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January 12, 2007

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Re: *In re Raines et al.*, OFHEO Notice No. 2006-1

Dear Mr. Lockhart:

I am counsel for Leanne Spencer. As you know, she previously served as the Controller and as a Senior Vice President of Fannie Mae. I respectfully request that you recuse yourself from any further participation in *In re Raines et al.*, OFHEO Notice No. 2006-1. OFHEO's enforcement procedures appoint you, as Director of the agency, to be the final arbiter of the charges that OFHEO filed against Ms. Spencer, Franklin D. Raines, and J. Timothy Howard. 12 U.S.C. § 4633(b) ("the Director shall render the decision"); *see also* 12 C.F.R. § 1780.5(b)(7) (stating that "only the Director shall have the power to ... make a final determination of the merits of the proceeding").

It is clear from your own statements and those of your predecessors, as well as from the reports issued by OFHEO on September 17, 2004, and May 23, 2006, that you and the agency have already decided that Ms. Spencer is liable for the claims brought in this matter. As delineated below, you have articulated unbridled hostility toward the respondents. Your statements are based solely on a one-sided investigation by OFHEO whose outcome was predetermined without affording the respondents any opportunity to be heard. That is not due process. Indeed, OFHEO's conclusions are premised on a full scale distortion of the witnesses and documents. The Inspector General of the Department of Housing and Urban Development even found evidence that the OFHEO examination was "altered and made to appear much more egregious and significant." Report of the Office of the Inspector General, U.S. Dep't of Housing & Urban Dev't, Investigation No. SID-04-0034-1, at 84 (Oct. 5, 2004) (hereinafter "OIG Report") (Exhibit 1). When the respondents are permitted a fair adjudication, they will undoubtedly prevail. However, as long as you continue to serve as both prosecutor and adjudicator, it will be impossible for Ms. Spencer to receive a fair resolution of the Notice of Charges.

The Supreme Court of the United States has stated repeatedly, a "fair trial in a fair tribunal is a basic requirement of due process. This applies to administrative agencies which adjudicate as well as to courts." *Withrow v. Larkin*, 421 U.S. 35, 46 (1975) (citations and internal quotation marks omitted). An adjudicator who has formed an opinion regarding the merits of the case

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before it is tried cannot provide a fair trial. *See, e.g., Cinderella Career & Finishing Schs., Inc. v. FTC*, 425 F.2d 583 (D.C. Cir. 1970); *Texaco, Inc. v. FTC*, 336 F.2d 739 (D.C. Cir. 1964), *vacated and remanded on other grounds*, 381 U.S. 754 (1965). Accordingly, whenever “a disinterested observer may conclude that (the agency) has in some measure adjudged the facts as well as the law of a particular case in advance of hearing it,” the agency is disqualified from participating in the case. *Cinderella*, 425 F.2d at 591 (citation and internal quotation marks omitted).

On July 17, 2003, OFHEO commenced a Special Examination of Fannie Mae, one of only two Government Sponsored Enterprises regulated by the Agency. As you know, Ms. Spencer fully cooperated with the Special Examination, providing testimony on three separate occasions. On September 17, 2004, OFHEO issued a preliminary report on the findings of examination. Report of Findings to Date, Special Examination of Fannie Mae (Sept. 17, 2004) (Exhibit 2). The 198-page report concluded, *inter alia*, “that the accounting used by Fannie Mae for amortizing purchase premiums and discounts on securities and loans as well as amortizing other deferred charges is not in accordance with GAAP” (*id.* at ii); that “management intentionally developed accounting policies and selected and applied accounting methods to inappropriately reduce earnings volatility and to provide themselves with inordinate flexibility in determining the amount of income and expense recognized in any accounting period” (*id.*); and that “Fannie Mae implemented SFAS 133 in a manner that placed minimizing earnings volatility and maintaining simplicity of operations above compliance with GAAP” (*id.* at v).

OFHEO continued its examination, culminating in a final report on May 23, 2006. Report on the Special Examination of Fannie Mae (May 23, 2006) (Exhibit 3). The report accuses Fannie Mae and the three respondents of manipulating earnings “in order to generate unjustified levels of compensation for themselves and other executives” (*id.* at 4); engaging in “a wide variety of unsafe and unsound practices” (*id.*); and “failing to establish a sound internal control system” (*id.* at 9), through the violation of at least eight different accounting standards. As Acting Director of OFHEO, you announced in a press release: “As the OFHEO report shows, the image of Fannie Mae as one of the lowest-risk and ‘best in class’ institutions was a façade. In fact, it was just the opposite. They promoted unconstrained growth while undermining proper internal controls by under investing in systems, risk management and staff. Our examination found an environment where the ends justified the means. There was a systematic effort by senior management to manipulate accounting, reap financial rewards, and prevent the rest of the world from knowing about it.” OFHEO Press Release, *OFHEO, SEC Reach Settlement With Fannie Mae; Penalty Imposed* (May 23, 2006) (Exhibit 4). In another press release issued the same day, you stated that “Fannie Mae’s executives were precisely managing earnings to the one-hundredth of a penny.” OFHEO Press Release, *OFHEO Report: Fannie Mae Façade* (May 23, 2006) (Exhibit 5). Their conduct, you alleged, “resulted in an estimated \$10.6 billion of losses, well over a billion dollars in expenses to fix the problems, and ill-gotten bonuses in the hundreds of millions of dollars.” *Id.*

