross CDO exposures, particularly given the questionable value of the monoline hedges, was material information that should have been disclosed given the representations that were made by O’Neal and Edwards during the 1Q07, 2Q07 and 3Q07 earnings calls.

A. Possible False and Misleading Representations in the Norma CDO Offering Documents

The FCIC discovered evidence indicating that Merrill Lynch may have violated the federal securities laws by misstating and omitting key facts regarding its issuance of a \$1.5 billion “hybrid” CDO called

“Norma,” which was created and marketed in March 2007. NIR Capital Management, LLC (“NIR”) was the collateral manager for Norma. The Norma Preliminary Offering Circular, marketing materials and NIR engagement letter all represented that NIR, as the collateral manager, bore sole responsibility for the selection of the Norma collateral.³ As a collateral manager, NIR was responsible for purchasing CDO assets and managing them according to specified guidelines.⁴ The Norma Preliminary Offering Circular provided a specific description of NIR’s role as the collateral manager, stating that the collateral manager will perform:

certain advisory functions and certain administrative functions with respect to the Collateral pursuant to a collateral management agreement . . . the Collateral Manager will manage the Acquisition and Disposition of the Collateral Debt Securities, including exercising rights and remedies associated with the Collateral Debt Securities, Disposing of the Collateral Debt Securities and certain related functions.⁵

The Preliminary Offering Circular described the collateral management agreement with NIR, which stated that NIR “will be authorized to supervise and direct the investment, reinvestment and Disposition of Collateral Debt Securities, Equity Securities and Eligible Investments, with full authority and at its discretion (without specific authorization from the Issuer), on the Issuer’s behalf and at the Issuer’s risk,”⁶

While NIR was the collateral manager, Magnetar Capital LLC (“Magnetar”), a hedge fund, was an equity investor in Norma, purchasing the \$50 million equity tranche in Norma for \$15.5 million, the G and H tranches at par (\$38 million), \$9.25 million of CDS against the B tranche and receiving \$4.5 million in fees.⁷ During a discussion on October 4, 2010, SEC staff told FCIC staff that Magnetar was short about \$94 million into the deal. Evidence obtained by the FCIC indicates that Merrill failed to disclose two important facts. First, Merrill did not disclose the fact that Magnetar was involved in the collateral selection process of the CDO. Second, Merrill failed to disclose that Magnetar had taken a short position in the assets it was selecting for Norma’s portfolio. By concealing Magnetar’s role in selecting the assets and its short interest, the Preliminary Offering Circular failed to disclose to Norma’s investors that assets were being selected by an investor that would profit if the value of the collateral declined.

Information obtained from counsel for Rabobank (a bank that sued Merrill to recover the balance of a \$58 million loan to Norma, and settled) indicates that Merrill knew that (i) Magnetar selected collateral for the Norma CDO, (ii) Magnetar had the right to veto collateral decisions made by NIR and (iii) Magnetar would take short positions in the assets it selected for the Norma CDO. The FCIC is in the process of obtaining documents directly from Merrill that were identified by Rabobank’s counsel and referenced in a letter to the court that will reportedly show the following:

³ BAC-ML-CDO 000057429-782 (Offering Circular); 59222-301 (marketing materials); 59153-164 (NIR engagement letter).

⁴ Suresh Sundaresan, “Fixed Income Markets and their Derivatives,” Academic Press, p. 400 (2009).

⁵ Preliminary Offering Circular of Norma CDO I LTD and Norma CDO I LLC dated January 18, 2007, p 5.

⁶ Preliminary Offering Circular of Norma CDO I LTD and Norma CDO I LLC dated January 18, 2007, p 197.

⁷ BAC-ML-CDO-000079743 (Magnetar investments in Norma); BAC-ML-CDO-000059221 (fees received).

