The SEC and IRS Whistleblower Acts and The FCA

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Included Herewith:

POWERPOINT: “THE FALSE CLAIMS ACT (QUI TAM ACTIONS) AND HEALTHCARE” BY SHAUNA B. ITRI AND DANIEL R. MILLER

POWERPOINT: “MORTGAGE FRAUD REMEDIES” BY HEIDI A. WENDEL

UNITED STATES V. DEUTSCHE BANK AG, DB STRUCTURED PRODUCTS, INC., ET AL., 11-CV-2976 (S.D. N.Y. AUGUST 2011): AMENDED COMPLAINT

UNITED STATES V. WELLS FARGO BANK, N.A., 12-CV-7527 (S.D. N.Y. DEC 2012): FIRST AMENDED COMPLAINT

UNITED STATES V. COUNTRYWIDE FINANCIAL CORPORATION ET AL., 12-CV-1422 (S.D. N.Y. JAN. 2013): AMENDED COMPLAINT


POWERPOINT: “THE FALSE CLAIMS ACT (QUI TAM ACTIONS) AND HEALTHCARE
BY SHAUNA B. ITRI AND DANIEL R. MILLER
THE FALSE CLAIMS ACT (QUI TAM ACTIONS) AND HEALTHCARE

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Whistleblower Law Basics

- The False Claims Act covers fraud against the government
- Also some 29 states and DC have FCAs
- IRS Whistleblower law ($2M minimum)
- SEC Whistleblower law ($1M Minimum)
- FCA cases filed under seal
- Triple Damages
- 15-30% awards for whistleblowers
History of the False Claims Act

  - “Lincoln’s Law”
  - Originally to deter fraud against the Government by suppliers to the Union Army
  - Qui Tam Provisions

- 1986 amendments
  - Increased incentives for qui tam relators
General Success of FCA Law

- Over $40 billion recovered in 26 years
- About 80 percent of recoveries concern health care
- Most of the rest involves military defense
- Significant recoveries also in oil and gas, construction, foreign aid, and mortgage fraud
Relevance to Healthcare

- Total Medicare Expenditures FY 2011 Estimated at $557.8 Billion

- Total Medicaid Expenditures FY 2011 (federal and state) were $428.7 Billion

- By 2021, Medicaid Spending is Projected to Account for Over 20% of the GDP
THE FALSE CLAIMS ACT BASICS

- Who can be a Whistleblower ("Relator")?
- Who can be a Defendant?
- What triggers liability?
- What are the damages?
- What other consequences are "out there"?
WHO CAN BE A RELATOR AND WHO CAN BE A DEFENDANT?

- Individuals
- Business Entities
- Government Entities
WHAT ACTIONS VIOLATE THE FALSE CLAIMS ACT?

• “Knowing” Submission of a “False” Request for Reimbursement (or Knowing Retention of Funds Owed to the Government, e.g., overpayments)
• Direct or Through 3rd Party (“Cause to submit”)
• “False” is Broadly Interpreted (e.g., Materially Incorrect or Non-Reimbursable)
• “Knowing” Does Not Require Actual Knowledge
• “Deliberate Ignorance” or “Reckless Disregard”
“HOW DID THIS HAPPEN?”

• Company Almost Always Gets First Bite!
• Then . . . Whistleblower Goes To Govt. or Attorney
• Then . . . Sealed Case Filed in Federal Court
• DOJ kicks complaint to defrauded agency
• Case is investigated, Relator Meets Secretly with Prosecutors
• Government Investigates, then Intervenes/Declines
• Case is Dismissed, Settled, or Goes to Trial
• Process Takes Several Years . . . Yes, Years!
“WHO IS ‘THE GOVERNMENT’?”

- U.S. Department of Justice
- United State Attorney’s Office
- OIG, FBI, FDA, DOD, etc.
- State Attorney General Offices – Medicaid Fraud Control Units (“NAMFCU”); Texas Civil Medicaid
- Nonetheless, Govt. Feels Overmatched
- Multi-Disciplinary Approach Works Best
THE PAIN: LENGTHY INVESTIGATIONS LEADING TO DAMAGES AND PENALTIES

• Invasive Investigations Cost Resources/Morale
• The Floggings Will Continue! (See Below)
• Treble (i.e., Triple) the Amount of False Billing
• Broadly Interpreted
• Civil Penalties of $5,500-$11,000 **PER CLAIM**
• PLUS, Corporate Integrity Agreement (or DPA)
Relator’s Share of Recovery

- Most Cases are not joined by the Government (80% declined); Declined cases are generally dropped (80%)
- Only 100-15 FCA cases a year are positively resolved; take on average 38 months but may take a decade
- Government intervenes = 15 to 25% of the Recovery
- Government Does Not Intervene = 25 to 30% of the Recovery
- Planned and Initiated the Fraud = Share may be Reduced
- Convicted of a Crime Arising From the Fraud = Dismissed Form the Case and Recover Nothing
COMMON FCA VIOLATIONS

• Anti-Kickback Statute (AKS)
  • Remuneration for Referrals Prohibited, Except . . . .

• The Stark Law
  • If Financial Relationship, No Referrals, Except . . . .
  • Significance of “Burden Shifting”

• Medicaid Rebate Fraud (pricing, grants, etc.)

• Off-label Marketing (non-reimbursable services)
Common FCA Violations (Continued)

- Billing for Services Not Rendered Or Undocumented Services
- Double Billing For Items Or Services
- Upcoding – Assigning Incorrect CPT codes to Secure Higher Reimbursement
- Medically Unnecessary Services
- Worthless Services (e.g., Defective Devices)
Last 10 years more than 100 settlements. Some recent settlements appear below:

- **Tulare Healthcare** (debt forgiveness and below market office space). $2.4 million.
- **Detroit Medical Center** (leases below FMV, lack of written evidence (burden shift)). $30 million.
- **Christiana Hospital** (above FMV payments for professional component in exchange for referrals).
KICKBACK AND STARK CASES

- **Tuomey Hospital** (part-time employment arrangement above FMV). Jury Verdict $45 million.
- **Covenant Medical Center** (employment arrangements above FMV). $4.5 million.
- **McAllen Hospitals** (sham Directorships, and bogus lease arrangements). $27.5 million.
- **Halifax Hospital** (employment arrangements above FMV (hospital actually losing money). U.S. intervened on 11/4/11.
2012 PHARMACEUTICAL OFF-LABEL MARKETING CASES

- GlaxoSmithKline (Wellbutrin et al.) $3B 2012
- Abbott (Depakote) $1.5B ($800M ; $700M )
- Merck (Vioxx) $950M ($628.4M; $321.6M)
- J&J-Texas (Risperdal) $158M
- Orthofix (bone growth device) $43M
- Blackstone Medical (bone growth device) $32M
PHARMACEUTICAL PRICING CASES

- **Medicaid Rebate Fraud**
  - Merck (Zocor, Pepcid, Vioxx) $649 million.
  - Wyeth (Protonix) Pending in Federal Court in Boston.

- **Spread Pricing - 2012**
  - Actavis Texas $202.6M
  - Sandoz $150M (non-intervened; CA and FL)
  - Mylan California $57M
GlaxoSmithKline

- Off label marketing of Wellbutrin and Paxil
- FDA Approved Wellbutrin for Treatment of Major Depressive Disorder
- Evidence that GSK developed and distributed Marketing Material Stating that Wellbutrin could be used for non-FDA approved uses such as Weight Loss, ADHD, Addiction, etc. and paid kickbacks to Doctors to Prescribe
- Unlawfully Developed and Distributed a Misleading Medical Journal that Misreported A Clinical Trial of Paxil Efficacy in Treating Children with Depression And Promoted Paxil for Pediatric Use and
GlaxoSmithKline (continued)

- Fraud on the FDA: GSK Failed To Include Safety Data Regarding Cardiovascular Risks to FDA on Avandia (diabetes drug)

- Fraudulent Price Reporting: Bundled Products and Offered Discounts, But ailed to Report “Best Price” To Government
GlaxoSmithKline (continued)

- Case settled for $3 Billion
- $1B Criminal Fine – Largest Fine Ever Imposed for a US Corporation in a Criminal Case
- Off-Label Marketing/Kickbacks: $1.043B total; $210M to States and Medicaid Programs and $832M to Federal Government
- Avandia: $657M total; $149M to States and Medicaid Programs and $508M to Federal Government
- Price Reporting: $300M total; $119M to States and Medicaid Programs, $20M Public Health Entities, and $161M to Federal Government
- 5 Year CIA Mandates Change in Compensation Structure and Implement Transparency in Research
J&J

- Down-Played Risks and Off-Label Marketing of Risperdal

- FDA Approved Risperdal for Adults with Schizophrenia and Bipolar Disorder. Evidence J&J Marketed the Drugs for dementia in elderly, depression/anxiety, pediatric use, etc.
The New Frontier: Consumer Cases (J & J)

- 2010: Pennsylvania Dismissed
- 2010: Louisiana $257.7 M (trial)
- December 2010: West Virginia Dismissed
- June 2011: South Carolina- $327M (trial)
- April 2012: Arkansas $1.2B (trial)
J&J False Claims Act

- 2012: Texas Settled Mid-Trial $158M
- Federal Government Reject $1B Deal, Seek $1.8B
- Note: Risperdal Was J&J’s Best Selling Drug and Earned $24.2B from 2003-2010
- Note: Class of Drugs Known as “Anti-Psychotics”
  - Eli Lilly sold Zyprexa - $1.7B
  - AstraZeneca Seroquel - $590M
Bristol Myers Squibb (BMS)

- $389M settlement with 43 states, and federal government

- Allegations BMS engaged in numerous improper marketing and pricing practices

- Reporting inflated prices for various prescription drugs knowing Medicaid and various federal health care programs would use these reported prices to pay for BMS and Apothecon products used by their recipients

- Paying illegal remuneration to physicians, health care providers, and pharmacies to induce them to purchase BMS and Apothecon products

- Promoting the sale and use of Abilify, an antipsychotic drug, for pediatric use and for treatment of dementia-related psychosis, uses which the federal Food and Drug Administration has not approved

- Misreporting sales prices for Serzone, antidepressant, resulting in improper reduction of amount of rebates paid to state Medicaid programs
Cephalon

- $375M in damages and penalties to states and federal government

- Resolve allegations that Cephalon promoted drugs Provigil, Gabitril, and Actiq for uses other than approved by the FDA. Cephalon also funded continuing medication education program, through millions of dollars in grants, to promote off-label uses for these drugs

- **Provigil**: FDA approved to treat only narcolepsy and sleep disorders; however, marketed as a non-stimulant drug to treat sleepiness, tiredness, decreased activity, lack of energy and fatigue

- **Gabitril**: FDA approved as a partial treatment for seizures; however, marketed as a remedy for anxiety, insomnia, and pain. Following reports of seizures in patients taking Gabitril that did not have epilepsy, FDA required Cephalon to send a warning to physicians advising them of risks of seizures in connection with off-label use

- **Actiq**: FDA approved to treat opioid-tolerant cancer patients (or when morphone-based painkillers are no longer effective); however, marketed for migraines, sickle-cell pain crises, and injuries
Blackstone Medical, Inc.

- Filed May 2007 by Whistleblower Regional Sales Manager
- Declined by DOJ in 2009
- Blackstone was paying doctors as “Medical Advisory Board” members = kickbacks
- District Court Dismissed in 2010
- Reversal on Appeal in June 2011
- Settled in February 2012 for $30M
- Whistleblower Share = $8M
- Attorneys Incurred $3,500 Hours and $50,000 Expenses
Eckard v. GlaxoSmithKline

- Whistleblower = Quality Insurance Manager at GSK
- Filed FCA Complaint February 2004
- Alleging GSK was Manufacturing/Distributing Contaminated and Adulterated Products
- July 2007 Declined and Unsealed
- Government Intervened When Settlement Reached in October 2010
- Settled $600M (civil) and $100M (criminal); Relator 22% or $96M
- Whistleblower Attorneys: 6 year investigation, 12,000 hours, 1.6 million documents, etc.
MEDICAL DEVICE CASES

- Relatively new area; Compliance years behind
- Initial Govt. Reluctance: Often no monetary loss
- Since 2007 have seen a drastic increase in filings
- Medtronic (2012) (“consulting” deals considered kickbacks) $235 million
- Dozens of cases in the Pipeline.
Potential Roadblocks and Obstacles

- Tax Bar – But See IRS Whistleblower Act
- Public Disclosure Bar
- Rule 9(b) Particularity Requirement
STATE FALSE CLAIMS ACTS

• Many states are like the feds: no tax
• Exceptions: NY, IL, NV
• New York: new division initiated 2011
• Cash-strapped legislatures. Trend?
I THINK SO!

- 1/1/88 California
- 1/1/92 Illinois
- 5/31/94 Florida
- 9/1/95 Texas
- 4/12/96 Wash. DC
- 7/15/97 Louisiana
- 1/1/99 Nevada
- 6/30/00 Delaware
- 7/1/00 Massachusetts
- 1/1/01 Tennessee
- 7/1/01 Hawaii
- 1/1/03 Virginia
- 1/19/04 New Mexico
- 1/1/05 New Hampshire
- 7/21/05 Indiana
- 10/1/05 Montana
- 1/3/06 Michigan
- 4/1/07 New York
- 4/13/07 Georgia
- 10/27/07 Wisconsin
- 11/1/07 Oklahoma
- 4/15/08 New Jersey
- 12/1/09 North Carolina
- 7/1/10 Minnesota
- 10/1/10 Maryland
- Next???
QUESTIONS?

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Mortgage Fraud Remedies and Cases

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Civil Statutes and Remedies DOJ Has Used to Pursue Financial Fraud Cases

- FIRREA: 12 U.S.C. § 1833a
- The Fraud Injunction Statute: 18 U.S.C. § 1345
The False Claims Act and Mortgage Lending: An Overview

• In short, the FCA imposes civil liability on any person who knowingly presents a false claim to the government, or knowingly makes a false record or statement material to a false claim.

• The FCA authorizes the U.S. to seek treble damages and civil penalties of $5,500 to $11,000 for each false claim.

• The FCA broadly defines “knowingly” to include deliberate ignorance and reckless disregard for the truth or falsity.

• Statute of limitations: Generally 6 years, max. 10 years.

• In the context of FHA lending, the government has used the FCA to impose liability on financial institutions based on false statements and certifications to HUD.
Early FCA Actions in the Mortgage Area

- **U.S. v. RBC Mortgage Company** (ND Ill. 2008)
  - RBC settled (without litigation), paying $11 million

- **U.S. v. Beazer Homes** (WD NC 2009)
  - Beazer settled with U.S. for $5 million, in deferred prosecution agreement and separate civil settlement

  - Lawsuit pending, 10 of 14 defendants have settled; lender defendants paid $1.2 million
Common Features of RBC, Beazer, and Buy-a-Home

• U.S. alleged that a HUD Direct Endorsement Lender was liable under the False Claims Act

• U.S. alleged that the DEL endorsing certain loans for FHA insurance that did not qualify for insurance

• U.S. alleged that the DEL made false statements to HUD, causing HUD to suffer losses when the loans defaulted

- Beazer Mortgage Corp. made FHA-insured loans for the purchase of homes built by Beazer Homes USA, Inc.

- U.S. alleged that former Beazer employees fraudulently induced homeowners to enter into mortgage loans with inflated interest rates, and that the U.S. paid claims on loans that defaulted

- Beazer settles with U.S. for $5 million, in deferred prosecution agreement and separate civil settlement

• Direct endorsement lender Cambridge Home Capital made FHA loans on properties sold by Buy-a-Home and related companies

• U.S. alleged that 14 defendants, including Cambridge, engaged in a conspiracy to flip properties for resale to unqualified home buyers

• 17 loans involved in the scheme defaulted, causing loss to the government

• Status: lawsuit pending, 10 of 14 defendants have settled, Cambridge defendants pay $1.2 million. Mitchell Cohen pled guilty to conspiracy to commit wire, bank and mail fraud, as well as perjury.
More Recent Cases Involving Reckless Lending

• Since 2011, the government has brought actions against lenders for not only intentional fraud, but also “reckless” mortgage lending.

• These more recent cases have focused on systemic underwriting failings impacting a larger number of loans.
Reckless Lending Cases

**U.S. v. Bank of America/Countrywide (S.D.N.Y)**
- Complaint filed in October 2012 alleges that Bank sold defective loans to Fannie Mae and Freddie Mac generated by fraudulent loan origination program called the “Hustle”

**U.S. v. Wells Fargo, N.A. (S.D.N.Y)**
- Complaint filed in September 2012 alleges that Bank falsely certified thousands of defective loans for FHA insurance and failed to self-report known bad loans to HUD

**U.S. v. Deutsche Bank AG (S.D.N.Y)**
- $202 million FHA fraud settlement in May 2012, included admissions of conduct

**U.S. v. CitiMortgage, Inc. (S.D.N.Y)**
- $158 million FHA fraud settlement in February 2012, included admissions of conduct and changed business practices

- $133 million FHA fraud settlement in February 2012, included admissions of conduct and changed business practices

**U.S. v. Bank of America/Countrywide (E.D.N.Y)**
- In February 2012, Bank of America agreed to pay up to $1 billion, as part of the DOJ/State AGs national servicer global settlement

**U.S. v. Allied Home Mortgage Corp. (S.D.N.Y)**
- $834 million FHA fraud case filed in November 2011

- U.S. alleges that from at least 2007 through 2009, Countrywide, and later Bank of America after acquiring Countrywide in 2008, implemented a loan origination process called the “Hustle.”
- U.S. alleges that the Hustle, which was designed to process loans at high speed without quality checkpoints, generated thousands of fraudulent and defective residential mortgage loans.
- U.S. alleges that Countrywide and Bank of America knowingly sold Hustle loans to Fannie Mae and Freddie Mac that later defaulted, causing over $1 billion dollars in losses.
- Fannie Mae and Freddie Mac received approximately $180 million bailout from Treasury.
- Suit seeks damages and civil penalties under the FCA and FIRREA.
- Whistleblower action under *qui tam* provisions of FCA.
- Status: pending
U.S. v. Wells Fargo (2012)

- Wells Fargo is largest FHA DEL
- U.S. alleges that during 2001-2005, Wells Fargo engaged in a regular practice of reckless origination and underwriting of its retail FHA loans, and falsely certified that thousands of loans were eligible for FHA insurance.
- U.S. alleges that Wells Fargo failed to conduct adequate quality control and comply with its self-reporting requirements to HUD during 2002-2010.
- Complaint seeks damages and civil penalties under FCA and FIRREA
- Status: pending
Deutsche Bank acquired lender MortgageIt in 2007

U.S. alleged quality control failures at MortgageIt tainted entire portfolio of loans going back 10 years

U.S. alleged that QC failures, including the failure to conduct required EPD reviews, led to false loan certifications and false annual certifications

FHA paid insurance claims on 3,100 loans

Deutsche Bank settled for $202.3 million, admitting certain conduct alleged in the government’s complaint
U.S. v. CitiMortgage (2012)

- CitiMortgage, a subsidiary of Citibank, NA, was an FHA direct endorsement lender
- U.S. alleged that Citi’s quality control failures led to reckless mortgage lending
- Misconduct included failing to report bad loans to HUD, failing to operate QC independent of production, and failing to fully review all EPD
- U.S. alleged that Citi falsely certified to HUD that loans met underwriting standards, resulting in nearly $200 million in insurance claims on 9,636 defaulted loans since 2004
- Whistleblower action under *qui tam* provisions of FCA
- Citi settled by paying $158.3 million, admitting certain conduct alleged in the government’s complaint
U.S. v. Flagstar Bank (2012)

• Flagstar had been a direct endorsement lender since 1988

• U.S. alleged that Flagstar’s practice of using untrained assistant underwriters to clear loan conditions, and paying them incentive awards for exceeding quotas of loans reviewed, led to reckless mortgage lending

• U.S. alleged that Flagstar falsely certified that its HUD-approved underwriters had personally underwritten the loans when in fact they had not, resulting in “hundreds of millions” of dollars paid in insurance claims

• Flagstar settled by agreeing to pay $132.8 million, admitting that it submitted “false certifications” to HUD

• As part of the DOJ/State AG national mortgage servicing settlement, Bank of America/Countrywide resolved an FCA investigation in the EDNY

• EDNY’s investigation focused on whether Bank of America, through Countrywide, knowingly made FHA loans to unqualified buyers, resulting in hundreds of millions of dollars in damages

• Bank of America agreed to pay $1 billion, as part of the global settlement payment, to resolve the EDNY’s FCA investigation

- Allied was a direct endorsement lender and correspondent lender

- U.S. alleges that Allied failed to comply with HUD rules, including by operating unapproved “shadow” branches under HUD’s regulatory radar and having a “dysfunctional” or “entirely nonexistent” quality control program

- U.S. alleges that Allied’s reckless lending practices led to 35,000 defaulted loans resulting in $834 million in insurance claims paid

- Status: pending
FIRREA

• Financial Institutions Reform, Recovery, and Enforcement Act ("FIRREA")

• FIRREA was enacted in 1989 in response to the savings and loan crisis

• Authorizes a civil enforcement lawsuit by DOJ for violations of enumerated criminal statutes
FIRREA’s Criminal Predicates

- Frauds Affecting a Federally Insured Financial Institution:
  - Mail Fraud
  - Wire Fraud
  - False Statements to U.S.
  - False Claims to U.S.
  - Concealment of Assets from FDIC

- Other Frauds:
  - Bank Fraud
  - Bank Bribery
  - Embezzlement
  - False Entries in Books and Records
  - False Statements Affecting FDIC
  - False Statements on Loan and Credit Applications
  - False Statements to SBA
Other Aspects of FIRREA

• FIRREA reaches more broadly than the FCA, covering fraud that does not victimize or cause any loss to the government

• FIRREA’s statute of limitations is 10 years

• FIRREA gives DOJ and USAOs subpoena power

• FIRREA authorizes disclosure of grand jury material for use in a civil case, facilitating parallel proceedings

• FIRREA authorizes the government to seek substantial civil penalties (up to the amount of the gain or loss)
FIRREA Cases: U.S. as Victim

- **U.S. v. Buy-a-Home LLC**
- **U.S. v. Allied Home Mortgage Corp.**
- **U.S. v. CitiMortgage**
- **U.S. v. Wells Fargo**
- **U.S. v. Bank of America**
The Fraud Injunction Statute: Low Standard, Immediate Impact

• 18 U.S.C. § 1345 authorizes the United States to seek injunctive relief to stop an on-going fraud

• Statute applies to stop on-going or imminent mail fraud, wire fraud, bank fraud, or health care fraud

• No requirement for U.S. to establish irreparable harm

• Some courts apply a low “probable cause” standard of proof rather than preponderance standard

• Allows the court to freeze the defendant’s assets

• Recently used 1345 to target financial fraud, including mortgage fraud
Recent 1345 Cases Involving Financial Institutions

• **U.S. v. Madison Home Equities (EDNY) (2008)**
  – Consent judgment enjoined lender from participating in the DEL program and required indemnification on 12 loans.

• **U.S. v. Ideal Mortgage Bankers/Lend America (EDNY) (2009)**
  – Consent judgment enjoined further endorsement of loans for FHA mortgage insurance or soliciting business to originate federally insured mortgage loans

  – Consent Judgment enjoined home seller from any involvement with FHA lending; seller later held in contempt of court for violating order

  – Consent judgment settling Government’s 1345 claim enjoined the bank from making certain representations with respect to its foreign exchange program
FIRREA Cases: Other Victims

• **U.S. v. Bank of New York Mellon**
  - Alleged that custodian bank defrauded hundreds of bank customers who used the bank’s standing instruction foreign exchange services
  - Amended Complaint alleges that the gain to the bank exceeded $1.5 billion, for the top 200 clients alone

• **U.S. v. Bella Homes, LLC**
  - Government alleged that defendants defrauded 450 distressed homeowners nationwide through foreclosure rescue scheme
Whistleblower Provisions

- Both FCA and FIRREA (via FIAFEA) encourage financial fraud whistleblowers by allowing them to share in the government’s recovery

- FCA: 15-25% or 25-30%, depending on whether US intervenes
  - U.S. v. CitiMortgage: Whistleblower recovered $31 million

- FIRREA/FIAFEA: Formula, with maximum award of $1.6 million
UNITED STATES V. DEUTSCHE BANK AG, DB STRUCTURED PRODUCTS, INC., ET AL., 11-CV-2976 (S.D. N.Y. AUGUST 2011): AMENDED COMPLAINT
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UNITED STATES DISTRICT COURT  
SOUTHERN DISTRICT OF NEW YORK

UNITED STATES OF AMERICA,  
Plaintiff,  

-against-  
DEUTSCHE BANK AG, DB STRUCTURED PRODUCTS, INC., DEUTSCHE BANK  
SECURITIES, INC., and MORTGAGEIT, INC.,  
Defendants.