On the same day the report issued, OFHEO entered into an agreement with Fannie Mae in which the entity agreed to pay \$400 million to OFHEO and the Securities and Exchange Commission to

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resolve the allegations. You commented: “The penalty and settlements represent a major step in correcting a dangerous course that had been followed by one of the largest financial institutions in the world. Unprincipled corporate behavior and inadequate controls will simply not be tolerated.” OFHEO Press Release, *OFHEO, SEC Reach Settlement With Fannie Mae; Penalty Imposed* (May 23, 2006) (Exhibit 4). On December 18, 2006, OFHEO issued the Notice of Charges against Mr. Raines, Mr. Howard and Ms. Spencer, which includes 101 different claims and seeks significant penalties from the respondents. Notice of Charges, OFHEO Notice No. 2006-1 (Exhibit 6).

OFHEO’s Rules of Practice and Procedure permit you to hand-pick an administrative law judge or “any other person” to hear evidence and make a recommendation to you on liability, restitution, and penalties of the respondents. 12 C.F.R. §§ 1780.3(h), 1780.5. Even after appointing such person, you may, “at any time during the pendency of a proceeding, perform, direct the performance of, or waive performance of any act that could be done or ordered by the presiding officer.” *Id.* § 1780.4. Moreover, you retain the exclusive power “to grant any motion to dismiss the proceeding or make a final determination of the merits of the proceeding.” *Id.* § 1780.5(b)(7). It is our view that a fair assessment of the evidence will demonstrate that the respondents are not liable for any of the claims in the Notice of Charges. However, under OFHEO procedure, you are free to reject a recommendation of the presiding officer in favor of the respondents. *Id.* §§ 1780.53-.55. Based upon your unqualified statements, it is clear that you would do just that.

Your statements to the press throughout the course of OFHEO’s investigation of Fannie Mae and its former officers demonstrate unequivocally that you have already determined that Ms. Spencer, Mr. Raines, and Mr. Howard are liable for all claims against them. For example, even before OFHEO issued the Notice of Charges, you told the press that these individuals “grossly mismanaged” Fannie Mae, “underspent dramatically on systems, internal controls, risk management—all the basic building blocks of a good corporation,” and went “beyond mismanagement to manipulating earnings.” David S. Hilzenrath, *Fannie Mae Final Tally: \$6.3 Billion Overstated*, Washington Post (Dec. 7, 2006) (Exhibit 7).

Moreover, you testified before Congress that “[b]y encouraging rapid growth, unconstrained by proper internal controls, risk management and other systems,” these individuals “did serious harm to Fannie Mae while enriching themselves through earnings manipulation.” Statement of James B. Lockhart III on OFHEO’s Report on the Special Examination of Fannie Mae Before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, U.S. House of Representatives (June 6, 2006) (Exhibit 8). You told Congress that the actions of these former Fannie Mae executives “were flat-out wrong, or, to use the proper regulatory phrase, they were managing Fannie Mae in an ‘unsafe and unsound’ manner. Senior management manipulated accounting; reaped maximum, undeserved bonuses; and prevented the rest of the world from knowing about it. They co-opted their internal auditors and other managers. They stonewalled OFHEO.” *Id.*

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You further stated that “[i]n 1998, management *should* have recognized significant losses from the amortization of premiums and the impairment of guaranty-fee buy-ups, but much of the actual loss was deferred so that management could meet bonus targets, as well as the expectations of analysts.” *Id.* (emphasis in original). Among other things, you concluded that “senior management did not make adequate investments in accounting systems and staffing,” which helped them “to hide improper actions that smoothed earnings; that they implemented FAS 115 and 133 in a manner that “did not comport with GAAP”; that they “went to extraordinary lengths to avoid recording GAAP required impairment losses”; and that they used “cookie-jar reserves, income shifting transactions and inappropriate debt repurchases.” *Id.*