In August 2006, Magnetar assumed NIR's role in directing the collateral purchases, as evidenced by the quote of Magnetar's James Prusko ("Prusko"), Head of Structured Products, stating, "Here is the first batch of protection purchases I'm planning for NIR."⁸

By November 2006, Magnetar had executed about \$600 million in trades for Norma without involving NIR, as evidenced by an unattributed quote, "Apparently NIR allowed Magnetar to do some trading for their portfolio (in the area of 600MM). This accounted for a large chunk of trading that NIR originally didn't recognize."⁹ In response to this statement, a Merrill corporate risk manager asked, "Dumb question. Is Magnetar allowed to trade for NIR?"¹⁰

Magnetar exercised veto rights on the trades that NIR actually executed, as Prusko told NIR that "I definitely want to approve any CDO's that go in the deal. . . ."¹¹

Merrill recognized that Magnetar's short positions in Norma were more important to it than its long positions, as evidenced by an unattributed quote most likely made by a Merrill employee, stating "I think Jim [Prusko] is less worried about his deal pricings and more worried about where he can short paper in the aftermarket."¹²

The circumstances surrounding Merrill's conduct in the Norma CDO are similar to Goldman's alleged conduct in the Abacus 2007-AC1 CDO that resulted in the SEC lawsuit and subsequent \$550 million settlement. In that case, Goldman represented in the ABACUS marketing materials and offering circular that ACA Management LLC acted as collateral manager for the CDO when in fact Paulson & Co. Inc. ("Paulson") participated in the collateral selection process and took a short position against the CDO.¹³

FCIC staff has spoken with SEC officials who have confirmed the SEC is investigating the Norma CDO. In addition, Rabobank sued Merrill on June 12, 2009, to recover the balance of a \$58 million loan to Norma. The Rabobank complaint alleged that Merrill fraudulently induced Rabobank to provide a \$57.7 million senior secured loan to Norma.¹⁴ Rabobank settled its case with Merrill, and on August 6, 2010 the case was dismissed.¹⁵ The terms of the settlement are confidential.

Possible Improprieties by Merrill and Collateral Managers to Help Merrill Sell CDOs As noted above, Merrill was retaining super senior tranches of CDO and selling the subordinate tranches in 2006 and 2007 in an effort to reduce warehouse risk. Many of the subordinate tranches were sold to collateral managers that put them in other CDOs they managed. For example, at least 10 of the 12 purchasers of the Norma tranches were collateral managers in CDOs underwritten by Merrill.¹⁶ FCIC has obtained from Merrill a listing of 44 CDOs underwritten by Merrill from 4Q06 through 8/07 that includes (1) the purchasers of each tranche, (2) the collateral manager for each CDO, (3) the performance of the CDO and

⁸ Document provided by Rabobank's counsel, ML01395145.

⁹ Document provided by Rabobank's counsel, ML01396714.

¹⁰ Document provided by Rabobank's counsel, ML01396714.

¹¹ Document provided by Rabobank's counsel, ML01396692.

¹² Document provided by Rabobank's counsel, ML01486349.

¹³ SEC Release No. 21592 (July 15, 2010).

¹⁴ *Cooperatieve Centrale Raiffeisen-Boerenleenbank, B.A. v. Merrill Lynch & Co.*, Case No. 09601832 (New York Supreme Court), Complaint at ¶4.

¹⁵ *Centrale Raiffeisen-Boerenleenbank, B.A. v. Merrill Lynch & Co.*, Index No. 601832/09 (August 6, 2010).

¹⁶ BAC-ML-CDO-000079743 (listing of Norma cash note purchasers) and 79752 (listing of collateral managers).

(4) a listing of Merrill's collateral managers. Many of the purchasers in these CDOs were collateral managers in CDOs underwritten by Merrill. During the July 22, 2007 presentation to the Merrill Finance Committee, it was reported that new CDO deals were contingent on managers committing to or placing equity tranches.¹⁷ The purchase of the CDO tranches by Merrill's collateral managers may have been improper if they purchased the tranches without proper due diligence and at the request – or demand – by Merrill. It is possible that there was a quid pro quo that the collateral managers had to buy Merrill's CDOs to continue to receive collateral manager business from Merrill.

FCIC staff spoke to SEC officials who said that the SEC is investigating CDOs and specifically the role of these collateral managers and their purchase of CDOs for other CDOs they managed. In fact, the SEC filed charges against ICP Asset Management on 6/22/10 alleging ICP fraudulently managed multi-billion-dollar CDOs by repeatedly causing the CDOs to purchase securities at inflated prices to make money for ICP and to protect certain ICP clients from realizing losses.¹⁸ More specifically, the SEC alleged in the complaint filed on 6/21/10 that "ICP and the other Defendants put their interests ahead of their advisory clients and improperly obtained tens of millions of dollars in fees and undisclosed profits at the expense of clients and investors."¹⁹ George S. Canellos, Director of the SEC's New York Regional Office, further discussed the complaint, stating that "[t]he CDOs were complex but the lesson is simple: collateral managers bear the same responsibilities to their clients as every other investment adviser. When they violate their clients' trust, we will hold them accountable."²⁰

The FCIC has information produced by Merrill related to the purchasers of 44 CDO Merrill underwrote and issued from 4Q06 through 8/07 and databases of information on CDOs obtained from Moody's and S&P. We do not know if the SEC has this information and believe we should make it available given the fact the SEC is investigating collateral manager dealings with Merrill and other CDO underwriters.