The United States of America (the "Government"), by its attorney, Preet Bharara, United States Attorney for the Southern District of New York, brings this action against Deutsche Bank AG, DB Structured Products, Inc., and Deutsche Bank Securities, Inc. (together, "Deutsche Bank"), as well as MortgageIT, Inc. ("MortgageIT") (collectively, "Defendants"), alleging upon information and belief as follows:
INTRODUCTION

1. This is a civil mortgage fraud lawsuit brought by the United States against Deutsche Bank and MortgageIT. As set forth below, Deutsche Bank and MortgageIT repeatedly lied to be included in a Government program to select mortgages for insurance by the Government. Once in that program, they recklessly selected mortgages that violated program rules in blatant disregard of whether borrowers could make mortgage payments. While Deutsche Bank and MortgageIT profited from the resale of these Government-insured mortgages, thousands of American homeowners have faced default and eviction, and the Government has paid hundreds of millions of dollars in insurance claims, with hundreds of millions of dollars more expected to be paid in the future. The Government brings this action seeking damages and penalties for the past and future claims that violate the False Claims Act, 31 U.S.C. §§ 3729 et seq., and the common law.

2. The Federal Housing Administration (“FHA”) of the Department of Housing and Urban Development (“HUD”) is the largest mortgage insurer in the world. FHA mortgage insurance makes home ownership possible for millions of American families by protecting lenders against defaults on mortgages, thereby encouraging lenders to make loans to borrowers who might not be able to meet conventional underwriting requirements. FHA accepts a fixed level of risk set by statute and HUD rules. FHA relies on this fixed level of risk to set appropriate mortgage insurance premiums to offset the costs of paying FHA insurance claims. By controlling risk and setting appropriate insurance premiums, FHA has been able to operate based solely on the income it generates from mortgage insurance premium proceeds. Since its
inception in 1934, FHA has insured more than 34 million home mortgages. FHA currently insures approximately one third of all new residential mortgages in the United States.

3. To assist as many qualified homeowners as possible, and to provide maximum economic opportunities to lenders interested in obtaining FHA insurance on mortgages, FHA operates a Direct Endorsement Lender program with lenders in the private sector. The Direct Endorsement Lender program grants participating lenders the authority to endorse mortgages that are qualified for FHA insurance. In reviewing mortgages for eligibility for FHA insurance, Direct Endorsement Lenders are entrusted with safeguarding the public from taking on risks that exceed statutory and regulatory limits. Direct Endorsement Lenders act as fiduciaries of HUD in underwriting mortgages and endorsing them for FHA insurance.

4. The integrity of the Direct Endorsement Lender program requires participating Direct Endorsement Lenders to carefully review mortgages to ensure compliance with HUD rules. HUD entrusts Direct Endorsement Lenders with great responsibility, and therefore places significant emphasis on the lenders’ qualifications. To qualify as a Direct Endorsement Lender, a lender must implement a mandatory quality control plan. Quality control plans are necessary to ensure that Direct Endorsement Lenders follow all HUD rules, and to provide procedures for correcting problems in a lender’s underwriting operations.

5. An essential part of every quality control plan is the auditing of all early payment defaults, i.e., those mortgages that default soon after closing. Early payment defaults may be signs of problems in the underwriting process. By reviewing early payment defaults, Direct Endorsement Lenders are able to monitor those problems, correct them, and report them to HUD. Every Direct Endorsement Lender must make an annual certification of compliance with the
Direct Endorsement Lender program’s qualification requirements, including the implementation of a mandatory quality control plan. Absent a truthful annual certification, a lender is not entitled to maintain its Direct Endorsement Lender status and is not entitled to endorse loans for FHA insurance.

6. On a mortgage-by-mortgage basis, HUD requires Direct Endorsement Lenders to conduct due diligence to ensure that each mortgage is eligible for FHA insurance as set forth in HUD rules. These rules exist to prevent HUD from insuring mortgages that exceed the risk levels set by statute and regulations. A Direct Endorsement Lender must assure HUD that every endorsed mortgage meets all HUD rules. HUD requires the Direct Endorsement Lender to certify, for each mortgage the lender endorses, that the lender has conducted due diligence in accordance with all HUD rules. Absent a truthful mortgage eligibility certification, a Direct Endorsement Lender cannot endorse a mortgage for FHA insurance.

7. Between 1999 and 2009, MortgageIT was an approved Direct Endorsement Lender. During that time period, MortgageIT endorsed more than 39,000 mortgages for FHA insurance, totaling more than $5 billion in underlying principal obligations. These FHA-insured mortgages were highly marketable for resale to investors because they were insured by the full faith and credit of the United States. MortgageIT and Deutsche Bank, which acquired MortgageIT in 2007, made substantial profits through the resale of these endorsed FHA-insured mortgages.

8. Deutsche Bank and MortgageIT had powerful financial incentives to invest resources into generating as many FHA-insured mortgages as quickly as possible for resale to investors. By contrast, Deutsche Bank and MortgageIT had few financial incentives to invest
resources into ensuring the quality of its FHA-insured mortgages through the maintenance of the mandatory quality control program, or into ensuring that MortgageIT limited its endorsement of mortgages to those loans that were eligible for FHA insurance under HUD rules.

9. Deutsche Bank and MortgageIT repeatedly lied to HUD to obtain and maintain MortgageIT’s Direct Endorsement Lender status. Deutsche Bank and MortgageIT failed to implement the quality control procedures required by HUD, and their violations of HUD rules were egregious. For instance, Deutsche Bank and MortgageIT failed to audit all early payment defaults, despite the requirement that this be done; Deutsche Bank and MortgageIT made it impossible for their few quality control employees to conduct the required quality control by grossly understaffing their quality control units; Deutsche Bank and MortgageIT repeatedly failed to address dysfunctions in the quality control system, which were reported to upper management; after its acquisition by Deutsche Bank, MortgageIT took the only staff member dedicated to auditing FHA-insured mortgages, and reassigned him to increase production instead; and when an outside auditor provided findings to MortgageIT revealing serious problems, those findings were literally stuffed in a closet and left unread and unopened.

10. Despite Deutsche Bank’s and MortgageIT’s egregious violations of the basic eligibility requirement of a compliant quality control plan, every year for a decade Deutsche Bank or MortgageIT annually certified that MortgageIT complied with the eligibility criteria of the Direct Endorsement Lender program. They did so to maintain MortgageIT’s Direct Endorsement Lender status in contravention of HUD rules. Moreover, on various occasions when HUD discovered evidence that MortgageIT was violating the quality control requirement, MortgageIT deceived HUD by falsely promising HUD that it had corrected or would correct the
failures. Through these false annual certifications and deceptions, Deutsche Bank and MortgageIT obtained and maintained MortgageIT’s Direct Endorsement Lender status without the required quality control program in place, thereby putting hundreds of millions of FHA dollars at risk.

11. As a Direct Endorsement Lender, MortgageIT repeatedly lied to HUD to obtain approval of mortgages that MortgageIT underwriters wrongfully endorsed for FHA insurance. These mortgages were not eligible for FHA insurance under HUD rules. Notwithstanding the mortgages’ ineligibility, underwriters at MortgageIT endorsed the mortgages by falsely certifying that they had conducted the due diligence required by HUD rules when, in fact, they had not. By endorsing ineligible mortgages and falsely certifying compliance with HUD rules, MortgageIT wrongfully obtained approval of these ineligible mortgages for FHA insurance. This happened both before and after MortgageIT was acquired by Deutsche Bank.

12. As of June 2011, HUD has paid more than $368 million in FHA insurance claims and related costs arising out of Defendants’ approval of mortgages for FHA insurance. Many of these losses were caused by the false statements Defendants made to HUD to obtain FHA insurance on thousands of individual loans. The Government expects HUD will be required to pay hundreds of millions of dollars in additional FHA insurance claims as additional mortgages underwritten by MortgageIT default in the months and years ahead.

13. In this suit, the United States seeks treble damages and penalties under the False Claims Act, 31 U.S.C. §§ 3729 et seq., and compensatory and punitive damages under the common law theories of breach of fiduciary duty, gross negligence, negligence, and indemnification, for the insurance claims already paid by HUD for mortgages wrongfully
endorsed by MortgageIT. In addition, the United States seeks compensatory and punitive damages under the common law theories of breach of fiduciary duty, gross negligence, negligence, and indemnification, for the insurance claims that HUD expects to pay in the future for mortgages wrongfully endorsed by MortgageIT.

JURISDICTION AND VENUE

14. This Court has jurisdiction pursuant to 31 U.S.C. § 3730(a), 28 U.S.C. §§ 1331 and 1345, and the Court’s general equitable jurisdiction.

15. Venue is appropriate in this judicial district pursuant to 31 U.S.C. § 3732(a) and 28 U.S.C. §§ 1391(b)(1) and (c) because Deutsche Bank and MortgageIT transact significant business within this district and therefore are subject to personal jurisdiction in this judicial district.

PARTIES

16. Plaintiff is the United States of America.

17. Defendant Deutsche Bank AG is a German business corporation with an office in Manhattan. Defendant DB Structured Products, Inc. (“DB Structured Products”) and Defendant Deutsche Bank Securities, Inc. (“DB Securities”) are wholly-owned subsidiaries of Deutsche Bank AG with their principal places of business in Manhattan.

18. Defendant MortgageIT is a New York business corporation with its principal place of business in Manhattan. Between 1999 and 2009, MortgageIT was a Direct Endorsement Lender. During that time period, MortgageIT employed more than 2,000 people, had branches throughout the country, and was licensed to originate residential mortgages in all 50 states. MortgageIT has been a wholly-owned Deutsche Bank subsidiary since January 2007.
19. Deutsche Bank acquired MortgageIT on or about January 3, 2007, pursuant to a merger. Following the merger, MortgageIT was directly owned by DB Structured Products and indirectly owned by Deutsche Bank AG. Moreover, employees of these two Deutsche Bank entities, as well as of DB Securities, had key roles in the post-merger management of MortgageIT, as demonstrated below.

20. As a result of the merger, and pursuant to the express terms of the merger agreement, Deutsche Bank acquired all of the pre-merger assets and liabilities of MortgageIT.

21. Prior to the merger, and beginning on or about May 22, 2006, Deutsche Bank conducted substantial due diligence of MortgageIT. This due diligence included access to an online datasite and direct communications with MortgageIT’s management. The due diligence also included access to MortgageIT’s books, records, properties, and personnel.

22. After the merger, Deutsche Bank operated the business of MortgageIT as part of its residential mortgage backed securities (“RMBS”) business based in Manhattan. Deutsche Bank established MortgageIT as a business unit within its Corporate and Investment Bank Division, and used MortgageIT as a means to execute its mortgage lending strategy in the United States. Indeed, in announcing the merger on July 12, 2006, MortgageIT stated that its “management team and infrastructure will become the cornerstone of DB’s existing and planned mortgage lending operations and strategy in the U.S. As part of the deal, DB’s existing U.S. mortgage operations will be combined under MortgageIT.”

23. Similarly, on July 12, 2006, Deutsche Bank issued a press release in which it described the merger as “a key element of the Bank’s build-out of a vertically integrated mortgage origination and securitization platform.” Deutsche Bank further explained that its
“acquisition of MortgageIT is the latest in a series of steps taken to significantly increase its presence in the US mortgage markets.”

24. In the Deutsche Bank press release, Philip Weingord, the Head of Global Markets Americas at Deutsche Bank, and Anshu Jain, the Head of Global Markets at Deutsche Bank and a member of the Deutsche Bank Group Executive Committee, described Deutsche Bank’s strategy to incorporate MortgageIT into its existing mortgage business. Mr. Weingord stated:

As Deutsche Bank continues to grow its RMBS business, we believe the vertical integration of a leading mortgage originator like MortgageIT will provide significant competitive advantages, such as access to a steady source of product for distribution into the mortgage capital markets . . . . MortgageIT is a significant lender in the prime Alt-A residential mortgage sector. Uniting their business with our other channels of mortgage loan origination coupled with our trading, structuring and distribution capabilities will further advance our position as a leading RMBS player.

Mr. Jain added: “The MortgageIT team has built an outstanding business, and we are extremely pleased to have them join our effort as we continue to expand our mortgage securitization platform in the US and globally.”

25. Upon acquiring MortgageIT, Deutsche Bank retained MortgageIT’s management and workforce. For example, both before and after the merger, Douglas Naidus was MortgageIT’s Chairman and Chief Executive Officer (“CEO”), Gary Bierfriend was MortgageIT’s President, Andy Occhino was MortgageIT’s General Counsel and Secretary, Robert Gula was MortgageIT’s Chief Financial Officer, and Patrick McEnerney was MortgageIT’s Chief Operating Officer. Moreover, both before and after the merger, MortgageIT had the same Director of Government Lending and the same Government Loan Auditor.

26. In announcing the merger on July 12, 2006, MortgageIT emphasized that, post-merger, there would be continuity of the MortgageIT business. MortgageIT stated that its
“management team and personnel will continue on in their same positions, and their phone numbers and location will not change.” MortgageIT assured its employees that, following the merger, “MortgageIT management and staff will retain their positions and play critical roles in the ongoing development of . . . [the] company.” MortgageIT further stated that the acquisition would have “no impact” on its relationship with its business partners and customers, and that “for now and after the deal closes, it[’]s ‘business as usual’ in every aspect of our operations.”

27. While MortgageIT’s management retained their positions following the merger, many also became principals of Deutsche Bank. For example, Douglas Naidus became a Managing Director of Deutsche Bank and the Head of Mortgage Origination within Deutsche Bank’s RMBS group. Similarly, Patrick McEnerney became a Managing Director of Deutsche Bank.

28. Although Deutsche Bank retained MortgageIT’s management and workforce, after the merger, Deutsche Bank supervised the various aspects of the MortgageIT business. For instance, after the merger, Deutsche Bank fully integrated MortgageIT into its compliance and risk management structure, such that Deutsche Bank was cognizant of, involved in, and ultimately responsible for MortgageIT’s activities. Among other things, Deutsche Bank had its employees oversee all of MortgageIT’s compliance programs.

29. In addition, Deutsche Bank established a committee structure through which it supervised MortgageIT’s credit and operational risks. To supervise credit risk, Deutsche Bank established the Credit Risk Committee, which consisted of seven senior managers from MortgageIT and five from Deutsche Bank. This committee met biweekly. To supervise operational risk, Deutsche Bank established five committees whose members also included
representatives from the senior management of both MortgageIT and Deutsche Bank. One of those committees was the Quality Control Committee, which consisted of fifteen senior managers from MortgageIT and two from Deutsche Bank. The other four committees were the Loan Investigation Department Committee (sixteen senior managers from MortgageIT and seven from Deutsche Bank); the Executive Level Repurchase Committee (eleven senior managers from MortgageIT and eight from Deutsche Bank); the Loan Investigation Recommendation Committee (twelve senior managers from MortgageIT and two from Deutsche Bank); and the Client Review Committee (ten senior managers from MortgageIT and one from Deutsche Bank). The Quality Control Committee met biweekly, the Loan Investigation Department Committee met “frequently as needed,” and the other three committees met weekly.

30. Deutsche Bank also established a reporting structure pursuant to which MortgageIT’s senior management reported to Deutsche Bank executives. For example, after the merger, Douglas Naidus, MortgageIT’s Chairman and CEO, reported to Philip Weingord, a Managing Director and the Head of Global Markets Americas at Deutsche Bank. Similarly, Andy Occhino, MortgageIT’s General Counsel and Secretary, reported to Jeffrey Welch, a Managing Director in Deutsche Bank’s Legal Department. In addition, MortgageIT’s Director of Government Lending reported to another MortgageIT employee, who in turn reported to Joseph Swartz, a Deutsche Bank Director. All MortgageIT employees were required to adhere to the Deutsche Bank Code of Professional Conduct.

31. Furthermore, upon closing of the merger, Deutsche Bank reconfigured MortgageIT’s Board of Directors to consist of three members, all of whom were Managing Directors of Deutsche Bank: Douglas Naidus, Philip Weingord, and Michael Commaroto. In

32. The Deutsche Bank employees who were involved in the post-merger management of MortgageIT were affiliated with a number of different Deutsche Bank entities, including Deutsche Bank AG, DB Structured Products, and DB Securities. For example, in addition to being a Director of MortgageIT: Michael Commaroto was a Director and Officer of DB Structured Products, as well as the Head of Asset Backed Whole Loan Trading at Deutsche Bank AG; Joseph Rice was a Director of DB Structured Products, as well as the Director of Corporate Treasury and of Group Treasury Americas at Deutsche Bank AG; and Joy Margolies was an Officer of DB Structured Products. Ms. Margolies was also an employee of DB Securities, as was Philip Weingord and Joseph Swartz.

33. Deutsche Bank’s post-merger management of the MortgageIT business included oversight of MortgageIT’s Direct Endorsement Lender business. After the acquisition, Deutsche Bank managed the quality control functions of the Direct Endorsement Lender business, and had its employees sign and submit MortgageIT’s Direct Endorsement Lender annual certifications to HUD.

34. When Deutsche Bank acquired MortgageIT, it was on notice of and expressly assumed responsibility for MortgageIT’s pre-merger actions as a Direct Endorsement Lender, including the misconduct identified herein. Moreover, after the acquisition, through its oversight of and involvement in MortgageIT’s Direct Endorsement Lender business, Deutsche Bank assumed responsibility for MortgageIT’s post-merger actions as a Direct Endorsement Lender, including the misconduct identified herein. Having assumed ultimate responsibility for
MortgageIT’s actions as a Direct Endorsement Lender, Deutsche Bank is liable for the misconduct identified herein under the False Claims Act and the common law.

**FACTS**

**I. BACKGROUND**

**A. The FHA Direct Endorsement Program**

35. FHA is the largest insurer of residential mortgages in the world. Pursuant to the National Housing Act of 1934, FHA offers various mortgage insurance programs. Through these programs, FHA insures approved lenders against losses on mortgage loans. FHA mortgage insurance may be granted on mortgages used to purchase homes, improve homes, or to refinance existing mortgages. FHA’s single family mortgage insurance programs cover owner-occupied principal residences.

36. FHA mortgage insurance programs help low-income and moderate-income families become homeowners by lowering some of the costs of their mortgage loans. FHA mortgage insurance encourages lenders to make loans to otherwise creditworthy borrowers and projects that might not be able to meet conventional underwriting requirements by protecting the lenders against defaults on mortgages.

37. To qualify for FHA mortgage insurance, a mortgage must meet all of the applicable HUD requirements. Those requirements relate to, among other things, the adequacy of the borrower’s income to meet the mortgage payments and other obligations, the borrower’s creditworthiness, and the appropriateness of the valuation of the property subject to the mortgage.
38. HUD operates the Direct Endorsement Program as part of the FHA-insured mortgage program. Under the Direct Endorsement process, HUD does not itself conduct a detailed review of applications for mortgage insurance before an FHA-insured mortgage closes. Rather, approved lenders, called Direct Endorsement Lenders, must determine whether the proposed mortgage is eligible for FHA insurance under the applicable program regulations. A Direct Endorsement Lender underwrites and closes mortgages without prior HUD review or approval. Direct Endorsement Lenders submit documentation regarding underwritten loans after the mortgage has closed, and certify that the endorsed mortgage complies with HUD rules.

39. The Direct Endorsement Program works as follows: The Direct Endorsement Lender originates a proposed loan, or in some instances, acts as a sponsoring lender by underwriting and funding proposed mortgages originated by other FHA lenders known as loan correspondents. In either case, the Direct Endorsement Lender ultimately reviews the proposed mortgage. The borrower, along with the Direct Endorsement Lender’s representative, completes the loan application. A loan officer collects all supporting documentation from the borrower and submits the application and documentation to the Direct Endorsement Lender. The Direct Endorsement Lender obtains an appraisal. A professional underwriter employed by the Direct Endorsement Lender performs a mortgage credit analysis to determine the borrower’s ability and willingness to repay the mortgage debt in accordance with HUD rules. The Direct Endorsement Lender’s underwriter makes the underwriting decision as to whether the mortgage may be approved for FHA insurance or not, according to HUD rules. If the underwriter has decided that the mortgage may be approved for FHA insurance in accordance with HUD rules, the Direct Endorsement Lender closes the loan with the borrower. Thereafter, the Direct Endorsement
Lender certifies that the mortgage qualifies for FHA insurance. FHA endorses the loan on the basis of the Direct Endorsement Lender’s certification and provides the Direct Endorsement Lender with a mortgage insurance certificate.

40. The Direct Endorsement Lender is responsible for all aspects of the mortgage application, the property analysis, and the underwriting of the mortgage. FHA endorses mortgages in reliance upon the Direct Endorsement Lender’s certifications that the mortgages may be approved for FHA insurance. Direct Endorsement Lenders obligate HUD without independent HUD review.

41. In the event that a borrower defaults on an FHA-insured mortgage, the holder of the mortgage is able to submit a claim to HUD for the costs associated with the defaulted mortgage.

42. In the mortgage industry, the imprimatur of FHA mortgage insurance makes covered mortgages highly marketable for resale to investors both because such mortgages are expected to have met all HUD requirements and because they are insured by the full faith and credit of the United States.

B. Direct Endorsement Lenders And Underwriters

43. A mortgage lender must apply to FHA’s Office of Lender Activities and Program Compliance to become a Direct Endorsement Lender.

44. To qualify for FHA approval as a Direct Endorsement Lender, a lender must have a qualified underwriter on staff. The underwriter’s responsibilities are critical elements of the Direct Endorsement Program, and a Direct Endorsement Lender must certify that its underwriters meet FHA qualifications.
45. An underwriter must be a full time employee of the mortgage lender and must either be a corporate officer with signatory authority or otherwise be authorized to bind the mortgage lender in matters involving origination of mortgage loans. An underwriter must also be a reliable and responsible professional who is skilled in mortgage evaluation and able to demonstrate knowledge and experience regarding principles of mortgage underwriting.

46. An underwriter must “evaluate [each] mortgagor’s credit characteristics, adequacy and stability of income to meet the periodic payments under the mortgage and all other obligations, and the adequacy of the mortgagor’s available assets to close the transaction, and render an underwriting decision in accordance with applicable regulations, policies and procedures.” 24 C.F.R. § 203.5(d). In addition, the underwriter must “have [each] property appraised in accordance with [the] standards and requirements” prescribed by HUD. 24 C.F.R. § 203.5(e).

C. Quality Control Prerequisites For Direct Endorsement Lenders

47. To qualify for FHA approval as a Direct Endorsement Lender, a lender must implement a quality control plan that ensures its underwriters’ compliance with HUD rules.

48. The development and implementation of a quality control plan is a basic eligibility requirement for Direct Endorsement Lenders. HUD has determined that the Direct Endorsement Lender program can be offered only if participating lenders have acceptable quality control plans. Accordingly, as a precondition to Direct Endorsement Lender approval, HUD will require each lender to have an acceptable quality control plan to manage, conduct, and review the underwriting of mortgages that are submitted for direct endorsement.
49. A Direct Endorsement Lender must have a fully functioning quality control program from the date of its initial FHA approval until final surrender or termination of its approval. Thus, a Direct Endorsement Lender must implement and continuously have in place a quality control plan as a condition of receiving and maintaining FHA approval.

50. The purposes of quality control plans include ensuring that the procedures and personnel used by Direct Endorsement Lenders when underwriting mortgages meet all HUD requirements, and providing procedures for correcting problems once a Direct Endorsement Lender becomes aware of their existence.

51. A mandatory HUD requirement for the implementation of Direct Endorsement Lender quality control plans is the review of all early payment defaults. Early payment defaults are mortgages that go into default (i.e., are more than 60 days past due) within the first six payments of the mortgage.

52. Early payment defaults are markers of mortgage fraud. Early payment defaults reveal that the borrower – whom the Direct Endorsement Lender had certified as having met all criteria for creditworthiness, and could thus be expected to make payments for the life of the mortgage – could not, in fact, make even the first six payments of the mortgage.

53. A Direct Endorsement Underwriter must review each early payment default for compliance with HUD underwriting requirements. A Direct Endorsement Lender that lacks a quality control program that provides for such review is in material violation of HUD’s quality control requirements.

54. Compliance with HUD’s quality control requirements is a condition of receiving and maintaining Direct Endorsement Lender eligibility, as well as of endorsing particular loans.
for FHA insurance. Without a compliant quality control program, which includes the review of all early payment defaults, a lender is not entitled to maintain its Direct Endorsement Lender status or endorse loans for FHA insurance.