In a speech you delivered to the American Enterprise Institute on September 13, 2006, you announced OFHEO’s intention to sue the respondents, declaring: “I think we need to send a very strong message. We sent a strong message with the \$400 million fine against Fannie Mae, but I think we also need to send a message about the mismanagement and—as the SEC says it—fraud committed by the former management.” Transcript of Remarks of Jim Lockhart to the American Enterprise Institute (Sept. 13, 2006) (Exhibit 9). Indeed, it appears that you anticipated overstepping the bounds of your lawful authority in your zeal to prosecute these individuals. You declared that OFHEO “will try to use our powers to the utmost,” noting: “In some cases we may end up being sued by Fannie and Freddie if we try to use some powers that we think we could possibly have. But we’ll try to do the best we can because that’s our job.” *Id.*

In a press release accompanying the Notice of Charges you filed against Ms. Spencer, Mr. Raines, and Mr. Howard, you did not mince words. On behalf of the agency, you characterized the charges not as allegations that you would fairly evaluate, but rather as facts you had already determined to be true. You stated: “The Notice of Charges details the harm to Fannie Mae resulting from the conduct of these individuals from 1998 to 2004. The 101 charges reveal how the individuals improperly manipulated the earnings to maximize their bonuses, while knowingly neglecting accounting systems and internal controls, misapplying over twenty accounting principles and misleading the regulator and the public. The Notice explains how they submitted six years of misleading and inaccurate accounting statements and inaccurate capital reports that enabled them to grow Fannie Mae in an unsafe and unsound manner. The misconduct cost the Enterprise and shareholders many billions of dollars and damaged the public trust.” OFHEO Press Release, *OFHEO Files Notice of Charges Against Former Fannie Mae Executives Franklin Raines, Timothy Howard and Leanne Spencer* (Dec. 18, 2006) (Exhibit 10).

Similarly, in a subsequent press conference, you declared that OFHEO “believed as an agency that these three individuals, separately and together, did serious harm to the company. There is a long list of charges that show they allowed this company to grow out of control.” See Eric Dash, *Fannie Mae Ex-Officers Sued By U.S.*, New York Times (Dec. 19, 2006) (Exhibit 11); see also, e.g., David S. Hilzenrath, *Fannie Mae Ex-Officials Are Sued For Disputed Pay*, Washington Post (Dec. 19, 2006) (Exhibit 12). You told reporters that Mr. Raines, Mr. Howard, and Ms. Spencer “knowingly” neglected “accounting systems and internal controls, misapplying over 20 accounting principles and misleading the regulator and the public.” James Tyson, *Fannie Mae Regulator Sues Raines, Former Executives*, Bloomberg.com (Dec. 18, 2006) (Exhibit 13). You

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further stated: “This activity was so unsafe and unsound that we have to take this action. We have no choice, really. We have to send a message to the management . . . , both present and previous, that this kind of activity cannot be allowed.” Damien Paletta, *OFHEO Files Notice of Charges vs. Ex-Fannie Executives*, Dow Jones Newswires (Dec. 18, 2006) (Exhibit 14).

These comments illustrate precisely the sort of bias that compels your recusal from participation in this case. Federal law requires you to recuse yourself from “any proceeding in which [your] impartiality might reasonably be questioned.” 28 U.S.C. § 455(a). Your public condemnations of Ms. Spencer, Mr. Raines, and Mr. Howard, which have been widely reported in every national newspaper, would cause any reasonable observer to question your impartiality. Indeed, the Washington Post has already noted that “after the evidence has been heard, it is the accuser who will render judgment.” David S. Hilzenrath, *Players Oddly Aligned in New Fannie Mae Case*, Washington Post (Dec. 20, 2006) (Exhibit 15); *see also id.* (noting that “[t]he playing field is inhospitable”). The New York Times has observed that OFHEO “seems intent on sending a message to Capitol Hill, where legislation is to be debated that would give the office greater authority.” Eric Dash, *Fannie Mae Ex-Officers Sued By U.S.*, Washington Post (Dec. 19, 2006) (Exhibit 11). As one commentator explained, “OFHEO basically may be trying to send a signal that they are going to be really tough under their jurisdiction. They traditionally have not had the clout compared to other regulators for banks. And by bringing this action, they may want to send the fear of God to these executives.” *Id.* (quoting Prof. Henry T. Hu, University of Texas Law School).