¹⁷ BAC-ML-CDO-000076862-884, at 869-870.

¹⁸ SEC Complaint against ICP Asset Management, LLC, ICP Securities, LLC, Institutional Credit Partners, LLC and Thomas C. Priore, filed June 21, 2010.

¹⁹ SEC Complaint against ICP Asset Management, LLC, ICP Securities, LLC, Institutional Credit Partners, LLC and Thomas C. Priore, filed June 21, 2010, pg 3.

²⁰ Press Release, SEC Charges N.Y.-Based Investment Adviser With Fraudulent Management of CDOs Tied to Mortgage-Backed Securities, June 21, 2010, p 2.



**Financial Crisis Inquiry Commission
Agenda Item 3 for Business Meeting of October 27, 2010
Minutes of Telephonic Business Meeting of
October 12, 2010**

**ATTACHMENT
Confidential Memorandum (Fannie Mae Subprime Disclosures)**

TO: Commissioners of the Financial Crisis Inquiry Commission

FROM: Financial Crisis Inquiry Commission Legal Staff

Cc: Wendy Edelberg, Greg Feldberg

DATE: October 11, 2010

RE: Fannie Mae's Subprime Disclosures/Commissioner Wallison's Request

Commissioner Wallison has expressed in prior Commission meetings and to Commission staff that the disclosure of the amount of subprime and Alt-A loans held by Fannie Mae in the past raises certain concerns. We have examined the disclosure issue in certain of Fannie Mae public filings from 2004 to 2008 and agree that the issue is worthy of consideration, but conclude that we do not believe a referral is warranted in these circumstances.

Background

In its **3Q08 Form 10-Q**, Fannie Mae included the following disclosures related to its classification of subprime and Alt-A loans.

Alt-A and Subprime loans. We provide information below on our exposure to Alt-A and subprime mortgage loans. We have classified mortgage loans as Alt-A if the lender that delivers the mortgage loan to us has classified the loan as Alt-A based on documentation or other features. 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 Alt-A and subprime loan exposures; however, ***we have other loans with some features that are similar to Alt-A and subprime loans that we have not classified as Alt-A or subprime because they do not meet our classification criteria. (emphasis added)***

Elsewhere in the 2008 filing, Fannie Mae did discuss with some specificity the levels of its holdings with characteristics "similar" to what it was calling Alt-A and subprime, such as the amount of loans in certain FICO ranges and the percent of loans characterized by (1) the original LTV ratio, (2) the estimated mark-to-market LTV ratio, and (3) loan type including interest-only, adjustable rate or fixed, and negative amortization.

This highlighted disclosure appears to be the culmination of an evolving disclosure standard concerning Fannie Mae's subprime and Alt-A holdings from 2004 through 2008.

To illustrate the evolving nature of the disclosure, Fannie Mae's **2004 Form 10-K** (filed 12-6-2006) makes no references with respect to either FICO exposure segmentation or "subprime", or alternative underwriting and documentation guidelines, except following.

"Alt-A mortgage" refers to a mortgage loan underwritten using more liberal standards such as higher loan-to-value ratios and less documentation of borrower income or assets.²¹

"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

²¹ 2004 Form 10-K at 35

offered for these mortgages often was insufficient compensation for the additional credit risk associated with these mortgages.”²²

In its **2005 Form 10-K**, Fannie Mae disclosed how it defined subprime and represented that the percentage in the single family credit book of business consisting of subprime loans or MBS backed by subprime mortgage loans was not material as of December 31, 2005.²³

“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. (emphasis added)

While not providing granularity within the single family book of business by LTV and FICO band, as was the case in the subsequent years, Fannie did disclose the volume of interest only and negative amortizing adjustable rate mortgages (ARM) for 2005 and 2004. Finally, disclosures regarding the extent of Fannie concentrations in loans with alternative or non-traditional underwriting and documentation guidelines were not evident in the 2005 10-K. Fannie did state it was increasing its level of participation in this space but was not specific in terms of product classification, business volume, and concentration of the single family book of business.²⁴