55. HUD has warned lenders that failure to comply with HUD’s quality control requirements could result in the withdrawal of their Direct Endorsement Lender status.

D. Direct Endorsement Lenders’ Duties

1. Due Diligence As Required By Regulation

56. HUD relies on Direct Endorsement Lenders to conduct due diligence on Direct Endorsement loans. The purposes of due diligence include (1) determining a borrower’s ability and willingness to repay a mortgage debt, thus limiting the probability of default and collection difficulties, see 24 C.F.R. § 203.5(d), and (2) examining a property offered as security for the loan to determine if it provides sufficient collateral, see 24 C.F.R. § 203.5(e)(3). Due diligence thus requires an evaluation of, among other things, a borrower’s credit history, capacity to pay, cash to close, and collateral. In all cases, a Direct Endorsement Lender owes HUD the duty, as prescribed by federal regulation, to “exercise the same level of care which it would exercise in obtaining and verifying information for a loan in which the mortgagee would be entirely dependent on the property as security to protect its investment.” 24 C.F.R. § 203.5(c).

57. HUD has set specific rules for due diligence predicated on sound underwriting principles. In particular, HUD requires Direct Endorsement Lenders to be familiar with, and to comply with, governing HUD Handbooks and Mortgagee Letters, which provide detailed processing instructions to Direct Endorsement Lenders. These materials specify the minimum due diligence with which Direct Endorsement Lenders must comply.
58. With respect to ensuring that borrowers have sufficient credit, a Direct Endorsement Lender must comply with governing HUD Handbooks, such as HUD 4155.1, *Mortgage Credit Analysis for Mortgage Insurance on One-to-Four-Family Properties*, to evaluate a borrower’s credit. The rules set forth in HUD 4155.1 exist to ensure that a Direct Endorsement Lender sufficiently evaluates whether a borrower has the ability and willingness to repay the mortgage debt. HUD has informed Direct Endorsement Lenders that past credit performance serves as an essential guide in determining a borrower’s attitude toward credit obligations and in predicting a borrower’s future actions.

59. To properly evaluate a borrower’s credit history, a Direct Endorsement Lender must, at a minimum, obtain and review credit histories; analyze debt obligations; reject documentation transmitted by unknown or interested parties; inspect documents for proof of authenticity; obtain adequate explanations for collections, judgments, recent debts and recent credit inquiries; establish income stability and make income projections; obtain explanations for any gaps in employment; document any gift funds; calculate debt and income ratios and compare those ratios to the fixed ratios set by HUD rules; and consider and document any compensating factors permitting deviations from those fixed ratios.

60. With respect to appraising the mortgaged property (*i.e.*, collateral for the loan), a Direct Endorsement Lender must ensure that an appraisal and its related documentation satisfy the requirements in governing HUD Handbooks, such as HUD 4150.2, *Valuation Analysis for Home Mortgage Insurance*. The rules set forth in HUD 4150.2 exist to ensure that a Direct Endorsement Lender obtains an accurate appraisal that properly determines the value of the property for HUD’s mortgage insurance purposes.
2. Due Diligence As Required By Common Law

61. Direct Endorsement Lenders owe HUD a common law duty of due diligence.

62. The exercise of due diligence is an affirmative duty of Direct Endorsement Lenders. This duty obligates Direct Endorsement Lenders to comply with HUD rules, accepted practices of prudent lending institutions, and all procedures that a prudent lender would use if it looked solely to the property as security to protect its interests. The duty further obliges the Direct Endorsement Lender to use due care in providing information and advice to FHA.

63. Indeed, “[t]he entire scheme of FHA mortgage guaranties presupposes an honest mortgagee performing the initial credit investigation with due diligence and making the initial judgment to lend in good faith after due consideration of the facts found.” United States v. Bernstein, 533 F.2d 775, 797 (2d Cir. 1976).

64. HUD has apprised Direct Endorsement Lenders of this common law duty since it first created the Direct Endorsement Lender program. See 48 Fed. Reg. 11928, 11932 (Mar. 22, 1983) (“The duty of due diligence owed the Department by approved mortgagees is based not only on these regulatory requirements, but also on civil case law.”); id. (“HUD considers the exercise of due diligence an affirmative duty on the part of mortgagees participating in the program.”).

3. The Fiduciary Duty Of Utmost Good Faith

65. A fiduciary relationship exists between Direct Endorsement Lenders and HUD.

66. HUD relies on the expertise and knowledge of Direct Endorsement Lenders in providing FHA insurance. HUD places confidence in their decisions. The confidence that HUD
reposes in Direct Endorsement Lenders invests those lenders with an advantage in the Direct Endorsement Lenders’ relationship with HUD.

67. Direct Endorsement Lenders are under a duty to act for HUD, and give advice to HUD, for HUD’s benefit, as to whether mortgages should be insured by FHA under the Direct Endorsement Lender program.

68. As a result of the fiduciary relationship between Direct Endorsement Lenders and HUD, Direct Endorsement Lenders have a duty to HUD of uberrimiae fidea, or, the obligation to act with the utmost good faith, candor, honesty, integrity, fairness, undivided loyalty, and fidelity in dealings with HUD.

69. The duty of uberrimiae fidea also requires Direct Endorsement Lenders to refrain from taking advantage of HUD by the slightest misrepresentation, to make full and fair disclosures to HUD of all material facts, and to take on the affirmative duty of employing reasonable care to avoid misleading HUD in all circumstances.

70. The duty of uberrimiae fidea further requires Direct Endorsement Lenders to exercise sound judgment, prudence, and due diligence on behalf of HUD in endorsing mortgages for FHA insurance.

E. Direct Endorsement Lender Certifications

1. Annual Certifications

71. To obtain and maintain Direct Endorsement Lender status, a Direct Endorsement Lender must submit an annual certification to HUD.

72. The Direct Endorsement Lender must make the following annual certification, in sum and substance:
I know or am in the position to know, whether the operations of the above named mortgagee conform to HUD-FHA regulations, handbooks, and policies. I certify that to the best of my knowledge, the above named mortgagee conforms to all HUD-FHA regulations necessary to maintain its HUD-FHA approval, and that the above-named mortgagee is fully responsible for all actions of its employees including those of its HUD-FHA approved branch offices.

73. The annual certification requires compliance with the basic eligibility requirements for Direct Endorsement Lenders, which includes compliance with the mandatory HUD rules concerning quality control, such as the rule requiring review of all early payment defaults.

74. As stated above, submitting truthful annual certifications to HUD is a condition of obtaining and maintaining status as a Direct Endorsement Lender and endorsing loans for FHA insurance.

2. Loan Application Certifications

75. A Direct Endorsement Lender must submit a certification to FHA for each loan for which it seeks FHA insurance.

76. A Direct Endorsement Lender may use an FHA-approved automated underwriting system to review loan applications. The automated underwriting system processes information entered by the Direct Endorsement Lender and rates loans as either an “accept”/“approve” or a “refer”/“caution.”

77. In cases where a Direct Endorsement Lender uses an FHA-approved automated underwriting system, and the system rates a loan as an “accept” or “approve,” the Direct Endorsement Lender must make the following certification, in sum and substance:

   This mortgage was rated as an “accept” or “approve” by a FHA-approved automated underwriting system. As such, the undersigned representative of
the mortgagee certifies to the integrity of the data supplied by the lender used to determine the quality of the loan, that Direct Endorsement Underwriter reviewed the appraisal (if applicable) and further certifies that this mortgage is eligible for HUD mortgage insurance under the Direct Endorsement program. I hereby make all certifications required by this mortgage as set forth in HUD Handbook 4000.4.

78. In cases where a Direct Endorsement Lender uses an FHA-approved automated underwriting system, and the system rates a loan as “refer” or “caution,” or in cases where a Direct Endorsement Lender does not use an FHA-approved automated underwriting system, the underwriter must make the following certification, in sum and substance:

This mortgage was rated as a “refer” or “caution” by a FHA-approved automated underwriting system, and/or was manually underwritten by a Direct Endorsement underwriter. As such, the undersigned Direct Endorsement Underwriter certifies that I have personally reviewed the appraisal report (if applicable), credit application, and all associated documents and have used due diligence in underwriting this mortgage. I find that this mortgage is eligible for HUD mortgage insurance under the Direct Endorsement program and I hereby make all certifications required for this mortgage as set forth in HUD Handbook 4000.4.

79. The certifications in HUD Handbook 4000.4, incorporated by reference in the certifications above, include the certification that the mortgage complies with HUD underwriting requirements contained in all outstanding HUD Handbooks and Mortgagee Letters.

80. Absent a truthful loan application certification, a Direct Endorsement Lender is not entitled to endorse a particular loan for FHA insurance.

II. MORTGAGEIT’S DIRECT ENDORSEMENT LENDER ACTIVITIES


82. MortgageIT maintained its status as an FHA-approved mortgage company and Direct Endorsement Lender through October 16, 2009.
83. MortgageIT, and Deutsche Bank after January 2007, filed with HUD annual certifications of MortgageIT’s purported compliance with the Direct Endorsement Lender program’s qualification requirements, including the implementation of a compliant quality control plan, a requirement of which is the review of all early payment defaults.

84. As a Direct Endorsement Lender, MortgageIT approved more than 39,000 mortgages for FHA insurance, totaling more than $5 billion in underlying principal obligations. For each mortgage, MortgageIT certified that it complied with all HUD rules.

85. As of June 2011, of the more than 39,000 mortgages for FHA insurance endorsed by MortgageIT, more than 12,900 of those mortgages (i.e., approximately a third) defaulted. Of those, more than more than 3,200 defaulted within six months, more than 4,500 defaulted within a year, and more than 6,900 defaulted within two years of closing.

86. As of June 2011, HUD has paid more than $368 million in FHA insurance claims and related costs arising out of more than 3,200 mortgages. Of these, HUD has paid more than $92 million in FHA claims and related costs arising out of more than 690 mortgages that defaulted within six months, more than $151 million in FHA claims and related costs arising out of more than 1,200 mortgages that defaulted within a year, and more than $245 million in FHA claims and related costs arising out of more than 2,000 mortgages that defaulted within two years.

87. As of June 2011, more than 7,400 additional mortgages, totaling more than $857 million in calculated unpaid principal balances, have defaulted, without any claims yet having been paid by HUD. Of these, there are more than $255 million of calculated unpaid principal

1 A list of the loans with respect to which HUD has paid FHA insurance claims through June 2011 is attached hereto as Exhibit A.
balances for more than 1,700 mortgages that defaulted within six months, there are more than $337 million of calculated unpaid principal balances for more than 2,300 mortgages that defaulted within a year, and there are more than $473 million of calculated unpaid principal balances for more than 3,400 mortgages that defaulted within two years.

III. DEUTSCHE BANK AND MORTGAGEIT LIED TO MAINTAIN MORTGAGEIT’S DIRECT ENDORSEMENT LENDER STATUS

88. Deutsche Bank and MortgageIT failed to comply with HUD rules and regulations regarding required quality control procedures, even though those procedures were mandatory for MortgageIT’s maintenance of its Direct Endorsement Lender status. Instead, Deutsche Bank and MortgageIT maintained MortgageIT’s Direct Endorsement Lender status by making false representations to HUD about MortgageIT’s purported compliance with HUD rules and regulations regarding quality control. In reality, MortgageIT’s quality control procedures egregiously violated HUD rules and regulations.

A. Deutsche Bank And MortgageIT Certified And Represented To HUD That MortgageIT Would Comply With HUD’s Mandatory Quality Control Requirements

1. Deutsche Bank and MortgageIT Annually Certified Compliance With Quality Control Requirements

89. Between 1999 and 2009, MortgageIT and, after January 2007, Deutsche Bank, filed annual certifications with HUD to obtain and maintain MortgageIT’s Direct Endorsement Lender status. In those annual certifications, Deutsche Bank and MortgageIT certified MortgageIT’s compliance with all HUD rules and regulations necessary for maintenance of its Direct Endorsement Lender status.
90. Between 1999 and 2006, MortgageIT filed the annual certifications with HUD. For instance, on February 1, 2005, Gary Bierfriend, the President of MortgageIT, signed an annual certification stating “I know or am in the position to know, whether the operations of this mortgagee conforms to all HUD regulations and guidelines. I certify that to the best of my knowledge, the mortgagee conforms to all HUD regulations necessary to maintain its HUD/FHA approval.” MortgageIT officers filed similar certifications each year between 1999 and 2006.

91. Between 2007 and 2009, Deutsche Bank filed the annual certifications with HUD. For instance, on March 9, 2007, Patrick McEnerney, a Managing Director of Deutsche Bank, signed an annual certification stating “I know, or am in the position to know, whether the operations of the above named mortgagee conform to HUD-FHA regulations, handbooks and policies. I certify that to the best of my knowledge, the above named mortgagee conforms to all HUD-FHA regulations necessary to maintain its HUD-FHA approval.” On February 6, 2009, Joseph Swartz, a Deutsche Bank Director, signed an identical certification. Deutsche Bank officers filed these certifications each year after 2007, until MortgageIT ceased its operations as a Direct Endorsement Lender in 2009.

92. After Deutsche Bank acquired MortgageIT, there was a discussion involving, among others, the Director of Government Lending at MortgageIT about who should sign the annual certifications. It ultimately was decided that a Deutsche Bank employee should sign them. Consequently, Patrick McEnerney signed the 2007 annual certification in his capacity as a Managing Director of Deutsche Bank. Indeed, underneath his signature on the 2007 annual certification, Mr. McEnerney handwrote the title, “Managing Director.” A Deutsche Bank officer also signed the annual certifications in 2008 and 2009.
93. A regulation necessary to maintain HUD approval for Direct Endorsement Lender status is the HUD regulation mandating continuous implementation of a quality control plan conforming to HUD rules, including the rule requiring review of all early payment defaults. The individuals who signed the annual certifications – including the Deutsche Bank officers who signed after January 2007 – either knew, deliberately ignored, or recklessly disregarded that MortgageIT did not have a quality control plan that conformed to HUD rules when they signed. For example, when Patrick McEnerney signed the 2007 annual certification representing that MortgageIT was in compliance with the HUD rules necessary to maintain Direct Endorsement Lender status, he knew that the certification was false, consciously avoided learning whether it was true or false, or recklessly disregarded whether it was true or false. Indeed, in 2007, the Government Loan Auditor at MortgageIT was in a position to tell Mr. McEnerney or anyone else who asked that MortgageIT was not reviewing all early payment defaults on FHA-insured loans. Similarly, the other MortgageIT and Deutsche Bank employees who signed the annual certifications would have learned that MortgageIT was not reviewing all early payment defaults on FHA-insured loans if they had conducted even a minimal inquiry before signing.

2. MortgageIT Made Additional Representations To HUD That It Would Comply With Quality Control Requirements

94. In addition to the annual certifications, MortgageIT made additional representations to HUD that MortgageIT would comply with quality control requirements, including, in particular, the review of all early payment defaults.

95. For example, a HUD audit conducted during the week of September 13, 2003, by the HUD Quality Assurance Division, Philadelphia Homeownership Center, revealed that MortgageIT had “not maintained a Quality Control Plan, (QC) plan in accordance with
HUD/FHA requirements,” and that, among other failures, MortgageIT had failed to “ensure that loans that go into default within the first 6 months are reviewed.” The 2003 audit required MortgageIT to provide a statement of corrective action to prevent a recurrence of the violation.

96. MortgageIT responded to the 2003 audit by informing HUD that it had altered its quality control procedures to follow HUD rules, including by ensuring the review of all early payment defaults. That representation was false.

97. As another example, a HUD audit conducted during the week of September 20, 2004, by the HUD Quality Assurance Division, Philadelphia Homeownership Center, again revealed that MortgageIT had failed, among other things, to ensure “that loans which go into default within the first six months are reviewed.” The 2004 audit required MortgageIT to provide a statement of corrective action to prevent a recurrence of the violation.

98. In response to the 2004 audit, MortgageIT promised HUD that it would review all early payment defaults. In particular, by letter dated June 24, 2005, the Director of Government Lending at MortgageIT acknowledged that MortgageIT’s failure to review all early payment defaults was “unacceptable,” and that “mortgagees must review all loans going into default within the first six payments.” The Direct of Government Lending at MortgageIT further represented that MortgageIT “understands HUD’s directive” to review all early payment defaults, and that MortgageIT would “comply with this request.” That representation was false.

99. Later, in February 2006, the HUD Quality Assurance Division, Philadelphia Homeownership Center, discovered, through communications with MortgageIT, that MortgageIT was not reviewing early payment defaults. HUD officials scolded personnel at MortgageIT for their failure to review all early payment defaults.
100. In response, the Director of Government Lending at MortgageIT represented to HUD that MortgageIT would review all early payment defaults. That representation was false. MortgageIT neither reviewed all early payment defaults nor had a system in place for reviewing all such defaults.

B. Contrary to Deutsche Bank And MortgageIT’s Representations And Certifications To HUD, They Egregiously Violated HUD’s Quality Control Rules

101. Contrary to the representations and certifications made by Deutsche Bank and MortgageIT, Deutsche Bank and MortgageIT failed to implement basic quality control requirements.

102. Deutsche Bank’s and MortgageIT’s quality control violations were not trivial or innocent, but knowing, material, and egregious.

103. These egregious quality control violations were being committed simultaneously with Deutsche Bank’s and MortgageIT’s false representations and certifications to HUD that MortgageIT would comply with HUD quality control requirements.

104. In submitting false annual certifications and making false representations, including each of the examples cited in the paragraphs above, Deutsche Bank and MortgageIT had actual knowledge of the falsity of their misrepresentations.

105. Alternatively, in submitting false annual certifications and making false representations, including each of the examples cited in the paragraphs above, Deutsche Bank and MortgageIT acted in deliberate ignorance and/or reckless disregard of the truth.
1. Deutsche Bank and MortgageIT Failed To Review All Early Payment Defaults

106. The HUD rules require Direct Endorsement Lenders to review all early payment defaults as a mandatory part of quality control.

107. Contrary to the repeated representations and certifications made by Deutsche Bank and MortgageIT, MortgageIT failed to review all early payment defaults as mandated by HUD rules. Nor did MortgageIT have a system in place to review all such defaults. Moreover, for some periods, MortgageIT failed to review any early payment defaults.

108. Deutsche Bank and MortgageIT personnel failed to review all early payment defaults. In fact, despite repeated representations to HUD that MortgageIT would conduct early payment default reviews as part of MortgageIT’s quality control, MortgageIT quality control personnel did not know how to identify early payment defaults until February 2006. After MortgageIT quality control personnel learned how to identify early payment defaults, MortgageIT nevertheless failed to review all early payment defaults.

109. This failure to review all early payment defaults continued after Deutsche Bank acquired MortgageIT in January 2007. The MortgageIT employee who monitored early payment defaults on FHA-insured loans after February 2006, the Government Loan Auditor, did not review all early payment defaults in 2006 or 2007. He was not instructed to do so. Moreover, by the end of 2007, the Government Loan Auditor was not reviewing any early payment defaults, because he had been reassigned to assist with loan production.

110. In addition, outside vendors failed to review all early payment defaults for MortgageIT. Although, in certain years, MortgageIT contracted with outside vendors to conduct
audits of certain MortgageIT loans, the outside vendors were unable to review all early payment defaults because MortgageIT failed to identify early payment defaults to the vendors.

2. Deutsche Bank And MortgageIT Ignored Quality Control

111. In addition to failing to review early payment defaults as required by HUD rules, Deutsche Bank and MortgageIT also failed to implement the minimal quality control processes they purportedly had in place.

   a. MortgageIT Stuffed Its Vendor’s Quality Control Audits in a Closet, Unread and Unopened

112. Until late 2005, MortgageIT had no personnel to conduct the required quality control reviews of closed FHA-insured loans.

113. In or about 2004, MortgageIT contracted with an outside vendor, Tena Companies, Inc. (“Tena”), to conduct quality control reviews of closed FHA-insured loans.

114. As noted above, those reviews did not include early payment defaults because MortgageIT failed to identify early payment defaults to Tena.

115. Throughout 2004, Tena prepared findings letters detailing underwriting violations it found in FHA-insured mortgages underwritten by MortgageIT.

116. The findings letters included the identification of serious underwriting violations. Among the serious underwriting violations identified in the Tena findings were violations by a MortgageIT underwriter in the MortgageIT Chicago branch. The underwriting violations involved mortgages in the Michigan market, including properties in and around Dearborn, Michigan, and certain repeat brokers in that market.

117. No one at MortgageIT read any of the Tena findings letters as they arrived in 2004.
118. Instead, MortgageIT employees stuffed the letters, unopened and unread, in a closet in MortgageIT’s Manhattan headquarters.

119. The letters remained unopened until December 2004 or January 2005.

120. In December 2004, MortgageIT hired its first quality control manager. The quality control manager asked to see the Tena findings, but was not provided with any findings. After searching throughout the office, the head of the credit department at MortgageIT showed the quality control manager to a closet. The quality control manager opened the closet and found a series of envelopes, unopened and still sealed, in the closet.

121. The envelopes were disorganized. They contained the unread Tena findings.

122. The quality control manager opened the Tena findings, for the first time, in December 2004 or January 2005. The quality control manager quickly identified serious underwriting violations, which had remained undiscovered over the course of the preceding year, because no one had bothered to read the Tena reports.

123. The quality control manager reported the Tena findings to her supervisor, the Senior Vice President of the Audit Department. The quality control manager subsequently discussed the Tena findings with the Vice President of Credit and, thereafter, with the President of MortgageIT. None of those individuals indicated any prior awareness of the Tena findings.

124. MortgageIT’s failure to read the audit reports from its outside vendor prevented MortgageIT from taking appropriate actions to address patterns of ongoing underwriting violations.
b. MortgageIT Upper Management Failed to Fix a Dysfunctional Quality Control System

125. When MortgageIT hired a quality control manager for the first time in December 2004, the quality control manager attempted to implement a quality control system at MortgageIT. The system quickly proved dysfunctional.

126. The quality control system was supposed to work as follows: The quality control manager would identify closed mortgages for review by an outside vendor. The outside vendor would perform a preliminary review and send the findings to the MortgageIT quality control manager. To evaluate the findings, the MortgageIT quality control manager would send the findings to the branches that had underwritten the mortgages at issue. The branches were to respond to the findings, so that the MortgageIT quality control manager could assess problems with the quality of MortgageIT’s underwriting. The MortgageIT quality control manager was to write up her assessment in a quarterly report to upper management.

127. The system described above never worked.

128. In particular, the branches never provided responses to the preliminary quality control findings of the outside vendor. The quality control system therefore broke down halfway.

129. As a result, the MortgageIT quality control manager was not able to generate an assessment of quality issues to present to management in a quarterly report.

130. The MortgageIT quality control manager complained to upper management at MortgageIT that the quality control system was broken. The MortgageIT quality control manager asked for assistance in addressing the problems with the quality control system. In addition, in or around August 2005, the quality control manager’s supervisor, the Senior Vice
President of the Audit Department, sent a letter to upper management at MortgageIT describing the problems that the quality control manager was facing.

131. MortgageIT, however, failed to make any changes in response to the complaints and requests of the quality control manager or her supervisor.

c. Deutsche Bank and MortgageIT Failed to Provide Guidance to MortgageIT Quality Control Personnel

132. Deutsche Bank and MortgageIT failed to provide guidance, including the required quality control plan, to its personnel conducting quality control.

133. For instance, from the first quarter of 2006 until 2009, MortgageIT’s quality control for FHA-insured loans was conducted by the Government Loan Auditor. During that period, the Government Loan Auditor was the only employee at Deutsche Bank and MortgageIT tasked with reviewing closed FHA-insured mortgage files.

134. Deutsche Bank and MortgageIT never provided the Government Loan Auditor with a copy of MortgageIT’s required quality control plan.

135. Deutsche Bank and MortgageIT never explained the contents of the required quality control plan to the Government Loan Auditor.

136. Deutsche Bank and MortgageIT never provided the Government Loan Auditor with any guidance concerning his review of closed FHA-insured mortgage files. Among other things, Deutsche Bank and MortgageIT never provided the Government Loan Auditor with criteria as to which mortgage files to review, or how many mortgage files to review.

137. Instead, the Government Loan Auditor was wholly without guidance as to any quality control plan at MortgageIT.
3. Deutsche Bank and MortgageIT Chronically Understaffed Quality Control

138. Deutsche Bank and MortgageIT failed to adequately staff the quality control reviews of closed FHA-insured mortgages.

139. When MortgageIT interviewed its first quality control manager in December 2004, MortgageIT informed the manager that she would have a full staff to conduct quality control reviews.