Moreover, your agency’s bitter and repeated criticisms of the respondents are premised on a perversion of the testimony and documents obtained in the Special Examination, where there was an institutional initiative to distort the evidence in order to marginalize Fannie Mae and damage the Respondents. Indeed, as early as April 2004, the Office of the Inspector General of the Department of Housing and Urban Development (“OIG”) launched an investigation at the request of Senator Christopher S. Bond into possible criminal misconduct stemming from improper leaks of confidential information by former Director Armando Falcon, based on OFHEO’s selective release to the press of “the results and partial recommendations of a confidential regulatory examination of Fannie Mae.” *OIG Report* at 2 (Exhibit 1). While the U.S. Attorney’s Office ultimately declined to prosecute Director Falcon “in favor of administrative remedies,” *id.* at 92, the *OIG Report* well documents OFHEO’s overwhelming institutional bias. For example, one member of OFHEO’s examination staff reported to the *OIG* that OFHEO staff members were instructed “that it’s our job, meaning all employees of OFHEO, to make the Director look good.” *Id.* at 9. Employees were told that “the Enterprises should fear OFHEO when we come onto the premises and that our relationship is inherently acrimonious and adversarial.” *Id.* According to this witness, OFHEO’s Special Examination of Fannie Mae “was focused on finding a way to bring into question the propriety of Fannie Mae’s approach,” and thus examination results and conclusions “were then altered and made to appear much more significant and egregious.” *Id.* at 84. The “ultimate objective on the part of the Director and the Deputy Director” was to force Fannie Mae “to recognize an increased level of impairment” and to “find a way to conclude that Fannie has misapplied the financial accounting standards.” *Id.* at 85.

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Another OFHEO employee told OIG that the agency's Special Examination was driven by the goal of "finding problems at Fannie Mae," and that employees were "rewarded for finding things versus saying that everything is okay." *Id.* at 80. OFHEO's former Chief Examiner, Scott Calhoun, testified that "the attitude prevailing at OFHEO was one in which efforts would be made to find things wrong at Fannie Mae, then take strong enforcement action; 'when we find them, we'll hammer you hard.'" *Id.* at 82. Managers who "did not conform to this new approach" were "marginalized" by senior management. *Id.* at 82-83. OFHEO's former Deputy Director, Stephen Blumenthal, acknowledged lecturing staff "about how public announcements by government officials could negatively impact the stock of Fannie Mae and could serve as a means for making the regulated entity ... 'submit to the will' of the regulator." *Id.* at 11.

Under these circumstances, your dual role as prosecutor and adjudicator casts inescapable doubt on your impartiality. As the Supreme Court has held, the Constitution does not permit a judge who has "in effect bec[ome] part of the prosecution and assumed an adversary position" to adjudicate a case. *Withrow v. Larkin*, 421 U.S. at 53; *see also, e.g., Wildberger v. Am. Fed'n of Gov't Employees*, 86 F.3d 1188, 1190, 1195 (D.C. Cir. 1996) (holding that a disciplinary procedure in which the same individual "initiated the investigation, determined probable cause, and served as the final adjudicator" violated constitutional due process). In light of OFHEO's politically motivated investigation and prosecution of Ms. Spencer, Mr. Raines, and Mr. Howard, in which you personally have played a crucial role, you must remove yourself from any further involvement in this case.

The Due Process Clause of the United States Constitution requires that "an administrative hearing 'must be attended, not only with every element of fairness but with the very appearance of complete fairness.'" *Cinderella*, 425 F.2d at 591 (quoting *Amos Treat & Co. v. SEC*, 306 F.2d 260, 267 (1962)). Your statements are prima facie evidence that you have "adjudged the facts as well as the law ... in advance of hearing [*In re Raines et al.*]." *Id.* You cannot back off your public statements now. Decision-makers are without "license to make speeches [or statements] which give the appearance that the case has been prejudged." *Id.* As long as you continue to participate in this case, Ms. Spencer will be denied her fundamental constitutional right to due process.

This letter is presented to you to permit you a fair opportunity to recuse yourself now. Because this matter will be irrevocably tainted by any further involvement from you – including appointment of a presiding officer pursuant to 12 C.F.R. § 1780.3(h) – you must act on this issue now. Your recusal cannot await completion of a hearing on the Notice of Charges. If you deny

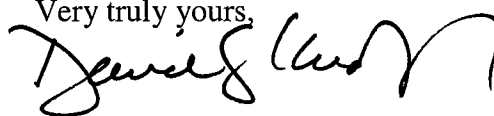
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our request or take any further action in this matter without responding, we will petition the United States Court of Appeals for the District of Columbia Circuit for a writ of mandamus removing you and OFHEO from the adjudication of this matter. *See* 28 U.S.C. § 1651(a). Whatever your action, please make this letter part of the administrative record of *In re Raines, et al.*, OFHEO Notice No. 2006-1.

Very truly yours,

A handwritten signature in black ink, appearing to read "David S. Krakoff", written in a cursive style.

David S. Krakoff

cc: Kevin M. Downey
Counsel for Franklin D. Raines

Steven M. Salky
Counsel for J. Timothy Howard

Alfred M. Pollard
General Counsel for OFHEO