In the **2007 Form 10-K**, Fannie disclosed the subprime classification criteria that was included in the 3Q08 Form 10-Q, but did not include the bolded portion that referenced the existence of other loans which might also meet the subprime and Alt-A criteria:

*“Subprime mortgage loans are typically originated by lenders specializing in these loans or by subprime divisions of large lenders, 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.”*²⁵

²² 2004 Form 10-K at 40

²³ 2005 Form 10-K at 122, emphasis added.

²⁴ 2005 Form 10-K at 122

²⁵ Pg 129 and 155, Fannie Mae 2007 Form 10K, emphasis added.

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 2005.²⁶

We estimate that subprime mortgage loans held in our portfolio or subprime mortgage loans backing Fannie Mae MBS, excluding re-securitized private label mortgage related securities backed by subprime mortgage loans, represented approximately *0.3% of our single-family mortgage credit book of business* as December 31, 2007, compared with 0.2% and 0.1% as of December 31, 2006 and 2005, respectively.²⁷

As of December 31, 2007, we held or guaranteed approximately ...\$41.4 billion in private-label mortgage-related securities backed by subprime loans.²⁸

However, Fannie also disclosed for 2007 the percent of loans acquired and overall loans by FICO band.²⁹ For example, Fannie reported that 5% of the conventional single-family book of business in 2005, 2006 and 2007 included loans where the borrower's FICO score was less than 620 and 10% of the conventional single-family book of business in 2005, 2006 and 2007 included loans where the borrower's FICO score was between 620 and 660.³⁰ Thus, although Fannie represented subprime loans as approximately 0.3% of the single family book of business at 12/31/07 using its definition of subprime, Fannie also disclosed that 15% of the single family book of business included loans with FICO scores less than 660.

Regarding Alt-A, Fannie disclosed the Alt-A classification criteria that was included in the 3Q08 Form 10-Q, ("We have classified mortgage loans as Alt-A if the lender that delivers the mortgage loan to us has classified the loan as Alt-A based on documentation or other features") but did not include the additional disclosure in the 3Q08 Form 10-Q which noted that there could be other loans held by Fannie Mae that had similar features. Fannie Mae also represented that "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."³¹

But Fannie also disclosed the percent of loans acquired and overall loans by (1) the original LTV ratio, (2) the estimated mark-to-market LTV ratio, and (3) loan type including interest-only, adjustable rate or fixed, and negative amortization. For example, Fannie reported that 10% of the conventional single-family book of business in 2007 included loans with original LTV ratios between 90% and 100%, and

²⁶ Pg 129, Fannie Mae 2007 Form 10K, emphasis added.

²⁷ Pg 130, Fannie Mae 2007 Form 10K, emphasis added.

²⁸ Pg 93 and 130, Fannie Mae 2007 Form 10-K

²⁹ 2007 Form 10-K at 126-130.

³⁰ 2007 Form 10-K at 127.

³¹ 2007 Form 10-K at 129.

that 1% of the conventional single-family book of business in 2007 was comprised of negatively amortizing adjustable rate loans.³²

Fannie Mae's disclosure in its **2006 Form 10-K** was very similar to the 2007 disclosure.

Conclusion

In summary, it appears that Fannie Mae certainly could have made better disclosure of its exposure to subprime and Alt-A loans in 2005 through 2008. Even in 2008 it is arguable that the Fannie Mae definition of subprime and Alt-A could have been more expansive. However, much of the information concerning Fannie Mae's exposure to those types of loans was available in 2006 and 2007 (even if Fannie Mae did not label them as such), and by 2008 they were explicitly calling attention to the definitional issues in their criteria for these types of loans. In addition, it is problematic to use improved disclosure to show that earlier disclosure was inadequate, as to do so will make it more firms less likely to be willing to improve and enhance their disclosure as circumstances warrant. Finally, we have no information to indicate that their form of disclosure was intentionally deceptive or reckless (scienter) which is necessary for a claim under Section 10(b) of the Exchange Act .

For this reason, we conclude that this issue does not rise to the level of other issues that the FCIC has referred to the Attorney General.

³² 2007 Form 10-K at 126.