140. In order to review all early payment defaults as required by HUD rules, Deutsche Bank and MortgageIT would have needed to employ a staff of at least six to eight employees.

141. Deutsche Bank and MortgageIT never provided the quality control manager at MortgageIT with a full staff.

142. In fact, Deutsche Bank and MortgageIT never employed more than one person to conduct quality control reviews of closed FHA-insured mortgages.

143. Between 2006 and 2009, the sole employee at Deutsche Bank or MortgageIT conducting quality control reviews of closed FHA-insured mortgages was the Government Loan Auditor. His review of closed FHA-insured mortgages continually declined during that period, and declined most significantly after Deutsche Bank acquired MortgageIT. By the end of 2007, the Government Loan Auditor was no longer spending any time conducting quality control reviews of closed mortgage files. To increase sales, Deutsche Bank and MortgageIT shifted his work from quality control reviews of closed mortgages (i.e., quality control audits) to assistance with production.

144. By the end of 2007, not a single person at Deutsche Bank or MortgageIT was conducting quality control reviews of closed FHA-insured mortgages, as required by HUD rules.
Thus, after Deutsche Bank acquired MortgageIT, it not only failed to fix the existing quality control deficiencies at MortgageIT, but it made a very bad problem even worse by directing the one employee who had been conducting only a portion of the required quality control reviews of closed FHA-insured mortgages to stop doing so altogether. As explained below, this failure to conduct the required quality control reviews after Deutsche Bank acquired MortgageIT in January 2007 resulted in additional defaulted loans, a dramatic increase in early payment defaults, and increased damages to HUD.

C. The Absence Of The Required Quality Control Systems Led To Patterns Of Underwriting Violations And Mortgage Fraud

145. Deutsche Bank’s and MortgageIT’s failure to implement the required quality control systems rendered them unable to prevent patterns of mortgage underwriting violations and mortgage fraud.

146. One illustration of this failure is the pattern of underwriting violations in Michigan, which MortgageIT could have and should have stopped with proper quality control systems and responses. In this example, as in other cases, the absence of the required quality control systems led MortgageIT to miss multiple opportunities to detect serious underwriting violations and mortgage fraud. Moreover, here, as elsewhere, MortgageIT failed to comply with its basic quality control obligations, including its obligation to address serious quality problems when they arise, and to report suspected mortgage fraud to HUD. Instead, MortgageIT – including upper management at MortgageIT – knowingly, wantonly, and recklessly permitted egregious underwriting violations to continue unabated. These failures caused the Government millions of dollars in losses.
147. As noted, MortgageIT lacked a system for reviewing early payment defaults. Such a system would have identified a pattern of early payment defaults in Michigan involving a common underwriter and common brokers. If MortgageIT had conducted the required early payment default reviews, it would have recognized these problems by 2004, terminated the underwriter and MortgageIT’s relationship with the brokers, and reported the problems to HUD, pursuant to HUD rules. MortgageIT failed to do so. As a result, the underwriter continued her pattern of serious underwriting violations, and the brokers continued their pattern of submitting ineligible and/or fraudulent mortgages.

148. Throughout 2004, the Tena findings described above identified underwriting violations by this MortgageIT underwriter who engaged in a pattern of serious underwriting violations with common brokers. If MortgageIT had read, in a timely manner, the findings provided to it by Tena, it would have recognized these problems by mid-2004, terminated the underwriter and MortgageIT’s relationship with the brokers, and reported the problems to HUD, pursuant to HUD rules. MortgageIT failed to do so. As a result, the underwriter continued her pattern of serious underwriting violations, and the brokers continued their pattern of submitting ineligible and/or fraudulent mortgages.

149. In December 2004 or January 2005, MortgageIT’s quality control manager read the Tena findings for the first time, and identified the MortgageIT underwriter engaging in the pattern of serious underwriting violations with common brokers. The quality control manager informed upper management within MortgageIT, including the President of the company, about these serious problems. In mid-2005, the quality control manager asked the President and other upper management at MortgageIT to take action. The President of MortgageIT failed to do so.
As a result, the underwriter continued her pattern of serious underwriting violations, and the brokers continued their pattern of submitting ineligible and/or fraudulent mortgages.

150. In September 2005, a MortgageIT employee employed outside of the quality control group identified the same pattern of underwriting violations described above. She likewise informed upper management of the problem. MortgageIT, however, once again failed to take action against the underwriter. As a result, the underwriter continued her pattern of serious underwriting violations, and some of the brokers continued their pattern of submitting ineligible and/or fraudulent mortgages.

151. In February 2006, HUD discovered the pattern of underwriting violations described above and discussed the pattern with MortgageIT. MortgageIT failed to take effective action for months. As a result, the underwriter continued her pattern of serious underwriting violations until May 2006, and some of the brokers likewise continued their pattern of submitting ineligible and/or fraudulent mortgages until then.

152. If MortgageIT had the required quality control procedures in place, it would have recognized the patterns described above by at least sometime in mid-2004 and addressed them. Doing so in this instance would have prevented approximately one hundred mortgages from being endorsed for FHA insurance, which subsequently defaulted, and which have accounted for millions of dollars in claims.

153. This is just one illustration of how Deutsche Bank and MortgageIT’s failure to implement the required quality control systems rendered them unable and unwilling to prevent patterns of mortgage underwriting violations and/or mortgage fraud.
D. The False Certifications and Representations By Deutsche Bank and MortgageIT Have Caused HUD To Pay Hundreds Of Millions Of Dollars In Insurance Claims Thus Far

154. The false certifications and representations by Deutsche Bank and MortgageIT regarding purported compliance with HUD quality control requirements permitted MortgageIT to endorse more than 39,000 mortgages for FHA insurance.

155. Absent a truthful annual certification, a lender is not entitled to maintain its Direct Endorsement Lender status and is not entitled to endorse loans for FHA insurance. If MortgageIT and Deutsche Bank had been truthful about their egregious failures to implement the requisite quality control procedures, MortgageIT would not been able to maintain its Direct Endorsement Lender status and continue endorsing loans for FHA insurance.

156. As of June 2011, HUD has paid more than $368 million in FHA insurance claims and related costs arising out of MortgageIT’s approval of mortgages for FHA insurance.

157. HUD expects to pay at least hundreds of millions of dollars in additional FHA insurance claims as additional mortgages underwritten by MortgageIT default in the months and years ahead.

158. The costs relating to FHA insurance claims paid by HUD to date and the costs relating to FHA insurance claims expected to be paid by HUD are the direct result of Deutsche Bank’s and MortgageIT’s false certifications and representations described above.

IV. BEFORE AND AFTER ITS ACQUISITION BY DEUTSCHE BANK, MORTGAGEIT ABUSED ITS DIRECT ENDORSEMENT LENDER STATUS TO ENDORSE THOUSANDS OF MORTGAGES INELIGIBLE FOR FHA INSURANCE

159. MortgageIT abused the Direct Endorsement Lender status that it maintained through the lies of Deutsche Bank and MortgageIT. In particular, as a Direct Endorsement
Lender, MortgageIT regularly violated HUD rules, prudent underwriting practices, and MortgageIT’s duties to HUD, by failing to conduct due diligence on mortgages that it reviewed and approved for FHA insurance. Despite its repeated violations of HUD rules, MortgageIT falsely certified, on a loan-by-loan basis, that it had complied with HUD rules and that the mortgages it endorsed were eligible for FHA insurance under HUD rules. MortgageIT engaged in this misconduct both before and after its merger with Deutsche Bank. If HUD had known that MortgageIT’s mortgage eligibility certifications were false, HUD would not have permitted MortgageIT to endorse those loans for FHA insurance.

A. MortgageIT Repeatedly Certified That It Conducted Due Diligence And Complied With HUD Rules

160. Between 1999 and 2009, as a Direct Endorsement Lender, MortgageIT approved more than 39,000 mortgages for FHA insurance.

161. For each mortgage, MortgageIT certified that it complied with all HUD rules, including HUD rules requiring due diligence.

B. Contrary to MortgageIT’s Certifications To HUD, MortgageIT Repeatedly Failed To Conduct Due Diligence In Accordance With HUD Rules

162. Contrary to the certifications appearing on each and every mortgage endorsed by MortgageIT, MortgageIT engaged in a nationwide pattern of failing to conduct due diligence in accordance with HUD rules and with sound and prudent underwriting principles.

163. MortgageIT knew that its certifications of compliance with HUD rules were false.

164. In the alternative, in falsely certifying compliance with HUD rules, MortgageIT acted with deliberate ignorance and/or reckless disregard of the truth.

165. In the alternative, MortgageIT’s false certifications, as well as its failure to
conduct due diligence in accordance with HUD rules, were reckless, grossly negligent, and/or negligent.

166. MortgageIT’s false certifications, as well as its failure to conduct due diligence in accordance with HUD rules, violated MortgageIT’s duty of care to HUD.

167. MortgageIT’s false certifications, as well as its failure to conduct due diligence in accordance with HUD rules, violated MortgageIT’s fiduciary obligations to HUD.

168. This pattern of false certifications extended to MortgageIT’s branches throughout the United States, as illustrated by the ten examples below. Moreover, this pattern continued after MortgageIT was acquired by, and was under the supervision and control of, Deutsche Bank, as also illustrated by the examples below. MortgageIT’s actions in these ten examples were not isolated events. These examples represent a small fraction, but a representative sample, of the total number of mortgages for which MortgageIT submitted false certifications.

1. New York Example: The Center Street Property

169. FHA case number 372-3209567 relates to a property on Center Street in Waterloo, New York (the “Center Street Property”). MortgageIT underwrote the mortgage for the Center Street Property, reviewed and approved it for FHA insurance, and certified that MortgageIT had conducted due diligence on the mortgage application (the “Center Street Mortgage Application”). The mortgage closed on or about June 27, 2002.

170. Contrary to the MortgageIT certification, MortgageIT did not comply with HUD rules in reviewing and approving the Center Street Mortgage Application for FHA insurance. Instead, MortgageIT violated multiple HUD rules, including HUD 4155.1, Ch. 2, § 3, HUD 4155.1, Ch. 2, § 7(F), HUD 4155.1, Ch. 2, § 10(C), and HUD 4155.1, Ch. 3, § 1.
171. MortgageIT’s violation of HUD 4155.1, Ch. 2, § 10(C), illustrates one of the multiple HUD rules that MortgageIT violated in approving the Center Street Mortgage Application. HUD 4155.1, Ch. 2, § 10(C), provides that, in order to ensure that gift funds are not provided by a party to the sales transaction, the Direct Endorsement Lender must document gift funds with a gift letter, signed by the borrower, that specifies the amount of the gift and states that no repayment is required, and that the Direct Endorsement Lender must document the transfer of the funds from the donor to the borrower. Contrary to this rule, MortgageIT failed to document the gift funds with a letter signed by the borrower, stating the amount of the gift, or stating that repayment was not required, and MortgageIT failed to document the transfer of the gift funds. In violating HUD 4155.1, Ch. 2, § 10(C), MortgageIT endorsed the Center Street Mortgage Application without proof that the borrower closed with gift funds from a proper source rather than from, for instance, the seller.

172. MortgageIT’s false certification on the Center Street Mortgage Application was material and bore upon the likelihood that borrower would make mortgage payments.

173. Within two months after closing, the Center Street Mortgage went into default.

174. As a result, HUD paid an FHA insurance claim of $80,198, including costs.

2. Colorado Example: The Bittercreed Drive Property

175. FHA case number 052-3466494 relates to a property on Bittercreed Drive in Colorado Springs, Colorado (the “Bittercreed Drive Property”). MortgageIT underwrote the mortgage for the Bittercreed Drive Property, reviewed and approved it for FHA insurance, and certified that MortgageIT had conducted due diligence on the mortgage application (the “Bittercreed Drive Mortgage Application”). The mortgage closed on or about June 29, 2004.
Contrary to the MortgageIT certification, MortgageIT did not comply with HUD rules in reviewing and approving the Bittercreed Drive Mortgage Application for FHA insurance. Instead, MortgageIT violated multiple HUD rules, including HUD 4155.1, Ch. 2, § 3; HUD 4155.1, Ch. 2, § 10(C), HUD 4155.1, Ch. 3, § 1(E), and HUD 4155.1, Ch. 9, § 2(H)(2).

MortgageIT’s violation of HUD 4155.1, Ch. 2, § 3, illustrates one of the multiple HUD rules that MortgageIT violated in approving the Bittercreed Drive Mortgage Application. HUD 4155.1, Ch. 2, § 3, requires Direct Endorsement Lenders to develop a credit history for borrowers who do not have established credit histories. Lenders must do so by assembling payment records for recurring expenses such as utilities, rentals, and automobile insurance. Contrary to this rule, MortgageIT failed to develop a credit history by assembling any such records in reviewing the Bittercreed Drive Mortgage Application, even though the borrower had no established credit history (i.e., lacked any credit score). In violating HUD 4155.1, Ch. 2, § 3, MortgageIT endorsed the Bittercreed Drive Mortgage Application without any measure of the borrower’s creditworthiness based on past credit.

MortgageIT’s false certification on the Bittercreed Drive Mortgage Application was material and bore upon the likelihood that borrower would make mortgage payments.

Within six months after closing, the Bittercreed Drive Mortgage went into default.

As a result, HUD paid an FHA insurance claim of $190,977, including costs.

3. Indiana Example: The Monument Avenue Property

FHA case number 151-7978818 relates to a property on Monument Avenue in Portage, Indiana (the “Monument Avenue Property”). MortgageIT underwrote the mortgage for
the Monument Avenue Property, reviewed and approved it for FHA insurance, and certified that MortgageIT had conducted due diligence on the mortgage application (the “Monument Avenue Mortgage Application”). The mortgage closed on or about November 4, 2005.

182. Contrary to the MortgageIT certification, MortgageIT did not comply with HUD rules in reviewing and approving the Monument Avenue Mortgage Application for FHA insurance. Instead, MortgageIT violated multiple HUD rules, including HUD 4155.1, Ch. 2, § 3-1, HUD 4155.1, Ch. 2, § 4, HUD 4155.1, Ch. 2, § 10, and HUD 4155.1, Ch. 2, § 11.

183. MortgageIT’s violation of HUD 4155.1, Ch. 2, § 10, illustrates one of the multiple HUD rules that MortgageIT violated in approving the Monument Avenue Mortgage Application. HUD 4155.1, Ch. 2, § 10, requires Direct Endorsement Lenders to verify and document a borrower’s cash investment in a property. Contrary to this rule, MortgageIT failed to verify and document the borrower’s purported investment in the Monument Avenue Property; indeed, the documentation in the Monument Avenue Mortgage Application reveals that the borrower had documented assets of thousands of dollars less than the amount the borrower was purportedly investing in the property. In violating HUD 4155.1, Ch. 2, § 10, MortgageIT endorsed the Monument Avenue Mortgage Application without proof that the borrower contributed the purported investment to the closing.

184. MortgageIT’s false certification on the Monument Avenue Mortgage Application was material and bore upon the likelihood that borrower would make mortgage payments.

185. Within nine months after closing, the Monument Avenue Mortgage went into default.

186. As a result, HUD paid an FHA insurance claim of $143,302, including costs.
4. Michigan Example: The Kentucky Street Property

187. FHA case number 261-8886675 relates to a property on Kentucky Street in Dearborn, Michigan (the “Kentucky Street Property”). MortgageIT underwrote the mortgage for the Kentucky Street Property, reviewed and approved it for FHA insurance, and certified that MortgageIT had conducted due diligence on the mortgage application (the “Kentucky Street Mortgage Application”). The mortgage closed on or about February 15, 2005.

188. Contrary to the MortgageIT certification, MortgageIT did not comply with HUD rules in reviewing and approving the Kentucky Street Mortgage Application for FHA insurance. Instead, MortgageIT violated multiple HUD rules, including HUD 4155.1, Ch. 3, § 1(E).

189. MortgageIT’s violation of HUD 4155.1, Ch. 3, § 1(E), illustrates one of the multiple HUD rules that MortgageIT violated in approving the Kentucky Street Mortgage Application. HUD 4155.1, Ch. 3, § 1(E), requires Direct Endorsement Lenders to verify current employment by telephone, and to record the name and telephone number of the person who verified employment on behalf of the employer. Contrary to this rule, MortgageIT failed to contact the employer, and, after the mortgage closed, the listed employer verified that the borrower was never its employee. In violating HUD 4155.1, Ch. 3, § 1(E), MortgageIT endorsed the Kentucky Street Mortgage Application based on unverified, and ultimately untrue, representations about the borrower’s employment.

190. MortgageIT’s false certification on the Kentucky Street Mortgage Application was material and bore upon the likelihood that borrower would make mortgage payments.

191. Within four months after closing, the Kentucky Street Mortgage went into default.

192. As a result, HUD paid an FHA insurance claim of $199,119, including costs.
5. **Oklahoma Example: The Sixth Street Property**

193. FHA case number 421-4018115 relates to a property on Southwest Sixth Street in Oklahoma City, Oklahoma (the “Sixth Street Property”). MortgageIT underwrote the mortgage for the Sixth Street Property, reviewed and approved it for FHA insurance, and certified that MortgageIT had conducted due diligence on the mortgage application (the “Sixth Street Mortgage Application”). The mortgage closed on or about January 2, 2004.

194. Contrary to the MortgageIT certification, MortgageIT did not comply with HUD rules in reviewing and approving the Sixth Street Mortgage Application for FHA insurance. Instead, MortgageIT violated multiple HUD rules, including HUD 4155.1, Ch. 2, § 3, HUD 4155.1, Ch. 2, § 6, HUD 4155.1, Ch. 2, § 10(A), HUD 4155.1, Ch. 3, § 1(E), and HUD 4155.1, Ch. 3, § 1(F).

195. MortgageIT’s violation of HUD 4155.1, Ch. 2, § 10(A), illustrates one of the multiple HUD rules that MortgageIT violated in approving the Sixth Street Mortgage Application. HUD 4155.1, Ch. 2, § 10(A), requires that Direct Endorsement Lenders must verify the source of any earnest money deposits that appear excessive in relation to the borrower’s savings by completing a verification of deposit, or by collecting bank statements, to document that the borrower had sufficient funds to cover the deposit. Contrary to this rule, MortgageIT obtained neither a verification of deposit nor bank statements for the Sixth Street Mortgage Application, even though the borrower’s earnest money deposit was excessive in relation to his accumulate savings. Moreover, MortgageIT approved the mortgage for FHA insurance despite the fact that closing documents reveal that the borrower received, at closing, an amount exactly equal to the amount he purportedly provided as an earnest money deposit. In
violating HUD 4155.1, Ch. 2, § 10(C), MortgageIT endorsed the Sixth Street Mortgage Application without proof that the borrower closed with his own funds rather than funds from, for instance, the seller.

196. MortgageIT’s false certification on the Sixth Street Mortgage Application was material and bore upon the likelihood that borrower would make mortgage payments.

197. Within seven months after closing, the Sixth Street Mortgage went into default.

198. As a result, HUD paid an FHA insurance claim of $122,666, including costs.

6. Texas Example: The Catalina Drive Property

199. FHA case number 491-8308519 relates to a property on Catalina Drive in Lancaster, Texas (the “Catalina Drive Property”). MortgageIT underwrote the mortgage for the Catalina Drive Property, reviewed and approved it for FHA insurance, and certified that MortgageIT had conducted due diligence on the mortgage application (the “Catalina Drive Mortgage Application”). The mortgage closed on or about March 31, 2004.

200. Contrary to the MortgageIT certification, MortgageIT did not comply with HUD rules in reviewing and approving the Catalina Drive Mortgage Application for FHA insurance. Instead, MortgageIT violated multiple HUD rules, including HUD 4155.1, Ch. 2, § 4(A)(1), and HUD Handbook 4000.4, Rev-1 CHG-2 (1994) (“HUD 4000.4”), Ch. 2, § 4(C)(5).

201. MortgageIT’s violation of HUD 4000.4, Ch. 2, § 4(C)(5), illustrates one of the multiple HUD rules that MortgageIT violated in approving the Catalina Drive Mortgage Application. HUD 4155.1, Ch. 2, § 4(C), requires Direct Endorsement Lenders to be aware of the warning signs of fraud by examining irregularities presented in mortgage applications. Contrary to this rule, MortgageIT failed to reconcile a purported verification of employment
(i.e., a document required for the file), which represented that the borrower worked at Employer X from 2002 through 2004, with conflicting records in the same file, which contradicted that verification and documented that the borrower had, in fact, worked at Employer Y from 2003 through 2004. In violating HUD 4155.1, Ch. 2, § 4(C)(5), MortgageIT endorsed the Catalina Drive Mortgage Application without verifying the employment history of the borrower.

202. MortgageIT’s false certification on the Catalina Drive Mortgage Application was material and bore upon the likelihood that borrower would make mortgage payments.

203. Within five months after closing, the Catalina Drive Mortgage went into default.

204. As a result, HUD paid an FHA insurance claim of $126,683, including costs.

7. **Oregon Example: The Lakeside Drive Property**

205. FHA case number 431-4301440 relates to a property on NE Lakeside Drive in Madras, Oregon (the “Lakeside Drive Property”). MortgageIT, using an FHA-approved automated underwriting system (“AUS”), underwrote the mortgage for the Lakeside Drive Property (the “Lakeside Drive Mortgage”), reviewed and approved it for FHA insurance, and certified as to the integrity of the data supplied to the AUS and that the loan was eligible for FHA insurance under the Direct Endorsement Program. The mortgage closed on or about August 27, 2007.

206. Because the soundness of the AUS’s evaluation of a mortgage is dependent on the accuracy and reliability of the data submitted by the mortgagee, a mortgagee may only enter into the AUS such income, assets, debts, and credit information that meets FHA’s applicable eligibility rules and documentation requirements, including those set forth in HUD Handbook 4155.1, Mortgagee Letters, the FHA TOTAL Mortgagee Scorecard User Guide, and the AUS
207. Contrary to the MortgageIT certification, the data MortgageIT entered into the AUS lacked integrity and failed to meet FHA’s eligibility rules and documentation requirements.

208. Despite clear requirements, MortgageIT failed to obtain the required documentation to verify the borrower’s mortgage payment history and income. In failing to verify this information, which was submitted into the AUS, MortgageIT endorsed a loan for FHA insurance that was ineligible for FHA insurance, and was supported by data lacking integrity.

209. Moreover, HUD Handbook 4155.1, Ch. 2, § 3(C), and the FHA TOTAL Scorecard User Guide require that court-ordered judgments entered against a borrower must be paid off before a mortgage is eligible for FHA insurance. Contrary to this requirement, MortgageIT certified the Lakeside Drive Mortgage as eligible for FHA insurance, even though a credit report included in the mortgage application showed that the borrower was subject to an unpaid court-ordered judgment.

210. MortgageIT’s false certification on the Lakeside Drive Mortgage was material and bore upon the likelihood that borrower would make mortgage payments.

211. Within ten months after closing, the Lakeside Drive Mortgage went into default.

212. As a result, HUD paid an FHA insurance claim of $146,392.98, including costs.

8. Idaho Example: The Wrigley Street Property

213. FHA case number 121-2377843 relates to a property on West Wrigley Street in Boise, Idaho (the “Wrigley Street Property”). MortgageIT, using the AUS, underwrote the mortgage for the Wrigley Street Property (the “Wrigley Street Mortgage”), reviewed and
approved it for FHA insurance, and certified as to the integrity of the data supplied to the AUS and that the loan was eligible for FHA insurance under the Direct Endorsement Program. The mortgage closed on or about September 28, 2007.

214. Contrary to the MortgageIT certification, the data MortgageIT entered into the AUS lacked integrity and failed to meet FHA’s eligibility rules and documentation requirements.

215. Despite clear requirements, MortgageIT failed to obtain the required documentation to verify the borrower’s employment, income, and depository assets. In failing to verify this information, which was submitted into the AUS, MortgageIT endorsed a loan for FHA insurance that was ineligible for FHA insurance, and was supported by data lacking integrity.

216. MortgageIT’s false certification on the Wrigley Street Mortgage was material and bore upon the likelihood that borrower would make mortgage payments.

217. Within one month after closing, the Wrigley Street Mortgage went into default.

218. As a result, HUD paid an FHA insurance claim of $104,207.89, including costs.

9. Indiana Example #2: The Chestnut Street Property

219. FHA case number 151-8415100 relates to a property on Chestnut Street in Michigan City, Indiana (the “Chestnut Street Property”). MortgageIT underwrote the mortgage for the Chestnut Street Property, reviewed and approved it for FHA insurance, and certified that MortgageIT had conducted due diligence on the mortgage application (the “Chestnut Street Mortgage Application”). The mortgage closed on or about October 15, 2007.

220. Contrary to the MortgageIT certification, MortgageIT did not comply with HUD rules in reviewing and approving the Chestnut Street Mortgage Application for FHA insurance.
Instead, MortgageIT violated multiple HUD rules, including HUD Handbook 4155.1, Ch. 2, §§ 3(B), 12, and 13, HUD Handbook 4155.1, Ch. 3, §§ 1(A), 1(E), and 1(G), and Mortgagee Letter 2005-16.

221. MortgageIT’s violations of HUD Handbook 4155.1, Ch. 3, §§ 1(E) and 1(G), illustrate two of the multiple HUD rules that MortgageIT violated in approving the Chestnut Street Mortgage Application. HUD Handbook 4155.1, Ch. 3, § 1(E), requires Direct Endorsement Lenders to verify a borrower’s current employment and obtain the borrower’s most recent pay stub. Additionally, § 1(G) requires Direct Endorsement Lenders to obtain Federal income tax returns for a self-employed borrower or a borrower paid on commission. Contrary to these requirements, MortgageIT failed to obtain the required documentation. In violating HUD Handbook 4155.1, Ch. 3, §§ 1(E) and 1(G), MortgageIT endorsed the Chestnut Street Mortgage Application based on undocumented employment and income.

222. MortgageIT’s false certification on the Chestnut Street Mortgage Application was material and bore upon the likelihood that borrower would make mortgage payments.

223. Within eight months after closing, the Chestnut Street Mortgage went into default.

224. As a result, HUD paid an FHA insurance claim of $104,034.73, including costs.

10. Pennsylvania Example: The Ilona Drive Property

225. FHA case number 441-8039970 relates to a property on Ilona Drive in Hellertown, Pennsylvania (the “Ilona Drive Property”). MortgageIT underwrote the mortgage for the Ilona Drive Property, reviewed and approved it for FHA insurance, and certified that
MortgageIT had conducted due diligence on the mortgage application (the “Ilona Drive Mortgage Application”). The mortgage closed on or about November 30, 2007.

226. Contrary to the MortgageIT certification, MortgageIT did not comply with HUD rules in reviewing and approving the Ilona Drive Mortgage Application for FHA insurance. Instead, MortgageIT violated multiple HUD rules, including HUD Handbook 4155.1, Ch. 2, §§ 3 and 4, and HUD Handbook 4155.1, Ch. 3, § 1.

227. MortgageIT’s violations of HUD Handbook 4155.1, Ch. 2, §§ 3 and 4, illustrate two of the multiple HUD rules that MortgageIT violated in approving the Ilona Drive Mortgage Application. HUD Handbook 4155.1, Ch. 2, §§ 3 and 4, require Direct Endorsement Lenders to analyze a borrower’s credit and obtain a credit report on all borrowers who will be obligated on the mortgage note. Contrary to these requirements, MortgageIT failed to obtain a credit report on the borrower, and thus failed adequately to analyze the borrower’s credit prior to the loan closing. In violating HUD Handbook 4155.1, Ch. 2, §§ 3 and 4, MortgageIT endorsed the Ilona Drive Mortgage Application without documenting or adequately analyzing the borrower’s creditworthiness.

228. MortgageIT’s false certification on the Ilona Drive Mortgage Application was material and bore upon the likelihood that borrower would make mortgage payments.

229. Within three months after closing, the Ilona Drive Mortgage went into default.

230. As a result, HUD paid an FHA insurance claim of $205,935.79, including costs.

C. The False Certifications By MortgageIT Have Caused HUD To Pay Hundreds Of Millions Of Dollars In Insurance Claims Thus Far

231. HUD has paid thousands of insurance claims relating to mortgages insured by FHA based on MortgageIT’s false certifications of due diligence, similar to the examples set
forth in the previous section of this Complaint. HUD would not have made a financial commitment to pay such mortgage insurance claims absent MortgageIT’s false certifications.

232. MortgageIT’s false certifications, similar to the examples set forth in the previous section of this Complaint, were material and bore upon the likelihood that borrowers would make mortgage payments.

233. As of June 2011, HUD has paid more than $368 million in FHA insurance claims and related costs arising out of MortgageIT’s approval of mortgages for FHA insurance. Many of those claims arose out of FHA mortgage insurance provided by HUD based on MortgageIT’s false certifications of due diligence.

234. HUD expects to pay at least hundreds of millions of dollars in additional FHA insurance claims as additional mortgages underwritten by MortgageIT default in the months and years ahead. Many of those future claims will arise out of FHA mortgage insurance provided by HUD based on MortgageIT’s false certifications of due diligence.

V. DEUTSCHE BANK KNEW ABOUT MORTGAGEIT’S WRONGFUL CONDUCT PRIOR TO THE MERGER AND, AFTER THE MERGER, ALLOWED THE WRONGFUL CONDUCT TO CONTINUE

235. When Deutsche Bank acquired MortgageIT, it was on notice that MortgageIT had been violating the HUD rules described herein, including the rule requiring review of all early payment defaults. Prior to the merger, and beginning on or about May 22, 2006, Deutsche Bank conducted substantial due diligence of MortgageIT. This due diligence included access to MortgageIT’s books, records, and personnel, as well as direct communications with MortgageIT’s management, including Douglas Naidus, MortgageIT’s Chairman and CEO, and Gary Bierfriend, MortgageIT’s President.
236. Through the due diligence process, Deutsche Bank had access to documents evidencing MortgageIT’s violations of HUD rules and its related false representations to HUD. For example, Deutsche Bank had access to the June 24, 2005 letter from MortgageIT to HUD in which MortgageIT’s Director of Government Lending acknowledged that MortgageIT had not been reviewing all early payment defaults on closed FHA-insured loans and falsely represented that MortgageIT would do so in the future. Deutsche Bank also had access to prior letters from HUD addressing MortgageIT’s failure to review all early payment defaults, including letters dated September 27, 2004, December 8, 2004, and March 14, 2005. In addition, Deutsche Bank had access to MortgageIT managers who had knowledge of these violations and false representations, including the Director of Government Lending.

237. Moreover, MortgageIT managers with whom Deutsche Bank communicated prior to the merger had knowledge of the misconduct identified herein. For example, before the merger, in February 2005, Gary Bierfriend, MortgageIT’s President, signed one of the false annual certifications. He did so knowing that the certification was false or in deliberate ignorance or reckless disregard of whether it was false. Additionally, in 2005, Mr. Bierfriend was told about the Tena findings. Therefore, before the merger, Mr. Bierfriend also knew that MortgageIT’s deficient quality control practices had resulted in the approval of numerous ineligible and/or fraudulent mortgages for FHA insurance.

238. Notwithstanding its knowledge of MortgageIT’s wrongful conduct, Deutsche Bank completed the merger with MortgageIT, pursuant to which it expressly agreed to acquire all of the pre-merger assets and liabilities of MortgageIT.
239. Following the merger, MortgageIT continued its wrongful conduct. And, it did so with the knowledge and/or participation of Deutsche Bank. For example, shortly after the merger, it was decided that a Deutsche Bank employee should sign the annual certifications. Consequently, in March 2007, Patrick McEnerney signed the false annual certification for 2007 in his capacity as a Managing Director of Deutsche Bank. Indeed, he handwrote the title “Managing Director” under his name. Thereafter, in 2008 and 2009, Deutsche Bank employees signed two additional false annual certifications.

240. Furthermore, after the merger, Deutsche Bank fully integrated MortgageIT into its compliance and oversight structure, such that Deutsche Bank was cognizant of, involved in, and ultimately responsible for MortgageIT’s activities. For example, Deutsche Bank had MortgageIT’s senior officers report directly to Deutsche Bank executives, it reconfigured MortgageIT’s Board of Directors to consist of individuals who were either Managing Directors or Directors of Deutsche Bank, and it established a series of committees through which Deutsche Bank personnel would oversee the various aspects of the MortgageIT business, including quality control.

241. Deutsche Bank also corresponded directly with HUD about the business of MortgageIT, thus confirming that it was cognizant of, involved in, and ultimately responsible for MortgageIT’s activities. For example, on or about May 16, 2008, HUD sent a letter to MortgageIT in which it requested indemnification for certain loans that had been issued in violation of HUD rules. On or about August 18, 2008, Joseph Swartz responded by sending a letter to HUD enclosing a signed indemnification agreement. Mr. Swartz’s letter was written on Deutsche Bank letterhead and was signed by Mr. Swartz in his capacity as a Director of
Deutsche Bank. In the letter, Mr. Swartz identified himself as a “Director” of Deutsche Bank’s “RMBS” group.

242. The wrongful conduct alleged herein not only continued after Deutsche Bank acquired MortgageIT in January 2007, but it got worse. And, so did its consequences. As explained above, and contrary to Deutsche Bank’s representations to HUD, MortgageIT was not doing the required quality control reviews after January 2007. And, by the end of 2007, MortgageIT was not reviewing any early payment defaults on closed FHA-insured loans. This failure to conduct the requisite quality control reviews resulted in an explosion of early payment defaults. Before Deutsche Bank acquired MortgageIT, approximately 30 percent of all FHA loans MortgageIT originated entered into default, with approximately 10 percent of the defaults constituting early payment defaults. After Deutsche Bank acquired MortgageIT, the percentage of loans that defaulted increased to approximately 46 percent, while the percentage of defaults constituting early payment defaults skyrocketed to approximately 65 percent. Specifically, there were approximately 9,477 defaults and 992 early payment defaults for loans that closed between June 2000 and January 2007, and approximately 3,461 defaults and 2,223 early payment defaults for loans that closed between January 2007 and March 2009. On the approximately 3,461 loans that defaulted after Deutsche Bank acquired MortgageIT, HUD has paid more than $58 million in claims, and there are more than $350 million in principal balances that have not yet been submitted to HUD as insurance claims.

243. The United States Department of Justice first learned about Defendants’ false claims and statements to HUD in July 2010.
FIRST CLAIM
Violations of the False Claims Act
Causing False Claims

244. The Government incorporates by reference each of the preceding paragraphs as if fully set forth in this paragraph.


246. As set forth above, Deutsche Bank and MortgageIT knowingly, or acting with deliberate ignorance and/or with reckless disregard for the truth, presented and/or caused to be presented, to an officer or employee of the Government, false and fraudulent claims for payment or approval in connection with its endorsement of FHA-insured mortgages, by:

a. Submitting false annual certifications and making false representations to HUD with respect to MortgageIT’s qualifications for Direct Endorsement Lender status; and/or

b. Submitting false loan-level certifications to HUD in endorsing mortgages for FHA insurance.

247. The Government paid insurance claims, and incurred losses, relating to FHA-insured mortgages wrongfully endorsed by MortgageIT because of Deutsche Bank’s and MortgageIT’s wrongful conduct.
248. By reason of the false claims of Deutsche Bank and MortgageIT, the Government has been damaged in a substantial amount to be determined at trial, and is entitled to a civil penalty as required by law for each violation.

**SECOND CLAIM**

**Violations of the False Claims Act**  

**Use of False Statements**

249. The Government incorporates by reference each of the preceding paragraphs as if fully set forth in this paragraph.


251. As set forth above, Deutsche Bank and MortgageIT knowingly, or acting in deliberate ignorance and/or with reckless disregard of the truth, made, used, or caused to be made or used, false records and/or statements material to false or fraudulent claims in connection with MortgageIT’s maintenance of its Direct Endorsement Lender status and/or MortgageIT’s endorsement of FHA-insured mortgages.

252. The Government paid insurance claims, and incurred losses, relating to FHA-insured mortgages wrongfully endorsed by MortgageIT because of Deutsche Bank’s and MortgageIT’s wrongful conduct.

253. By reason of the false records and/or statements of Deutsche Bank and MortgageIT, the Government has been damaged in a substantial amount to be determined at trial, and is entitled to a civil penalty as required by law for each violation.
THIRD CLAIM

Violations of the False Claims Act

Reverse False Claims

254. The Government incorporates by reference each of the preceding paragraphs as if fully set forth in this paragraph.


256. As set forth above, Deutsche Bank and MortgageIT knowingly made, used or caused to be made or used false records and/or statements to conceal, avoid, or decrease an obligation to pay or transmit money or property to the United States.

257. The Government paid insurance claims, and incurred losses, relating to FHA-insured mortgages wrongfully endorsed by MortgageIT because of Deutsche Bank’s and MortgageIT’s wrongful conduct.

258. By virtue of the false records or statements made by Deutsche Bank and MortgageIT, the Government suffered damages and therefore is entitled to treble damages under the False Claims Act, to be determined at trial, and a civil penalty as required by law for each violation.

FOURTH CLAIM

Breach of Fiduciary Duty

259. The Government incorporates by reference each of the preceding paragraphs as if fully set forth in this paragraph.
260. Deutsche Bank and MortgageIT were fiduciaries of the Government, and owed the Government fiduciary duties.

261. As fiduciaries, Deutsche Bank and MortgageIT had a duty to act for, and give advice to, the Government for the benefit of the Government as to whether mortgages should be insured by FHA under the Direct Endorsement Lender program.

262. As fiduciaries, Deutsche Bank and MortgageIT had a duty of *uberrimae fidei*, or, the obligation to act in the utmost good faith, candor, honesty, integrity, fairness, undivided loyalty, and fidelity in their dealings with the Government.

263. As fiduciaries, Deutsche Bank and MortgageIT had a duty to refrain from taking advantage of the Government by the slightest misrepresentation, to make full and fair disclosures to the Government of all material facts, and to take on the affirmative duty of employing reasonable care to avoid misleading the Government in all circumstances.

264. As fiduciaries, Deutsche Bank and MortgageIT had a duty to exercise sound judgment, prudence, and due diligence on behalf of the Government in endorsing mortgages for FHA insurance.

265. As set forth above, Deutsche Bank and MortgageIT breached their fiduciary duties to the Government.

266. As a result of the breach of the fiduciary duties of Deutsche Bank and MortgageIT to the Government, the Government has paid insurance claims, and incurred losses, relating to FHA-insured mortgages endorsed by MortgageIT.
267. As a result of the breach of the fiduciary duties of Deutsche Bank and MortgageIT to the Government, the Government will pay future insurance claims, and incur future losses, relating to FHA-insured mortgages endorsed by MortgageIT.

268. By virtue of the above, the Government is entitled to compensatory and punitive damages, in an amount to be determined at trial.

**FIFTH CLAIM**

**Gross Negligence**

269. The Government incorporates by reference each of the preceding paragraphs as if fully set forth in this paragraph.

270. Deutsche Bank and MortgageIT owed the Government a duty of reasonable care and a duty to conduct due diligence.

271. As set forth above, Deutsche Bank and MortgageIT breached their duties to the Government.

272. As set forth above, Deutsche Bank and MortgageIT recklessly disregarded their duties to the Government.

273. As a result of the gross negligence of Deutsche Bank and MortgageIT, the Government has paid insurance claims, and incurred losses, relating to FHA-insured mortgages endorsed by MortgageIT.

274. As a result of the gross negligence of Deutsche Bank and MortgageIT, the Government will pay future insurance claims, and incur future losses, relating to FHA-insured mortgages endorsed by MortgageIT.
275. By virtue of the above, the Government is entitled to compensatory and punitive damages, in an amount to be determined at trial.

**SIXTH CLAIM**

*Negligence*

276. The Government incorporates by reference each of the preceding paragraphs as if fully set forth in this paragraph.

277. Deutsche Bank and MortgageIT owed the Government a duty of reasonable care and a duty to conduct due diligence.

278. As set forth above, Deutsche Bank and MortgageIT breached their duties to the Government.

279. As a result of the negligence of Deutsche Bank and MortgageIT, the Government has paid insurance claims, and incurred losses, relating to FHA-insured mortgages endorsed by MortgageIT.

280. As a result of the negligence of Deutsche Bank and MortgageIT, the Government will pay future insurance claims, and incur future losses, relating to FHA-insured mortgages endorsed by MortgageIT.

281. By virtue of the above, the Government is entitled to compensatory damages, in an amount to be determined at trial.

**SEVENTH CLAIM**

*Indemnification*

282. The Government incorporates by reference each of the preceding paragraphs as if fully set forth in this paragraph.
283. Deutsche Bank and MortgageIT owed the Government a duty of reasonable care and a duty to conduct due diligence.

284. As set forth above, Deutsche Bank and MortgageIT breached their duties to the Government.

285. As a result of the breach of the duties of Deutsche Bank and MortgageIT to the Government, the Government has paid insurance claims, and incurred losses, relating to FHA-insured mortgages endorsed by MortgageIT.

286. As a result of the breach of the duties of Deutsche Bank and MortgageIT to the Government, the Government will pay future insurance claims, and incur future losses, relating to FHA-insured mortgages endorsed by MortgageIT.

287. By virtue of the above, the Government is entitled to indemnification of its losses relating to FHA-insured mortgages endorsed by MortgageIT.

WHEREFORE, the Government respectfully requests that judgment be entered in its favor and against Deutsche Bank and MortgageIT as follows:

a. For treble the Government’s damages for past claims paid by the Government, in an amount to be determined at trial;

b. For compensatory damages for past claims paid, and future claims expected to be paid, by the Government, in an amount to be determined at trial, and, in the alternative, for indemnification;

c. For such civil penalties as are required by law;

d. For punitive damages;
e. For an award of costs pursuant to 31 U.S.C. § 3729(a); and

f. For an award of any such further relief as is proper.

Dated: New York, New York
       August 22, 2011

PREET BHARARA
United States Attorney for the
Southern District of New York
Attorney for the United States

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Christopher.Harwood@usdoj.gov
Exhibit A

FHA Case Numbers for Claims Paid as of June 2011
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CERTIFICATE OF SERVICE

I, Pierre G. Armand, an Assistant United States Attorney for the Southern District of New York, hereby certify that on August 22, 2011, I caused a copy of the foregoing Amended Complaint to be served upon the following by U.S. mail and e-mail:

Andrew J. Levander
Cheryl A. Krause
Michael H. Park
DECHERT LLP
1095 Avenue of the Americas
New York, NY 10036

PIERRE G. ARMAND
UNITED STATES V. WELLS FARGO BANK, N.A., 12-CV-7527 (S.D. N.Y. DEC 2012):
FIRST AMENDED COMPLAINT
UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

UNITED STATES OF AMERICA,

Plaintiff,

-against-

WELLS FARGO BANK, N.A.,

Defendant.

12 Civ. 7527 (JMF)(JCF)

FIRST AMENDED COMPLAINT OF THE
UNITED STATES OF AMERICA

Jury Trial Demanded

The United States of America (the “United States” or the “Government”), by its attorney, Preet Bharara, United States Attorney for the Southern District of New York, brings this complaint against Wells Fargo Bank, N.A. (“Wells Fargo”), alleging as follows:

INTRODUCTION

1. This is a civil fraud action by the United States to recover treble damages and civil penalties under the False Claims Act, as amended, 31 U.S.C. §§ 3729 et seq., civil penalties under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (“FIRREA”), 12 U.S.C. § 1833a, and common-law damages arising from fraud on the United States
Department of Housing and Urban Development ("HUD") in connection with Wells Fargo’s residential mortgage lending business.

2. As set forth more fully below, Wells Fargo, the largest HUD-approved Federal Housing Administration ("FHA") residential mortgage lender, engaged in a regular practice of reckless origination and underwriting of its retail FHA loans over the course of more than four years, from May 2001 through October 2005, all the while knowing that it would not be responsible when the materially deficient loans went into default. Rather, as explained below, under FHA’s Direct Endorsement program, HUD insured the loans that Wells Fargo was originating. During this four and a half year period, Wells Fargo certified to HUD that over 100,000 retail FHA loans met HUD’s requirements for proper origination and underwriting, and therefore were eligible for FHA insurance, when the bank knew that a very substantial percentage of those loans – nearly half of the loans in certain months – had not been properly underwritten, contained unacceptable risk, and were ineligible for FHA insurance.

3. Moreover, the extremely poor quality of Wells Fargo’s loans was a function of management’s nearly singular focus on increasing the volume of FHA originations (and the bank’s profits), rather than on the quality of the loans being originated. Management’s actions included hiring temporary staff to churn out and approve an ever-increasing quantity of FHA loans, failing to provide its inexperienced staff with proper training, paying improper bonuses to its underwriters to incentivize them to approve as many FHA loans as possible, and applying pressure on loan officers and underwriters to originate and approve more and more FHA loans as quickly as possible. As a consequence of Wells Fargo’s misconduct, FHA paid hundreds of millions of dollars in insurance claims on defaulted loans that the bank had falsely certified met
HUD’s requirements, and thousands of Americans lost their homes through mortgage foreclosures across the country. Furthermore, Wells Fargo actually received hundreds of millions of dollars in FHA payments on those false claims, as the bank not only falsely certified those mortgages for government insurance, but also remained the holder of record for the vast majority of those mortgages, such that it submitted the claims and received the insurance payments for nearly all of the loans that defaulted. Accordingly, the Government seeks recovery for its loss on these materially deficient mortgage loans that Wells Fargo recklessly underwrote and falsely certified were eligible for FHA insurance.

4. To compound matters, from January 2002 through December 2010, Wells Fargo purposely violated HUD reporting requirements and kept its materially deficient loans a secret. Wells Fargo was well aware that HUD regulations required it to perform monthly reviews of its FHA loan portfolio and to self-report to HUD any loan that was affected by fraud or other serious violations. This reporting requirement permits HUD to investigate the bad loans and request reimbursement or indemnification, as appropriate. But, although the bank generally performed the monthly loan reviews and internally identified over 6,000 materially deficient loans during this period, including over 3,000 loans that had gone into default within the first six months after origination (known as “Early Payment Defaults” or “EPDs”), it chose not to comply with its self-reporting obligation to HUD.

5. Prior to October 2005, Wells Fargo, the largest originator of FHA loans in America, did not self-report a single bad loan to HUD. Instead, the bank concealed its bad loans and shoddy underwriting to protect its enormous profits from the FHA program. And when HUD inquired about Wells Fargo’s self-reporting practices in 2005, the bank attempted to cover
up its misdeeds by falsely suggesting to HUD that the bank had in fact been reporting bad loans. Thereafter, the bank’s self-reporting was woefully and purposefully inadequate, all in an effort to avoid indemnification claims from HUD and pushback from wholesale brokers whose materially deficient loans would be reported to HUD. All told, from January 1, 2002 through December 31, 2010, Wells Fargo internally identified 6,558 loans that it was required to self-report, including 3,142 Early Payment Defaults, but self-reported only 238 loans. As a consequence of Wells Fargo’s intentional failure to self-report these ineligible loans to HUD, FHA was required to pay hundreds of millions of dollars in insurance claims when the loans defaulted, with additional losses expected in the future. Moreover, for the vast majority of these loans, Wells Fargo remained the holder of the mortgage notes and received the FHA insurance payments on those claims.

**JURISDICTION AND VENUE**

6. This Court has jurisdiction pursuant to 31 U.S.C. § 3730(a) and 28 U.S.C. § 1331.

7. Venue is proper in this judicial district pursuant to 31 U.S.C. § 3732(a) and 28 U.S.C. §§ 1391(b)(1), (b)(3), and (c) because the defendant can be found and transacts business in this judicial district.

**PARTIES**

8. Plaintiff is the United States of America.

9. Defendant Wells Fargo Bank, N.A. is a national bank and federally insured financial institution with its principal place of business in California. Wells Fargo Bank, N.A. is the parent company of Wells Fargo Home Mortgage, a mortgage lender headquartered in Des Moines, Iowa, with branches and offices in all 50 states.
10. The False Claims Act provides liability for any person (i) who “knowingly presents, or causes to be presented, a false or fraudulent claim for payment or approval”; or (ii) who “knowingly makes, uses, or causes to be made or used, a false record or statement material to a false or fraudulent claim.” 31 U.S.C. § 3729(a)(1)(A)-(B). The False Claims Act further provides that any person who violates the Act: “is liable to the United States Government for a civil penalty of not less than [\$5,500] and not more than [\$11,000] . . . , plus 3 times the amount of damages which the Government sustains because of the act of that person.” 31 U.S.C. § 3729(a); see 28 C.F.R. § 85.3(a)(9).

11. Congress enacted FIRREA in 1989 to reform the federal banking system. Toward that end, FIRREA authorizes civil enforcement of enumerated criminal predicate offenses—as established by a preponderance of the evidence—that involve financial institutions and certain government agencies. See 12 U.S.C. § 1833a(e). Several of the predicate offenses that can form the basis of liability under FIRREA are relevant here: First, 18 U.S.C. § 1014 prohibits “knowingly mak[ing] any false statement or report, or willfully overvalu[ing] any land, property, or security, for the purpose of influencing in any way the action of [FHA].” Id. The Government asserts that cause of action for false statements or reports that Wells Fargo made after July 30, 2008, to influence the actions of FHA. Second, 18 U.S.C. § 1005 prohibits anyone who, with “intent to defraud the United States or any agency thereof, or any financial institution referred to in this section, participates or shares in or receives (directly or indirectly) any money, profit, property, or benefits through any transaction, loan, commission, contract, or any other act of any such financial institution.” Third, 18 U.S.C. §§ 1341, 1343 prohibit using the mails or
wires, respectively, for the purpose of executing a “scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises.” Fourth, 18 U.S.C. § 1001 prohibits any person from, “in any matter within the jurisdiction of the executive, legislative, or judicial branch of the Government of the United States, knowingly and willfully . . . mak[ing] any materially false, fictitious, or fraudulent statement or representation.”

12. FIRREA provides that the United States may recover civil penalties of up to $1 million per violation, or, for a continuing violation, up to $1 million per day or $5 million, whichever is less. 12 U.S.C. § 1833a(b)(1)-(2). The statute further provides that the penalty can exceed these limits to permit the United States to recover the amount of any gain to the person committing the violation, or the amount of the loss to a person other than the violator stemming from such conduct, up to the amount of the gain or loss. 18 U.S.C. § 1833a(b)(3).

FACTUAL BACKGROUND

I. THE FHA MORTGAGE INSURANCE PROGRAM

A. Background

13. FHA, a part of HUD, is the largest mortgage insurer in the world, insuring approximately one third of all new residential mortgages in the United States. Pursuant to the National Housing Act of 1934, FHA offers various mortgage insurance programs. Through these programs, FHA insures approved lenders (“mortgagees”) against losses on mortgage loans made to buyers of single-family housing. The programs help low-income and moderate-income families become homeowners by lowering some of the costs of their mortgage loans. FHA mortgage insurance encourages lenders to make loans to creditworthy borrowers who nevertheless might not meet conventional underwriting requirements.
14. Under HUD’s mortgage insurance programs, if a homeowner defaults on a loan and the mortgage holder forecloses on the property, HUD will pay the mortgage holder the balance of the loan and assume ownership and possession of the property. HUD also incurs expenses in managing and marketing the foreclosed-upon property until it is resold. By protecting lenders against defaults on mortgages, FHA mortgage insurance encourages lenders to make loans to millions of creditworthy Americans who might not otherwise satisfy conventional underwriting criteria. FHA mortgage insurance also makes mortgage loans valuable in the secondary markets, as FHA loans are expected to have met HUD requirements and because they are secured by the full faith and credit of the United States.

15. HUD’s Direct Endorsement Lending program is one of the FHA-insured mortgage programs. A Direct Endorsement Lender is authorized to underwrite mortgage loans, decide whether the borrower represents an acceptable credit risk for HUD, and certify loans for FHA mortgage insurance without prior HUD review or approval. To qualify for FHA mortgage insurance, a mortgage must meet all of the applicable HUD requirements (e.g., income, credit history, valuation of property, etc.).

16. HUD relies on the expertise and knowledge of Direct Endorsement Lenders in providing FHA insurance and relies on their decisions. A Direct Endorsement Lender is therefore obligated to act with the utmost good faith, honesty, fairness, undivided loyalty, and fidelity in dealings with HUD. The duty of good faith also requires a Direct Endorsement Lender to make full and fair disclosures to HUD of all material facts and to take on the affirmative duty of employing reasonable care to avoid misleading HUD in all circumstances.

B. Underwriting and Due Diligence Requirements
17. A Direct Endorsement Lender is responsible for all aspects of the mortgage application, the property analysis, and the underwriting of the mortgage. The underwriter must “evaluate [each] mortgagor’s credit characteristics, adequacy and stability of income to meet the periodic payments under the mortgage and all other obligations, and the adequacy of the mortgagor’s available assets to close the transaction, and render an underwriting decision in accordance with applicable regulations, policies and procedures.” 24 C.F.R. § 203.5(d). In addition, the underwriter must “have [each] property appraised in accordance with [the] standards and requirements” prescribed by HUD. 24 C.F.R. § 203.5(e).

18. Mortgagees must employ underwriters who can detect warning signs that may indicate irregularities, as well as detect fraud; in addition, underwriting decisions must be performed with due diligence in a prudent manner. HUD Handbook 4000.4 REV-1, ¶ 2-4(C)(5); see also HUD Handbook 4155.2 ¶ 2.A.4.b. The lender must also maintain a compliant compensation system for its staff, an essential element of which is the prohibition on paying commissions to underwriters. HUD Handbook 4060.1 REV-2, ¶ 2-9(A).

19. HUD relies on Direct Endorsement Lenders to conduct due diligence on Direct Endorsement loans. The purposes of due diligence include (1) determining a borrower’s ability and willingness to repay a mortgage debt, thus limiting the probability of default and collection difficulties, see 24 C.F.R. § 203.5(d), and (2) examining a property offered as security for the loan to determine if it provides sufficient collateral, see 24 C.F.R. § 203.5(e)(3). Due diligence thus requires an evaluation of, among other things, a borrower’s credit history, capacity to pay, cash to close, and collateral. In all cases, a Direct Endorsement Lender owes HUD the duty, as prescribed by federal regulation, to “exercise the same level of care which it would exercise in
obtaining and verifying information for a loan in which the mortgagee would be entirely dependent on the property as security to protect its investment.” 24 C.F.R. § 203.5(c).

20. HUD has set specific rules for due diligence predicated on sound underwriting principles. In particular, HUD requires Direct Endorsement Lenders to be familiar with, and to comply with, governing HUD Handbooks and Mortgagee Letters, which provide detailed processing instructions to Direct Endorsement Lenders. These materials specify the minimum due diligence with which Direct Endorsement Lenders must comply.

21. With respect to ensuring that borrowers have sufficient credit, a Direct Endorsement Lender must comply with governing HUD Handbooks, such as HUD Handbook 4155.1 (Mortgage Credit Analysis for Mortgage Insurance on One-to Four-Unit Mortgage Loans), to evaluate a borrower’s credit. The rules set forth in HUD Handbook 4155.1 exist to ensure that a Direct Endorsement Lender sufficiently evaluates whether a borrower has the ability and willingness to repay the mortgage debt. HUD has informed Direct Endorsement Lenders that past credit performance serves as an essential guide in determining a borrower’s attitude toward credit obligations and in predicting a borrower’s future actions.

22. To properly evaluate a borrower’s credit history, a Direct Endorsement Lender must, at a minimum, obtain and review credit histories; analyze debt obligations; reject documentation transmitted by unknown or interested parties; inspect documents for proof of authenticity; obtain adequate explanations for collections, judgments, recent debts and recent credit inquiries; establish income stability and make income projections; obtain explanations for gaps in employment, when required; document any gift funds; calculate debt and income ratios
and compare those ratios to the fixed ratios set by HUD rules; and consider and document any compensating factors permitting deviations from those fixed ratios.

23. With respect to appraising the mortgaged property (i.e., collateral for the loan), a Direct Endorsement Lender must ensure that an appraisal and its related documentation satisfy the requirements in governing HUD Handbooks, such as HUD Handbook 4150.2 (Valuation Analysis for Single Family One- to Four-Unit Dwellings). The rules set forth in HUD Handbook 4150.2 exist to ensure that a Direct Endorsement Lender obtains an accurate appraisal that properly determines the value of the property for HUD’s mortgage insurance purposes.

C. Quality Control Requirements and Wells Fargo Quality Control

24. Furthermore, to maintain HUD-FHA approval, a Direct Endorsement Lender must implement and maintain a quality control program. HUD requires the quality control department to be independent of mortgage origination and servicing functions. See HUD Handbook 4060.1 REV-1, ¶ 6-3(B); HUD Handbook 4060.1 REV-2, ¶ 7-3(B); HUD Handbook 4700.2 REV-1, ¶ 6-1(A). To comply with HUD’s quality control requirements, a lender’s quality control program must (among other things): (a) review a prescribed sample of all closed loan files to ensure they were underwritten in accordance with HUD guidelines; and (b) conduct a full review of “all loans going into default within the first six payments,” which HUD defines as “early payment defaults.” HUD Handbook 4060.1 REV-1, ¶¶ 6-6(C), 6-6(D); HUD Handbook 4060.1 REV-2, ¶¶ 7-6(C), 7-6(D); HUD Handbook 4700.2 REV-1, ¶¶ 6-1(B), 6-1(D).

25. In conducting a quality control review of a loan file, the lender must, among other things, review and confirm specific items of information. For instance, “[d]ocuments contained in the loan file should be checked for sufficiency and subjected to written re-
verification. Examples of items that must be reverified include, but are not limited to, the mortgagor’s employment or other income, deposits, gift letters, alternate credit sources, and other sources of funds.” HUD Handbook 4060.1 REV-2, ¶ 7-6(E)(2). Further, “[a]ny discrepancies must be explored to ensure that the original documents . . . were completed before being signed, were as represented, were not handled by interested third parties and that all corrections were proper and initialed.” *Id.*; *see also* HUD Handbook 4060.1 REV-1, ¶ 6-6(E)(2); HUD Handbook 4700.2 REV-1, ¶ 6-3(A)(2).

26. The HUD Handbook lays out a rating system for the quality control reviews, in which the lender implements a “system of evaluating each Quality Control sample on the basis of the severity of the violations found during the review. The system should enable a mortgagee to compare one month’s sample to previous samples so the mortgagee may conduct trend analysis.” HUD Handbook 4060.1 REV-2, ¶ 7-4; *see also* HUD Handbook 4060.1 REV-1, ¶ 6-4. The ratings provided for this purpose are “Low”, *i.e.*, no or minor violations, “Acceptable,” *i.e.*, issues identified were not material to insurability of the loan, “Moderate,” *i.e.*, significant unresolved questions or missing documentation created a moderate risk to the mortgagee and FHA, and “Material,” *i.e.*, issues identified were material violations of FHA or mortgagee requirements and represent an unacceptable level of risk, such that the loans must be reported to HUD. HUD Handbook 4060.1 REV-1, ¶ 6-4; HUD Handbook 4060.1 REV-2, ¶ 7-4.

27. Specifically, the HUD Handbook defines “Material Risk” loans as follows:

The issues identified during the review were material violations of FHA or mortgagee requirements and represent an unacceptable level of risk. For example, a significant miscalculation of the insurable mortgage amount or the applicant’s capacity to repay, failure to underwrite an assumption or protect abandoned property from damage, or fraud. Mortgagees must report these loans,
in writing, to the Quality Assurance Division in the FHA Home Ownership Center having jurisdiction.

HUD Handbook 4060.1 REV-2, ¶ 7-4(D); see also HUD Handbook 4060.1 REV-1, ¶ 6-4(D).

28. Under HUD’s rules, a lender must report to HUD (along with the supporting documentation) “[s]erious deficiencies, patterns of non-compliance, or fraud uncovered by mortgagees” during the “normal course of business and by quality control staff during reviews/audits of FHA loans” within 60 days of the initial discovery. HUD Handbook 4060.1 REV-1, CHG-1, ¶¶ 6-13, 6-3(J); see also HUD Handbook 4060.1 REV-2, ¶ 7-3(J) (requiring Direct Endorsement Lenders to “immediately” report findings of “fraud or other serious violations” affecting an FHA loan); HUD Handbook 4060.1 REV-2, ¶ 2-23 (“Mortgagees are required to report to HUD any fraud, illegal acts, irregularities or unethical practices.”). Upon making such findings, the lender must also expand the scope of the quality control review both by increasing the number of files reviewed and conducting a more in-depth review of the selected files.

29. Until 2005, HUD’s rules instructed Direct Endorsement Lenders to make the required self-reports of loans with serious deficiencies, patterns of noncompliance, or fraud in writing to HUD through the Quality Assurance Division of the HUD Homeownership Centers (“HOCs”) having jurisdiction. In May 2005, HUD issued Mortgagee Letter 2005-26, which notified lenders that going forward they would have to participate in mandatory electronic reporting through HUD’s online Neighborhood Watch system. That new method became

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1 Prior to November 2003, lenders were required to self-report to HUD loans affected by “significant discrepancies,” such as “any violation of law or regulation, false statements or program abuses by the mortgagee, its employees, or any other party to the transaction.” HUD Handbook 4060.1 REV-1, ¶ 6-1(H).
mandatory at the end of November 2005, and required mortgagees “to report serious deficiencies, patterns of noncompliance, or suspected fraud, to HUD in a uniform, automated fashion” and in lieu of written reports to the various individual HOCs.

30. In addition to reporting loans affected by fraud or other serious violations to HUD, the lender is required to take corrective action in response to its findings. In particular, quality control review findings must “be reported to the mortgagee’s senior management within one month of completion of the initial report” and “[m]anagement must take prompt action to deal appropriately with any material findings. The final report or an addendum must identify the actions being taken, the timetable for their completion, and any planned follow-up activities.” HUD Handbook 4060.1 REV-2, ¶ 7-3(I); see also HUD Handbook 4060.1 REV-1, ¶ 6-3(I); HUD Handbook 4700.2 REV-1, ¶ 6-1(F). Appropriate action by management includes following up with underwriters responsible for material findings to ensure that they are properly trained and diligently reviewing each file before endorsing it for FHA mortgage insurance.

31. Wells Fargo’s home mortgage division’s quality control function included both the Fraud Risk Management (“FRM”) and Quality Assurance (“QA”) departments. The QA department’s procedures included the following with respect to FHA-insured loans: monthly reviews of a random sample of loans originated and sponsored within the prior 60 days, reviews of at least some portion of its EPDs, and preparation and circulation of internal reports of the reviews’ findings. The FRM department also reviewed loans referred to it as potentially involving fraud or misrepresentation. The FRM department had several sources for these referrals, including the QA department, its branches, and the bank’s fraud reporting hotline.
32. In evaluating the loans it reviewed, Wells Fargo tracked HUD Handbook terminology, rating its findings regarding the risks of the loans as either “Material,” “Moderate,” or “Acceptable.” Wells Fargo’s definition for the “Material” rating mirrored HUD’s in substance, and made clear that a loan with that rating contained unacceptable risk and was ineligible for FHA insurance. Specifically, Wells Fargo’s defined the “Material” rating in October 2002 was as follows:

The loan contains significant deviations from the specific loan program parameters under which it was originated, making the loan ineligible for sale to the investor or resulting in potential repurchase or indemnification. [And/or] The loan contains significant risk factors affecting the underwriting decision and/or contains misrepresentation, which may render the loan non-investment quality.

33. Wells Fargo’s May 2004 Quality Control Plan for FHA loans, which was provided to HUD, similarly defined “Material risk” rated loans as follows:

The loan contains significant deviations from the specific loan program parameters under which it was originated or significant risk factors affecting the underwriting decision and/or contains misrepresentation, making the loan ineligible for sale to the investor or resulting in potential repurchase or indemnification.

That Plan also included examples drawn directly from the HUD Handbook’s definition of “Material risk” loans, stating: “Examples of material risks include the applicant’s capacity to repay the mortgage, failure to underwrite an assumption or protect abandoned property from damage, or fraud.”

34. Both the QA and FRM departments made monthly reports to senior management, including the Wells Fargo Quality Control (“QC”) Committee. Wells Fargo’s QA department provided written reports, summarizing its findings resulting from QA’s reviews of statistically random monthly samples of loans, as well as loans that were categorized as EPDs. Among other
information, those QA reports summarized the percentage of loans reviewed in various categories and lines of business that contained “Material” risk ratings.

35. Where FRM received a referral and conducted an initial review of a loan, if the loan file indicated there may have been origination and underwriting violations, FRM performed a “deep dive” review. In this “deep dive,” the FRM reviewers sought to verify the employment and income, whether “middle men” were being used for purchases, the validity of appraisals, and other items. On the retail side of home mortgage, according to a former Wells Fargo FRM manager, these reviews exposed a “dirty underbelly of bad loan officers.”

36. The FRM reports to the QC Committee provided information regarding loans whose underwriting showed serious violations, including loans reviewed in its “deep dive.” Loans reported by FRM to the QC Committee included loan files containing misrepresentations of assets, credit, and income, as well as appraisal fraud. According to a former manager in the FRM department, FRM understood that the QC Committee then determined what information would be reported to HUD and that the QC Committee would make those reports.

D. Direct Endorsement Lender Certifications

37. Every Direct Endorsement Lender must make an annual certification of compliance with the program’s qualification requirements, including due diligence in underwriting and the implementation of a mandatory quality control plan. The annual certification states, in sum or substance:

I know or am in the position to know, whether the operations of the above named mortgagee conform to HUD-FHA regulations, handbooks, and policies. I certify that to the best of my knowledge, the above named mortgagee conforms to all HUD-FHA regulations necessary to maintain its HUD-FHA approval, and that the
above-named mortgagee is fully responsible for all actions of its employees including those of its HUD-FHA approved branch offices.

Absent a truthful annual certification, a lender is not entitled to maintain its direct endorsement lender status and is not entitled to endorse loans for FHA insurance.

38. In addition to the annual certification requirement, after each mortgage closing, the Direct Endorsement Lender must certify that the lender conducted due diligence and/or ensured data integrity such that the endorsed mortgage complies with HUD rules and is “eligible for HUD mortgage insurance under the Direct Endorsement program.” Form HUD-92900-A. For each loan that was underwritten with an automated underwriting system approved by FHA, the lender must additionally certify to “the integrity of the data supplied by the lender used to determine the quality of the loan [and] that a Direct Endorsement Underwriter reviewed the appraisal (if applicable).” *Id.* For each loan that required manual underwriting, the lender must additionally certify that the underwriter “personally reviewed the appraisal report (if applicable), credit application, and all associated documents and ha[s] used due diligence in underwriting th[e] mortgage.” *Id.*

39. Whether a loan is approved through automated or manual underwriting, the underwriter additionally must certify: “I, the undersigned, as authorized representative of mortgagee at this time of closing of this mortgage loan, certify that I have personally reviewed the mortgage loan documents, closing statements, application for insurance endorsement, and all accompanying documents. I hereby make all certifications required for this mortgage as set forth in HUD Handbook 4000.4.” *Id.* If the loan does not meet the requirements of HUD Handbook 4000.4, then it is not eligible for FHA insurance and cannot be certified for endorsement. Both
the annual certification form and the individual loan certification forms are submitted to HUD electronically.

E. HUD’s Procedure for Submission and Payment of FHA Claims

40. HUD relies on each individual loan certification to endorse the loan and provide the lender with an FHA mortgage insurance certificate. Once a loan is endorsed for insurance, the loan receives a unique FHA case number. In the event that HUD later discovers that a loan was endorsed despite being ineligible for the FHA program, HUD seeks indemnification from the Direct Endorsement Lender that certified the loan via an indemnification agreement whereby the lender agrees to indemnify HUD should claims for FHA insurance be submitted on that loan.

41. Whenever an FHA loan defaults and an insurance claim is submitted for processing through HUD’s electronic claim system, the claim must include the FHA case number as well as the FHA mortgagee identifying number of the lender inputting the claim, which must be either the holder of record or the servicer of record of the mortgage. If a valid FHA case number is not submitted with the claim, an insurance payment will not be processed on that claim.

42. After a claim is submitted, HUD’s electronic system will automatically conduct a series of edits to ensure data validity, date consistency and that reasonable and valid amounts are requested for reimbursement, including that the FHA insurance for the case number provided is in Active status and there are no other impediments (such as a no-pay flag or indemnification agreement) to paying the claim. After a claim has passed all the electronic edits in the claim processing system, the claim is approved for payment and a disbursement request is sent to the United States Treasury to issue the funds via wire transfer to the holder of record.
43. However, where a lender and HUD have entered into an indemnification agreement with respect to a particular loan, and an insurance claim is submitted with respect to that loan, if the holder of record to which claim proceeds would be disbursed is also the indemnifying lender, the electronic claim system will not process payment of the claim. But, if the holder of record is not the lender that indemnified HUD for the loan, HUD will disburse payment to the holder of record and then issue a billing letter to the indemnifying lender to recoup HUD’s losses.

II. WELLS FARGO SUBMITTED THOUSANDS OF FALSE INDIVIDUAL LOAN CERTIFICATIONS TO HUD IN CONNECTION WITH FHA LOANS THAT THE BANK ORIGINATED FROM MAY 2001 THROUGH OCTOBER 2005

44. From May 2001 through October 2005, Wells Fargo engaged in a regular practice of reckless origination and underwriting of its retail FHA loans and falsely certified to HUD that tens of thousands of those loans were eligible for FHA insurance. During this time period, the quality of Wells Fargo’s retail FHA loans was extremely poor. This was a function of the bank’s concerted effort to vastly increase its FHA loan volume by hiring temporary staff to underwrite loans, failing to give the staff proper training, paying incentive bonuses to underwriters based on the number of loans that they approved, andpressuring loan officers and underwriters to originate and approve as many FHA loans as possible as quickly as possible. Not surprisingly, this increase in loan volume came at the expense of loan quality.

45. From May 2001 through October 2005, Wells Fargo’s management was aware that a substantial percentage of its retail FHA loan portfolio – nearly 50% in certain months – did not comply with HUD requirements, contained an unacceptable level of risk, and therefore was ineligible for HUD insurance. But management failed to take effective action to address the
seriously deficient loan originations and underwriting. Instead, Wells Fargo reaped all the
profits by certifying falsely that its entire portfolio of retail FHA loans met HUD requirements
and was eligible for insurance. And to avoid any indemnification claims from FHA, Wells Fargo
concealed the fact that it was having very serious loan quality problems from HUD and failed to
self-report, as required, any of the bad loans. As a result of Wells Fargo’s false loan
certifications, FHA paid insurance claims on thousands of defaulted mortgage loans that Wells
Fargo knew, or should have known, did not meet HUD’s requirements and were ineligible for
FHA insurance. FHA’s payments on more than 94% of those claims were made directly to
Wells Fargo, as holder of the mortgage notes on those loans.

A. Wells Fargo’s Widespread Loan Quality Problems, Reckless Underwriting,
and False Loan Certifications: May 2001 through January 2003

46. The underlying causes of Wells Fargo’s very serious loan quality problems and
reckless underwriting are multifold. In or around the middle of 2000, Wells Fargo significantly
increased its FHA loan originations. From January 1, 2001 through December 31, 2002, Wells
Fargo originated or sponsored approximately 225,000 FHA loans. To facilitate this substantial
increase in FHA originations, Wells Fargo expanded its staff, including hiring temporary
underwriters to review FHA loans. Many of these employees were not adequately trained with
respect to the requirements of the FHA program. Indeed, Wells Fargo’s senior management was
aware that these employees had not received the in-depth training necessary to properly
underwrite these loans and adhere to FHA’s submission requirements.

47. To compound matters, Wells Fargo paid its underwriters a bonus (in addition to
their salaries) based on the number of loans approved, rather than the number of loans reviewed.
This improper *de facto* commission incentivized the underwriters to approve as many FHA loans as possible, regardless of the risk of default or the loan’s eligibility for FHA insurance. Worse yet, the incentive was tied to the total number of loans approved at a particular underwriting site, thereby fostering a group dynamic whereby individual underwriters felt pressure from their peers at the site to approve loans.

48. Apart from the incentive system, management applied heavy pressure on loan officers and underwriters to originate, approve, and close loans. And management required underwriters to make decisions on loans on extremely short turnaround times and employed lax and inconsistent underwriting standards and controls.

49. The extraordinarily heavy volume of FHA loans also overwhelmed Wells Fargo’s FHA underwriters and further contributed to the extremely poor loan quality. This heavy volume was particularly problematic given the underwriting staff’s general lack of experience.

50. As a result of this multitude of factors, the quality of the bank’s retail FHA loans dropped precipitously beginning in the summer of 2000. This huge decline in loan quality was detected contemporaneously by Wells Fargo’s Quality Assurance division and was directly reported to senior management. For example, QA’s report for loans originated in December 2000 advised that 26% of the retail FHA loans that were randomly sampled contained a material violation of HUD’s requirements. In other words, based on Wells Fargo’s sampling, greater than one out of every four retail FHA loan that the bank originated in December 2000 and certified to HUD for FHA insurance bore unacceptable risk and did not meet HUD’s requirements. The report for December 2000 originations was consistent with prior monthly QA reports from the
summer and fall of 2000 showing material violation rates in randomly sampled retail FHA loans of between about 15% to 20%.

51. Despite these troubling findings, Wells Fargo’s management failed to take action to address these issues. No written action plans were prepared for loans with material violations. Corrective action for such loans was not formally tracked. There was little to no follow-up on the material violations. And the bank failed to self-report any of these loans with serious deficiencies to HUD. Instead, Wells Fargo continued on the same path, originating tens of thousands of FHA loans with the same reckless underwriting, and certifying its entire portfolio of FHA loans for insurance.

52. As a result of management’s inaction, the material violation rate worsened significantly beginning in May 2001, and escalated tremendously throughout 2002. Based on Wells Fargo’s own QA findings, during the 21 months from May 2001 through January 2003, the material violation rate for randomly reviewed FHA loans exceeded 25% in 18 of those months. That means that at least one out of every four retail FHA loan that Wells Fargo certified to HUD for FHA insurance during those months did not qualify, and the bank knew it.

53. Even worse, during a seven-month stretch from April 2002 through October 2002, the material violation rate never dipped below 42%, and reached as high as 48%. That means that during those months nearly one out of every two retail FHA loan that Wells Fargo certified to HUD did not qualify for insurance, and the bank knew it. This was an extraordinary departure from Wells Fargo’s internal benchmark for material violations, which was set at 5%. And QA’s material violation rate for FHA loans that went into early payment default was even higher, averaging 66% in 2002, and hitting an astronomical high of nearly 90% in one of those months.
54. Wells Fargo QA’s month-by-month findings for its random reviews specific to the retail FHA business for this period are as follows:²

<table>
<thead>
<tr>
<th>LOAN FUNDING MONTH</th>
<th>MATERIAL VIOLATION</th>
<th>MODERATE VIOLATION</th>
<th>TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>May 2001</td>
<td>19.9%</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>June 2001</td>
<td>30.2%</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>July 2001</td>
<td>36.5%</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>August 2001</td>
<td>26.5%</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>September 2001</td>
<td>NOT AVAILABLE</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>October 2001</td>
<td>30.5%</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>November 2001</td>
<td>28.9%</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>December 2001</td>
<td>21.8%</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>January 2002</td>
<td>30.5%</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>February 2002</td>
<td>21.6%</td>
<td>24.4%</td>
<td>46.0%</td>
</tr>
<tr>
<td>March 2002</td>
<td>35.7%</td>
<td>29.1%</td>
<td>64.8%</td>
</tr>
<tr>
<td>April 2002</td>
<td>48.0%</td>
<td>28.6%</td>
<td>76.6%</td>
</tr>
<tr>
<td>May 2002</td>
<td>46.2%</td>
<td>28.8%</td>
<td>75.0%</td>
</tr>
<tr>
<td>June 2002</td>
<td>46.6%</td>
<td>36.2%</td>
<td>82.8%</td>
</tr>
<tr>
<td>July 2002</td>
<td>42.6%</td>
<td>40.3%</td>
<td>82.9%</td>
</tr>
<tr>
<td>August 2002</td>
<td>43.6%</td>
<td>32.6%</td>
<td>76.2%</td>
</tr>
<tr>
<td>September 2002</td>
<td>NO TESTING</td>
<td>PERFORMED</td>
<td></td>
</tr>
<tr>
<td>October 2002</td>
<td>NO TESTING</td>
<td>PERFORMED</td>
<td></td>
</tr>
<tr>
<td>November 2002</td>
<td>28.5%</td>
<td>38.9%</td>
<td>67.4%</td>
</tr>
<tr>
<td>December 2002</td>
<td>27.5%</td>
<td>47.1%</td>
<td>74.6%</td>
</tr>
<tr>
<td>January 2003</td>
<td>27.5%</td>
<td>49.0%</td>
<td>76.5%</td>
</tr>
</tbody>
</table>

55. Month after month, Wells Fargo QA reported the extraordinarily severe and worsening loan quality problems to the bank’s senior management, yet no effective action was

² Information regarding Wells Fargo QA’s review of September 2001 FHA originations is not available. Information is not provided for September and October 2002, because Wells Fargo did not conduct random sample reviews of FHA loans for those months.
taken. Again, no written action plans were prepared to address loans with material violations. There was little to no follow-up on the material violations. Corrective action was not formally tracked. And the bank did not self-report a single loan to HUD.

56. The examples set forth below represent a tiny sample of the total number of mortgages for which Wells Fargo submitted false certifications in this period.

1. The Marsh Salt Property in Texas

57. FHA case number 492-6423217 relates to a property on Marsh Salt Court, in Springtown, TX (the “Marsh Salt Property”). Wells Fargo underwrote the mortgage for the Marsh Salt Property, reviewed and approved it for FHA insurance, and certified that a Direct Endorsement (“DE”) underwriter had conducted the required due diligence on the loan application and that the loan was eligible for HUD mortgage insurance. The mortgage closed on or about July 1, 2002.

58. Contrary to Wells Fargo’s certification, Wells Fargo did not comply with HUD rules in reviewing and approving this loan for FHA insurance, and did not exercise due diligence in underwriting the mortgage. Instead, Wells Fargo violated multiple HUD rules, including HUD Handbook 4155.1 ¶¶ 2-10, 2-3, 3-1 and Mortgagee Letter 2001-01.

59. Wells Fargo’s violation of HUD Handbook 4155.1 ¶ 2-10 is illustrative of the multiple rules that Wells Fargo violated in approving the Marsh Salt Property. HUD underwriting guidelines state that all funds for the borrower’s investment in the property must be verified. HUD Handbook 4155.1 ¶ 2-10. Contrary to this clear requirement, Wells Fargo failed to verify and document the borrower’s purported investment in the Marsh Salt Property; indeed, the documents in the Marsh Salt Property mortgage application reveal that the borrower had
documented assets of thousands of dollars less than the amount the borrower was purportedly investing in the property. In violating HUD Handbook 4155.1 ¶ 2-10, Wells Fargo endorsed the Marsh Salt Property for FHA insurance without proof of the borrower’s contribution to the purported investment.

60. Wells Fargo’s false certification on this loan was material and bore upon the loan’s eligibility for FHA insurance and the likelihood that the borrower would make mortgage payments.

61. Within three months after closing, this mortgage went into default. As a result, HUD paid Wells Fargo, as holder of the mortgage note, an FHA insurance claim of $120,751.83, including costs.

2. The Albert Drive Property in New Jersey

62. FHA case number 352-4722386 relates to a property on Albert Drive in Old Bridge Township, NJ (the “Albert Drive Property”). Wells Fargo underwrote the mortgage for the Albert Drive Property, reviewed and approved it for FHA insurance, and certified that a DE underwriter had conducted the required due diligence on the loan application and that the loan was eligible for HUD mortgage insurance. The mortgage closed on or about September 27, 2002.

63. Contrary to Wells Fargo’s certification, Wells Fargo did not comply with HUD rules in reviewing and approving this loan for FHA insurance, and did not exercise due diligence in underwriting the mortgage. Instead, Wells Fargo violated multiple HUD rules, including HUD Handbook 4155.1 ¶¶ 2-3, 2-12, and 2-13, HUD Handbook 4000.4 ¶ 2-4(c)(5), and Mortgagee Letter 1992-5.
64. Wells Fargo’s violation of HUD Handbook 4155.1 ¶¶ 2-12 and 2-13 is illustrative of the multiple rules that Wells Fargo violated in approving the Albert Drive Property. HUD underwriting guidelines state that lenders cannot exceed HUD’s established debt-to-income ratio benchmarks unless significant compensating factors are present. At the time this loan closed, the total-fixed-payment-to-effective-income ratio (“TPI” ratio) limit was 41%. HUD Handbook 4155.1 ¶¶ 2-12 and 2-13. Contrary to this clear requirement, Wells Fargo failed to document adequate compensating factors even though the borrower’s TPI ratio exceeded the 41% limit. In violating HUD Handbook 4155.1 ¶¶ 2-12 and 2-13, Wells Fargo endorsed the Albert Drive Property for FHA insurance without sufficiently analyzing the borrower’s ability to support the monthly mortgage payments.

65. Wells Fargo’s false certification on this loan was material and bore upon the loan’s eligibility for FHA insurance and the likelihood that borrower would make mortgage payments.

66. Soon after closing, this mortgage went into default. As a result, HUD paid Wells Fargo, as holder of the mortgage note, an FHA insurance claim of $251,783.42, including costs.

3. The North Main Street Property in Indiana

67. FHA case number 151-6793642 relates to a property on North Main Street in Laketon, IN (the “North Main Street Property”). Wells Fargo, using an FHA-approved Automated Underwriting System (“AUS”), underwrote the mortgage for the North Main Street Property, reviewed and approved it for FHA insurance, and certified to the integrity of the data supplied and that the mortgage qualified for HUD mortgage insurance. The mortgage closed on or about August 9, 2002.
68. Because the soundness of the AUS’s evaluation is dependent on the accuracy and reliability of the data submitted by the mortgagee, a mortgagee may only enter into the AUS such income, asset, debt, and credit information that meets FHA’s applicable eligibility rules and documentation requirements, including those set forth in HUD Handbook 4155.1, Mortgagee Letters, the FHA TOTAL Mortgage Scorecard User Guide, and the AUS certificate.

69. Contrary to Wells Fargo’s certification, the data Wells Fargo entered into the AUS lacked integrity and the mortgage loan failed to meet FHA’s eligibility and documentation requirements. Despite clear requirements, Wells Fargo entered income data variables into the AUS that overstated the borrower’s income and lacked integrity. In failing to enter accurate and verified information into AUS, Wells Fargo submitted a loan for FHA endorsement that was supported by data lacking integrity.

70. Wells Fargo’s false certification on this loan was material and bore upon the loan’s eligibility for FHA insurance and the likelihood that the borrower would make mortgage payments.

71. Within seven months after closing, this mortgage went into default. As a result, HUD paid Wells Fargo, as holder of the mortgage note, an FHA insurance claim of $62,226.16, including costs.

4. The Coriander Lane Property in Kentucky

72. FHA case number 201-2966012 relates to a property on Coriander Lane in Lexington, KY (the “Coriander Lane Property”). Wells Fargo, using an FHA-approved AUS, underwrote the mortgage for the Coriander Lane Property, reviewed and approved it for FHA
insurance, and certified to the integrity of the data supplied and that the mortgage qualified for HUD mortgage insurance. The mortgage closed on or about May 31, 2001.

73. Because the soundness of the AUS’s evaluation is dependent on the accuracy and reliability of the data submitted by the mortgagee, a mortgagee may only enter into the AUS such income, asset, debt, and credit information that meets FHA’s applicable eligibility rules and documentation requirements, including those set forth in HUD Handbook 4155.1, Mortgagee Letters, the FHA TOTAL Mortgage Scorecard User Guide, and the AUS certificate.

74. Contrary to Wells Fargo’s certification, the data Wells Fargo entered into the AUS lacked integrity and the mortgage loan failed to meet FHA’s eligibility and documentation requirements. Despite clear requirements, Wells Fargo entered credit and debt variables that were stale and lacked integrity. In failing to enter timely and verified information into AUS, Wells Fargo submitted a loan for FHA endorsement that was supported by data lacking integrity.

75. Wells Fargo’s false certification on this loan was material and bore upon the loan’s eligibility for FHA insurance and the likelihood that the borrower would make mortgage payments.

76. Soon after closing, this mortgage went into default. As a result, HUD paid Wells Fargo, as holder of the mortgage note, an FHA insurance claim of $111,879.30, including costs.

5. The Courville Street Property in Michigan

77. FHA case number 261-8163025 relates to a property on Courville Street in Detroit, MI (the “Courville Street Property”). Wells Fargo underwrote the mortgage for the Courville Street Property, reviewed and approved it for FHA insurance, and certified that a DE
underwriter had conducted the required due diligence on the loan application and that the loan was eligible for HUD mortgage insurance. The mortgage closed on or about July 17, 2002.

78. Contrary to Wells Fargo’s certification, Wells Fargo did not comply with HUD rules in reviewing and approving this loan for FHA insurance, and did not exercise due diligence in underwriting the mortgage. Instead, Wells Fargo violated multiple HUD rules, including HUD Handbook 4155.1 ¶¶ 2-3, 2-10, 2-12, 2-13, and 3-1, and Mortgagee Letter 2001-01.

79. Wells Fargo’s violation of HUD Handbook 4155.1 ¶¶ 2-12 and 2-13 is illustrative of the multiple rules that Wells Fargo violated in approving the Courville Street Property. HUD underwriting guidelines state that lenders cannot exceed HUD’s established debt-to-income ratio benchmarks unless significant compensating factors are present. At the time this loan closed, the TPI ratio limit was 41%. HUD Handbook 4155.1 ¶¶ 2-12 and 2-13. Contrary to this clear requirement, Wells Fargo failed to document any compensating factors whatsoever even though the borrowers TPI ratio exceeded the 41% limit. In violating HUD Handbook 4155.1 ¶¶ 2-12 and 2-13, Wells Fargo endorsed the Courville Street Property for FHA insurance without sufficiently analyzing the borrower’s ability to support the monthly mortgage payments.

80. Wells Fargo’s false certification on this loan was material and bore upon the loan’s eligibility for FHA insurance and the likelihood that the borrower would make mortgage payments.

81. Soon after closing, this mortgage went into default. As a result, HUD paid Wells Fargo, as holder of the mortgage note, an FHA insurance claim of $142,123.04, including costs.

* * * * *
In short, from May 2001 through January 2003, Wells Fargo engaged in reckless loan origination and underwriting and falsely certified tens of thousands of retail FHA loans for FHA insurance when the bank knew, or should have known, that the loans contained unacceptable risk and did not qualify for insurance. Wells Fargo sold many of its retail FHA loans to third parties knowing that the third parties would submit claims for FHA insurance in the event that the loans defaulted. However, Wells Fargo remained the holder of record for the vast majority of its retail FHA loans originated in this period, and indeed was the holder of record for 6,271 of the 6,740 claims for FHA insurance submitted for those loans. Accordingly, Wells Fargo was paid on claims for FHA insurance when those loans defaulted.

As a result of Wells Fargo’s false certifications, the United States has suffered hundreds of millions of dollars in damages for the insurance claims FHA has paid on defaulted mortgage loans that were not eligible for FHA insurance.

B. Wells Fargo’s Widespread Loan Quality Problems, Reckless Underwriting, and False Loan Certifications: February 2003 through October 2005

Although Wells Fargo purported to make some efforts to improve loan quality in 2002, management’s focus remained on maintaining and even expanding loan volume, and the bank’s reckless underwriting and serious loan quality problems persisted from February 2003 through October 2005. During this period, Wells Fargo continued to certify its entire portfolio of retail FHA loans for insurance even though the bank knew that a substantial percentage of those loans did not meet HUD requirements. And, as before, Wells Fargo failed to self-report a single bad loan to HUD and did not otherwise inform HUD of the loan quality problems that it was experiencing.
85. As shown by Wells Fargo’s internal QA reports from February 2003 through October 2005, month after month QA reported to management about the significant problems it was finding with respect to the bank’s retail FHA loans. Despite these reports, and QA’s increasingly specific direction to management about the very serious underwriting problems, no effective action was taken. For example, in July 2003, QA candidly advised that one of the “overall root cause[s]” for the exceedingly high material violation rates in underwriting across all business lines was “[v]olume, pressure to approve loans, and the experience levels.” QA was even more explicit in its August 2003 report on the same issue: “heavy volume, pressure to approve loans and meet acceptable turn times along with inexperienced staff are key contributing factors overall to the issues leading to material findings.” But management did not change course.

86. Instead of limiting its FHA originations or training an appropriate underwriting staff to match the volume of loans the bank was originating, Wells Fargo slashed the number of its FHA underwriters from 919 to 401. This smaller crew of underwriters remained inadequately trained, and the bank’s improper bonus system for underwriters continued throughout this period.

87. Consequently, Wells Fargo’s QA reports show that the material violation rate for randomly sampled retail FHA loans remained very high, over 20% in many months. At the same time, the moderate violation rate skyrocketed. For a number of months during this period, the combined material and moderate violation rate exceeded 80% of the randomly sampled retail FHA loans, hitting a high of 87.2% in July 2003. And for 18 consecutive months that combined rate hovered between 70% and 80% and never fell below 63%. This astoundingly high violation rate – including the moderate violations – was a very serious problem because the “moderate”
risk rating classification encompassed underwriting violations that actually were material to whether the loans met HUD’s requirements and were eligible for FHA insurance. Indeed, QA noted that “[i]n many instances the only difference between a moderate or material rating are the loan characteristics. Therefore, attention should be given to all deficiencies if improved quality is to be achieved and maintained.”

88. The “moderate” rated loans in this and prior periods included loan files that lacked support for critical borrower income and asset information, including missing or incomplete verifications of employment, missing income, asset, and debt documentation, incorrect calculations of income, and social security number discrepancies. For example, one QA report in this period identified “moderate” and “material” violations as follows: “Critical documentation needed for either loan decisioning or program requirements are missing … Examples noted were employment gaps, discrepancies on pay-stubs for hours worked, ytd earnings that don’t coincide with current earnings, etc.” Failure by the bank’s underwriters to resolve any of these discrepancies evidences a lack of due diligence in underwriting the loan for FHA insurance.

89. Wells Fargo QA’s month-by-month findings for its random reviews of the bank’s distributed retail FHA business in this period are as follows:

<table>
<thead>
<tr>
<th>LOAN FUNDING MONTH</th>
<th>MATERIAL VIOLATION</th>
<th>MODERATE VIOLATION</th>
<th>TOTAL VIOLATION</th>
</tr>
</thead>
<tbody>
<tr>
<td>February 2003</td>
<td>21.1%</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>March 2003</td>
<td>22.4%</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>April 2003</td>
<td>19.3%</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>May 2003</td>
<td>19.6%</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>June 2003</td>
<td>24.6%</td>
<td>56.5%</td>
<td>80.1%</td>
</tr>
<tr>
<td>July 2003</td>
<td>17.2%</td>
<td>60.0%</td>
<td>87.2%</td>
</tr>
<tr>
<td>MONTH</td>
<td>VIOLATION</td>
<td>MODERATE VIOLATION</td>
<td>TOTAL</td>
</tr>
<tr>
<td>-------------</td>
<td>-----------</td>
<td>--------------------</td>
<td>--------</td>
</tr>
<tr>
<td>August 2003</td>
<td>14.9%</td>
<td>58.9%</td>
<td>73.8%</td>
</tr>
<tr>
<td>September 2003</td>
<td>20.4%</td>
<td>52.6%</td>
<td>73.0%</td>
</tr>
<tr>
<td>October 2003</td>
<td>27.0%</td>
<td>53.3%</td>
<td>80.3%</td>
</tr>
<tr>
<td>November 2003</td>
<td>18.5%</td>
<td>58.5%</td>
<td>77.0%</td>
</tr>
<tr>
<td>December 2003</td>
<td>21.7%</td>
<td>46.1%</td>
<td>67.8%</td>
</tr>
<tr>
<td>January 2004</td>
<td>14.2%</td>
<td>56.6%</td>
<td>70.8%</td>
</tr>
<tr>
<td>February 2004</td>
<td>13.0%</td>
<td>62.0%</td>
<td>75.0%</td>
</tr>
<tr>
<td>March 2004</td>
<td>21.0%</td>
<td>62.9%</td>
<td>83.9%</td>
</tr>
<tr>
<td>April 2004</td>
<td>15.8%</td>
<td>47.4%</td>
<td>63.2%</td>
</tr>
<tr>
<td>May 2004</td>
<td>14.9%</td>
<td>62.4%</td>
<td>77.3%</td>
</tr>
<tr>
<td>June 2004</td>
<td>26.2%</td>
<td>48.6%</td>
<td>74.8%</td>
</tr>
<tr>
<td>July 2004</td>
<td>21.3%</td>
<td>52.1%</td>
<td>73.4%</td>
</tr>
<tr>
<td>August 2004</td>
<td>25.3%</td>
<td>47.3%</td>
<td>72.6%</td>
</tr>
<tr>
<td>September 2004</td>
<td>16.1%</td>
<td>53.8%</td>
<td>69.9%</td>
</tr>
<tr>
<td>October 2004</td>
<td>8.5%</td>
<td>55.3%</td>
<td>63.8%</td>
</tr>
<tr>
<td>November 2004</td>
<td>20.9%</td>
<td>44.0%</td>
<td>64.9%</td>
</tr>
<tr>
<td>December 2004</td>
<td>16.7%</td>
<td>36.7%</td>
<td>53.4%</td>
</tr>
<tr>
<td>January 2005</td>
<td>12.8%</td>
<td>36.2%</td>
<td>49.0%</td>
</tr>
<tr>
<td>February 2005</td>
<td>6.5%</td>
<td>57.0%</td>
<td>63.5%</td>
</tr>
<tr>
<td>March 2005</td>
<td>5.0%</td>
<td>44.0%</td>
<td>49.0%</td>
</tr>
<tr>
<td>April 2005</td>
<td>9.8%</td>
<td>46.1%</td>
<td>55.9%</td>
</tr>
<tr>
<td>May 2005</td>
<td>6.2%</td>
<td>45.4%</td>
<td>51.6%</td>
</tr>
<tr>
<td>June 2005</td>
<td>11.7%</td>
<td>36.9%</td>
<td>48.6%</td>
</tr>
<tr>
<td>July 2005</td>
<td>15.8%</td>
<td>31.7%</td>
<td>47.5%</td>
</tr>
<tr>
<td>August 2005</td>
<td>10.1%</td>
<td>36.4%</td>
<td>46.5%</td>
</tr>
<tr>
<td>September 2005</td>
<td>12.3%</td>
<td>41.5%</td>
<td>53.8%</td>
</tr>
<tr>
<td>October 2005</td>
<td>9.1%</td>
<td>31.8%</td>
<td>40.9%</td>
</tr>
</tbody>
</table>

90. The examples set forth below represent a tiny sample of the total number of mortgages for which Wells Fargo submitted false certifications in this period.
1. The Palmer Court Property in Minnesota

91. FHA case number 271-9084779 relates to a property on Palmer Court in Lindstrom, MN (the “Palmer Court Property”). Wells Fargo underwrote the mortgage for the Palmer Court Property, reviewed and approved it for FHA insurance, and certified that a DE underwriter had conducted the required due diligence on the loan application and that the loan was eligible for HUD mortgage insurance. The mortgage closed on or about May 14, 2004.

92. Contrary to Wells Fargo’s certification, Wells Fargo did not comply with HUD rules in reviewing and approving this loan for FHA insurance, and did not exercise due diligence in underwriting the mortgage. Instead, Wells Fargo violated multiple HUD rules, including HUD Handbook 4155.1 ¶¶ 2-3, 2-6, 2-7, and 3-1, and Mortgagee Letter 2001-01.

93. Wells Fargo’s violation of HUD Handbook 4155.1 ¶ 3-1 is illustrative of the multiple rules that Wells Fargo violated in approving the Palmer Court Property. HUD underwriting guidelines state that to verify and document a borrower’s income, the lender must obtain a Verification of Employment and the borrower’s most recent pay stubs. HUD Handbook 4155.1 ¶ 3-1. Contrary to this clear requirement, Wells Fargo failed to obtain the borrower’s most recent pay stubs that could corroborate the information on the verification of employment and would allow the lender to accurately calculate and adequately document the amount of income received by the borrower. In violating HUD Handbook 4155.1 ¶ 3-1, Wells Fargo endorsed the Palmer Court Property for FHA insurance without adequate proof of the borrower’s employment or income.
94. Wells Fargo’s false certification on this loan was material and bore upon the loan’s eligibility for FHA insurance and the likelihood that the borrower would make mortgage payments.

95. Soon after closing, this mortgage went into default. As a result, HUD paid Wells Fargo, as holder of the mortgage note, an FHA insurance claim of $42,632.61, including costs.

2. The King Blvd. Property in New Jersey

96. FHA case number 352-4948464 relates to a property on Martin Luther King Blvd. in Newark, NJ (the “King Blvd. Property”). Wells Fargo underwrote the mortgage for the King Blvd. Property, reviewed and approved it for FHA insurance, and certified that a DE underwriter had conducted the required due diligence on the loan application and that the loan was eligible for HUD mortgage insurance. The mortgage closed on or about July 23, 2003.

97. Contrary to Wells Fargo’s certification, Wells Fargo did not comply with HUD rules in reviewing and approving this loan for FHA insurance, and did not exercise due diligence in underwriting the mortgage. Instead, Wells Fargo violated multiple HUD rules, including HUD Handbook 4155.1 ¶ 2-3 and 3-1, HUD Handbook 4000.4 ¶ 2-4(c)(5), and Mortgagee Letters 1992-5 and 2001-01.

98. Wells Fargo’s violation of HUD Handbook 4155.1 ¶ 2-3 is illustrative of the multiple rules that Wells Fargo violated in approving the King Blvd. Property. HUD underwriting guidelines state that lenders must analyze a mortgage applicant’s credit and determine the creditworthiness of the applicant. Specifically, lenders must verify and analyze the borrower’s payment history of housing obligations, and obtain written explanations from the borrower of past derogatory credit. HUD Handbook 4155.1 ¶ 2-3. Contrary to this clear
requirement, Wells Fargo failed to verify the borrower’s history of housing obligations or obtain explanations from the borrower for past derogatory credit. In violating HUD Handbook 4155.1 ¶ 2-3, Wells Fargo endorsed the King Blvd. Property for FHA insurance without sufficiently analyzing the borrower’s creditworthiness.

99. Wells Fargo’s false certification on this loan was material and bore upon the loan’s eligibility for FHA insurance and the likelihood that the borrower would make mortgage payments.

100. Within nine months of closing, this mortgage went into default. As a result, HUD paid Wells Fargo, as holder of the mortgage note, an FHA insurance claim of $228,580.31, including costs.

3. The 240th Street Property in Washington

101. FHA case number 561-7803393 relates to a property on 240th Street in Spanaway, WA (the “240th Street Property”). Wells Fargo, using an FHA-approved AUS, underwrote the mortgage for the 240th Street Property, reviewed and approved it for FHA insurance, and certified to the integrity of the data supplied and that the mortgage qualified for HUD mortgage insurance. The mortgage closed on or about June 30, 2003.

102. Because the soundness of the AUS’s evaluation is dependent on the accuracy and reliability of the data submitted by the mortgagee, a mortgagee may only enter into the AUS such income, asset, debt, and credit information that meets FHA’s applicable eligibility rules and documentation requirements, including those set forth in HUD Handbook 4155.1, Mortgagee Letters, the FHA TOTAL Mortgage Scorecard User Guide, and the AUS certificate.
103. Contrary to Wells Fargo’s certification, the data Wells Fargo entered into the AUS lacked integrity and the mortgage loan failed to meet FHA’s eligibility and documentation requirements. Despite clear requirements, Wells Fargo failed to obtain the required documentation to verify the borrower’s income and misrepresented the borrower’s eligibility for the amount of insurance for which the loan was submitted. In failing to accurately and reliably verify information submitted into AUS, Wells Fargo submitted a loan for FHA endorsement that was ineligible for FHA insurance, and was supported by data lacking integrity.

104. Wells Fargo’s false certification on this loan was material and bore upon the loan’s eligibility for FHA insurance and the likelihood that the borrower would make mortgage payments.

105. Within five months after closing, this mortgage went into default. As a result, HUD paid Wells Fargo, as holder of the mortgage note, an FHA insurance claim of $179,558.03, including costs.

4. The West Summit Property in Missouri

106. FHA case number 291-3292799 relates to a property on West Summit in Seymour, Missouri (the “West Summit Property”). Wells Fargo underwrote the mortgage for the West Summit Property, reviewed and approved it for FHA insurance, and certified that a DE underwriter had conducted the required due diligence on the loan application and that the loan was eligible for HUD mortgage insurance. The mortgage closed on or about July 29, 2004.

107. Contrary to Wells Fargo’s certification, Wells Fargo did not comply with HUD rules in reviewing and approving this loan for FHA insurance, and did not exercise due diligence in underwriting the mortgage. Instead, Wells Fargo violated multiple HUD rules, including
HUD Handbook 4155.1 ¶¶ 2-3, 2-11, 2-12, and 2-13, HUD Handbook 4000.4 ¶ 2-4(c)(5), and Mortgagee Letter 1992-5.

108. Wells Fargo’s violation of HUD Handbook 4000.4 ¶ 2-4(c)(5) and Mortgagee Letter 1992-5 is illustrative of the multiple rules that Wells Fargo violated in approving the West Summit Property. HUD underwriting guidelines state that lenders must be aware of warnings signs of fraud and irregularity and examine all irregularities presented in the mortgage application. HUD Handbook 4000.4 ¶ 2-4(c)(5) and Mortgagee Letter 1992-5. Contrary to this rule, Wells Fargo failed to reconcile conflicting information concerning the borrower’s rental and residence history. In violating this requirement, Wells Fargo endorsed the West Summit Property for FHA insurance without sufficiently resolving discrepancies and analyzing the borrower’s history of paying housing obligations.

109. Wells Fargo’s false certification on this loan was material and bore upon the loan’s eligibility for FHA insurance and the likelihood that the borrower would make mortgage payments.

110. Soon after closing, this mortgage went into default. As a result, HUD paid Wells Fargo, as holder of the mortgage note, an FHA insurance claim of $56,604.91, including costs.

5. The Brentwood Drive Property in Kentucky

111. FHA case number 202-0208757 relates to a property on Brentwood Drive in Dry Ridge, KY (the “Brentwood Drive Property”). Wells Fargo, using an FHA-approved AUS, underwrote the mortgage for the Brentwood Drive Property, reviewed and approved it for FHA insurance, and certified to the integrity of the data supplied and that the mortgage qualified for HUD mortgage insurance. The mortgage closed on or about December 12, 2003.
112. Because the soundness of the AUS’s evaluation is dependent on the accuracy and reliability of the data submitted by the mortgagee, a mortgagee may only enter into the AUS such income, asset, debt, and credit information that meets FHA’s applicable eligibility rules and documentation requirements, including those set forth in HUD Handbook 4155.1, Mortgagee Letters, the FHA TOTAL Mortgage Scorecard User Guide, and the AUS certificate.

113. Contrary to Wells Fargo’s certification, the data Wells Fargo entered into the AUS lacked integrity and the mortgage loan failed to meet FHA’s eligibility and documentation requirements. Despite clear requirements, Wells Fargo entered asset and debt data variables into the AUS that understated the borrower’s monthly debt obligations and overstated the borrower’s assets. In failing to enter accurate and verified information into AUS, Wells Fargo submitted a loan for FHA endorsement that was supported by data lacking integrity.

114. Wells Fargo’s false certification on this loan was material and bore upon the loan’s eligibility for FHA insurance and the likelihood that the borrower would make mortgage payments.

115. Soon after closing, this mortgage went into default. As a result, HUD paid Wells Fargo, as holder of the mortgage note, an FHA insurance claim of $123,224.54, including costs.

116. Moreover, Wells Fargo management knew, or should have known, that certain of its branches and underwriters were originating and approving loans of astoundingly poor quality. For instance, Wells Fargo’s Baton Rouge, Louisiana Branch – whose FHA status was not terminated until 2009 – originated a total of 1,519 FHA loans, 771 of which went into default, for a default rate of 51%. And the EPD rate for that branch was an incredible 12%. Wells Fargo
also allowed underwriters with default rates of over 30% to continue to underwrite FHA loans, and even employed underwriters with FHA default rates of greater than 60%.

117. As shown, from February 2003 through October 2005, Wells Fargo falsely certified that tens of thousands of distributed retail FHA loans met HUD’s requirements and were eligible for FHA insurance when the bank knew, or should have known, that the loans did not qualify for insurance. Wells Fargo sold many of its distributed retail FHA loans to third parties knowing that the third parties would submit claims for FHA insurance in the event that the loans defaulted. However, Wells Fargo remained the holder of record for the vast majority of its distributed retail FHA loans, and indeed was the holder of record for 6,588 of the 6,920 claims for FHA insurance submitted for those loans. Accordingly, Wells Fargo submitted and was paid on claims for FHA insurance when those loans defaulted.

118. The United States Department of Justice learned the facts material to its claims against Wells Fargo related to the bank’s reckless underwriting during the period May 2001 through October 2005 no earlier than 2011, the year in which the United States Attorney’s Office for the Southern District of New York (“USAO SDNY”) commenced its investigation resulting in this action.

119. The United States is owed hundreds of millions of dollars in damages for the insurance claims it paid on defaulted mortgage loans that Wells Fargo falsely certified were eligible for FHA insurance.
III. WELLS FARGO KNOWINGLY FAILED TO REPORT OVER 6,000 BAD LOANS TO HUD FROM JANUARY 2002 THROUGH DECEMBER 2010, RESULTING IN HUNDREDS OF MILLIONS OF DOLLARS OF LOSSES TO FHA

120. As discussed above, HUD required Direct Endorsement Lenders to perform post-closing reviews of the FHA loans they originated and to report to HUD loans that had an unacceptable risk. This requirement provided HUD with an opportunity to investigate the loans and request reimbursement or indemnification, as appropriate. Wells Fargo, however, decided unilaterally that it did not have to comply with this requirement.

121. Prior to 2003, the self-reporting regulation required lenders to report loans that contained “significant discrepancies,” such as “any violation of law or regulation, false statements or program abuses . . .” HUD Handbook 4060.1 REV-1, ¶ 6-1(H) (1993). In 2003, the requirement was amended to require reporting of “serious deficiencies, patterns of noncompliance or fraud,” HUD Handbook 4060.1 REV-1, CHG-1, ¶ 6-13 (2003), and lenders were instructed that loans identified as having material violations by the bank’s quality control had to be reported, id. ¶ 6-3(J). And in 2006, the requirement was restated to require reporting of “[f]indings of fraud or other serious violations,” to include any material violations found by quality control. HUD Handbook 4060.1 REV-2, ¶¶ 7-3(J), 7-4(D) (2006).

122. Wells Fargo’s internal memoranda make clear that the bank was aware of HUD’s requirement to report in writing loans affected by fraud and other serious violations, and that the bank consciously flouted this obligation. Wells Fargo’s Quality Control plan, which was provided to HUD in or about May 2004, declared that the bank would report to HUD “when fraud or other serious violations of FHA requirements are identified (whether during the normal
course of business or by Quality Control staff during reviews/audits of FHA loans).” Similarly, a Wells Fargo internal memorandum from August 2005 confirmed that the bank knew that “HUD has always requested significant findings or fraud on FHA loans be reported to HUD.”

123. Behind closed doors, however, Wells Fargo decided to disregard the self-reporting requirement entirely. It did so by simply ignoring its self-reporting obligations prior to 2004, and then redefining the reporting requirement so narrowly as to obliterate it. At or about the time of a HUD-Office of the Inspector General (“HUD-OIG”) audit in 2004, Wells Fargo management first began to concern itself with the topic of reporting bad loans to HUD. An April 8, 2004 memorandum states that the Vice President of Decision Quality Management (the “VP of Quality Control”) “will organize a working group to address reporting to HUD. Some of the items in the scope of this group are: fraud, significant credit risks, significant servicing risks, EPD issues, non-owner occupied issues, fair lending issues.” But no self-reporting occurred.

124. Rather, in August 2004, the working group agreed not to follow the HUD reporting requirements and not to report loans to HUD that it internally identified as containing material violations of HUD requirements. In an August 13, 2004 memorandum bearing the subject line “Reporting Process to HUD,” the author recounts issues discussed in the recent working group call, stating that “[Wells Fargo Home Mortgage] is required to report violations and deficiencies that are identified. Fraud or other serious deficiencies must be reported to Director of HUD … within 60 days of initial discovery. It was agreed that loans reviewed and rated material through the Quality Assurance process would not necessarily meet that definition.”
125. Later, the Quality Control working group further unilaterally narrowed the bank’s reporting obligations. In response to an April 2005 email from Wells Fargo’s FRM Director which laid out numerous HUD reporting requirements and requested specific guidance on reporting broker fraud, the VP of Quality Control stated that he and two others had reviewed the reporting requirements and had “determined ‘serious deficiencies’ did not include material findings and unallowable fees, but that systemic fraud issues need to be reported to HUD . . . One-off borrower fraud generally would not be reported, but LO, broker, appraiser, realtor fraud would be.” Yet the bank did not even comply with its own unilaterally narrowed formulation of Wells Fargo’s reporting obligation, and continued not to self-report any loans.

126. Then in 2005, when HUD questioned whether Wells Fargo was complying with its self-reporting obligations, the bank went into full double-speak mode. In a January 18, 2006 letter mailed to HUD, responding to HUD’s concerns, the Division Presidents of Wells Fargo Home Mortgage acknowledged that “HUD requires that ‘serious deficiencies, patterns of non-compliance, or fraud uncovered by mortgagees must be report[ed] in writing,’” and then represented (falsely) that “[p]rocedures are, and have been, in place to report appropriate items to the HUD Homeownership Centers.” The Division Presidents then described these procedures, which supposedly included “obtaining input from various groups including Quality Assurance, Fraud Risk management, Legal Servicing, etc.,” and assured HUD that “[r]egular meetings are held to discuss what files should be reported.” They explained the bank’s prior self-reporting policy as follows: “[h]istorically Wells Fargo interpreted HUD’s [self-reporting] requirement . . . to mean that reporting was required on incidents that involve several files or patterns of fraud or non compliance . . . .” Based on this interpretation, the Division Presidents continued, “Wells
Fargo did not report *every* incident of fraud or non-compliance that involved a single instance or file, but rather focused on reporting larger global fraud issues which involved numerous parties and files.” (emphasis added). They assured HUD, however, that the bank had now “broadened its reporting requirements to meet the guidance provided” in HUD’s May 27, 2005 Mortgagee Letter.

127. Wells Fargo’s abject failure to report a single loan prior to October 2005 puts the lie to those representations and makes clear that the bank had no intention to report anything at all prior to HUD’s inquiry.

128. Following HUD’s inquiry, Wells Fargo began to self-report loans in October 2005, but even then the bank failed to adhere to its own self-reporting policy and, more importantly, knowingly failed to comply with HUD’s self-reporting regulations. Indeed, from October 2005 through December 2010, the bank’s self-reporting was cursory at best. During that more than five-year period, Wells Fargo, the largest originator and sponsor of FHA home mortgages for much, if not all, of this period, self-reported fewer than 250 loans.

129. Wells Fargo’s woefully inadequate reporting was the product of regular monthly meetings of the Wells Fargo QC working group. Those meetings began in October 2005 and were attended by numerous high-level employees. At these meetings, the attendees conducted only bare reviews of a handful of loans and, accordingly, reported to HUD only a tiny number of loans. For example, at the October 2005 meeting, seven loans were discussed but none was reported. There was no November 2005 meeting. In December 2005 and January 2006, four loans were discussed in each month. Then, in February 2006 – the month after Wells Fargo laid out its purported, historic review and reporting process in its January 18, 2006 letter and told
HUD that “Wells Fargo takes its reporting requirements very seriously” – the working group discussed one loan and reported none. Amongst the loans discussed and not reported at these QC working group meetings were loans for which Suspicious Activity Reports were filed with an agency of the United States Department of Treasury.

130. Wells Fargo’s motive for not self-reporting loans to HUD is made clear in the bank’s internal documents. In an inter-office memorandum to “Senior Management” on August 4, 2005, before the bank had done any self-reporting to HUD, the Wells Fargo “HUD Deficiency Reporting Cross Functional Team” listed the following two concerns about starting to self-report: First, the team highlighted that “[b]y self reporting all significant audit results and suspected fraud to HUD on FHA originations, [Wells Fargo Home Mortgage] has potentially given HUD a list of loans which could result in indemnification from HUD.” In other words, the bank’s bottom line would be hurt by complete self-reporting. The August 4, 2005 memorandum further stated that “[t]his is however, similar to our current self reporting requirements with” Fannie Mae and Freddie Mac. Second, the team underscored that “[Wells Fargo Home Mortgage] will be reporting audit findings for wholesale brokers. This could cause client issues or concerns, depending upon direction other lenders take.” Again, the bank’s overriding concern rested with losing some wholesale FHA business, thereby affecting its profits.

131. It was not until June 2011, shortly after this Office served Wells Fargo with a subpoena, that the bank began self-reporting a more significant quantity of loans, and, on information and belief, retroactively reported loans back to the beginning of 2011.

132. Wells Fargo’s complete failure to self-report bad loans prior to October 2005, and woefully inadequate reporting thereafter, stands in stark contrast to the findings of Wells Fargo’s
QA reviews. From January 2002 through December 2010, Wells Fargo reported 238 loans to HUD. In contrast, during that same time, Wells Fargo QA identified 6,558 loans as having a material violation. Of those, 2,628 were identified through randomly sampled QA reviews, 3,142 from mandated EPD reviews, and an additional 788 through targeted reviews. Wells Fargo failed to report 6,320 of these “material” risk loans to HUD. (Attached as Exhibit A to the Amended Complaint is a list of the 6,320 FHA loans that Wells Fargo failed to self-report.) Those loans alone resulted in FHA’s payment of nearly $190 million in FHA benefits on defaulted mortgage loans.

Moreover, on information and belief, the 6,558 “material” risk-rated loans that QA identified do not constitute the universe of bad loans that Wells Fargo was aware of and failed to self-report. For example, the 6,558 loans do not include any loans that Fraud Risk Management determined during this period were affected by fraud or other serious violations. Accordingly, there are additional loans containing material violations that Wells Fargo should have self-reported to HUD and that almost certainly resulted in insurance claims that FHA was required to satisfy.

Further, Wells Fargo QA failed to review all early payment defaults as required under the HUD Handbook. That is because, according to QA, the loan file often “was not available for review.” On average, approximately 20% of the FHA EPDs were not reviewed each month by QA. For example, in its July 2002 report, QA reported that there were 36 FHA EPDs but QA reviewed only 24. The next month there were 29 FHA EPDs and QA reviewed 20. The following month there were 41 EPDs and QA reviewed 30.
135. This failure is particularly problematic because a loan that is 60 days in default within the first six months after origination has an increased likelihood of fraud or other serious violations. As a result of QA’s failure to review all EPDs, Wells Fargo never identified additional loans that contained unacceptable risk and never self-reported these loans to HUD. As a consequence, HUD never had the opportunity to investigate these loans or request reimbursement or indemnification, and FHA was required to pay insurance claims on these loans when they defaulted. Of the 6,320 “material” risk-rated loans that Wells Fargo failed to self-report, 1,443 of those loans defaulted and resulted in claims being submitted for FHA insurance. Wells Fargo remained the holder of record on 97% of the 1,443 loans, and received more than $185 million in FHA insurance payments in connection with claims submitted for those loans. (Attached as Exhibit B is a list of the 1,406 “material” risk-rated loans that Wells Fargo did not self-report, and for which a claim was submitted and Wells Fargo was paid as holder of record. Attached as Exhibit C is a list of the 37 “material” risk-rated loans that Wells Fargo did not self-report, and for which claims were submitted and paid to another entity as holder of record.)

136. The United States Department of Justice learned the facts material to its claims against Wells Fargo related to the bank’s failure to self-report “material” risk-rated FHA loans to HUD no earlier than 2011, the year in which the USAO SDNY commenced its investigation resulting in this action.

137. Accordingly, Wells Fargo’s failure to self-report over 6,000 FHA loans that did not meet HUD requirements, and failure to review all EPDs, caused FHA to pay hundreds of millions of dollars in insurance claims for loans that were not eligible for insurance.
FIRST CLAIM

Violations of the False Claims Act
Presenting or Causing False Claims to Be Presented (Reckless Underwriting)

138. The Government incorporates by reference paragraphs 1 through 137 as if fully set forth in this paragraph.


140. As set forth above, from May 2001 through October 2005, Wells Fargo engaged in a regular practice of reckless origination and underwriting of its retail FHA loans. During that time, Wells Fargo’s senior management was aware of the very serious loan quality problems that the bank was experiencing with respect to its retail FHA loans. Similarly, Wells Fargo’s underwriters knew, or should have known, that a substantial portion of the bank’s retail FHA loans during this time period did not meet the FHA loan program parameters, contained unacceptable risk, and were ineligible for FHA insurance. Nonetheless, Wells Fargo certified its entire portfolio of retail FHA loans for insurance, and thereby falsely certified that thousands of retail FHA loans were eligible for insurance when they were not.

141. Wells Fargo knowingly, or acting with deliberate ignorance and/or with reckless disregard for the truth, caused false or fraudulent claims for FHA insurance to be presented to an officer or employee of the United States Government. Wells Fargo did so by, inter alia, submitting false loan-level certifications for retail FHA loans to HUD in order to get FHA to endorse these mortgages that did not meet HUD requirements and contained unacceptable risk
for FHA insurance, and then selling the mortgage loans to third parties whom Wells Fargo knew would submit insurance claims in the event the mortgage loans defaulted.

142. Wells Fargo knowingly, or acting with deliberate ignorance and/or with reckless disregard for the truth, presented to an officer or employee of the Government false or fraudulent claims for payment when it submitted claims for FHA insurance for defaulted loans that Wells Fargo falsely certified were eligible for FHA insurance.

143. A truthful individual loan certification for FHA endorsement is a condition of payment of FHA insurance on that loan. HUD paid insurance claims, and incurred losses, on these retail FHA loans that Wells Fargo falsely certified were eligible for HUD insurance.

144. By reason of the foregoing, the Government has been damaged in a substantial amount to be determined at trial, and is entitled to treble damages and a civil penalty as required by law for each violation.

SECOND CLAIM

Violations of the False Claims Act
Use of False Statements in Support of False Claims (Reckless Underwriting)

145. The Government incorporates by reference each of the preceding paragraphs as if fully set forth in this paragraph.


147. As set forth above, from May 2001 through October 2005, Wells Fargo knowingly, or acting in deliberate ignorance and/or with reckless disregard of the truth, made,
used, or caused to be made or used, false records and/or statements material to false or fraudulent claims with respect to the thousands of FHA loans that Wells Fargo falsely certified were eligible for FHA insurance. Specifically, during this period, Wells Fargo knowingly submitted thousands of false individual retail FHA loan certifications to HUD representing, inter alia, that each loan was eligible for HUD mortgage insurance under the Direct Endorsement program. Wells Fargo submitted the false loan certifications to induce FHA to endorse the mortgages for insurance and to get HUD to pay false insurance claims when the mortgages defaulted. In addition, Wells Fargo submitted and caused to be submitted false records and statements to HUD in connection with claims that were submitted for FHA insurance for defaulted loans that Wells Fargo had falsely certified were eligible for FHA insurance.

148. A truthful individual loan certification for FHA endorsement is a condition of payment of FHA insurance on that loan. HUD paid insurance claims, and incurred losses, on these retail FHA loans that Wells Fargo falsely certified were eligible for HUD insurance.

149. By reason of the foregoing, the Government has been damaged in a substantial amount to be determined at trial, and is entitled to treble damages and a civil penalty as required by law for each violation.

**THIRD CLAIM**

**Violations of the False Claims Act**


**Presenting or Causing False Claims to Be Presented (Self-Reporting)**

150. The Government incorporates each of the preceding paragraphs as if fully set forth in this paragraph.

152. As set forth above, from January 2002 through December 2010, Wells Fargo intentionally failed to self-report to HUD, as required, at least 6,320 FHA loans that it knew failed to meet the FHA loan program parameters, contained an unacceptable level of risk, and were not eligible for HUD insurance. (Attached as Exhibit A to the Amended Complaint is a list of the 6,320 FHA loans that Wells Fargo failed to self-report.) Wells Fargo’s failure to self-report these loans evidences Wells Fargo’s intent to knowingly present or cause to be presented false or fraudulent claims for FHA insurance. Moreover, with knowledge that those loans were ineligible for HUD insurance, Wells Fargo submitted the claims or caused the claims to be submitted for, and was paid FHA insurance on, nearly all of those loans for which claims were submitted. (Attached as Exhibit B to the Amended Complaint is a list of those 1,406 loans which Wells Fargo failed to self-report and for which it was paid as the holder of record, after FHA claims were submitted.) Likewise, with knowledge that those loans were ineligible for HUD insurance, Wells Fargo sold some of the loans to third parties knowing that the third parties would submit claims for insurance in the event these deficient loans defaulted. (Attached as Exhibit C to the Amended Complaint is a list of those 37 loans which Wells Fargo failed to self-report and for which a third party was paid as the holder of record, after FHA claims were submitted.)

153. Wells Fargo knowingly, or acting with deliberate ignorance and/or with reckless disregard for the truth, caused to be presented to an officer or employee of the Government, false
and fraudulent claims for payment or approval. Wells Fargo submitted false loan-level certifications to HUD to induce FHA to endorse these mortgages for FHA insurance and failed to self-report these mortgages that the bank knew failed to meet the FHA loan program parameters, contained an unacceptable level of risk, and were not eligible for HUD insurance. Wells Fargo did so knowing that third parties to whom Wells Fargo had sold these FHA loans or who were servicing these FHA loans would submit false claims for insurance when the loans defaulted.

154. Wells Fargo knowingly, or acting with deliberate ignorance and/or with reckless disregard for the truth, presented to an officer or employee of the Government, false and fraudulent claims for payment when it submitted claims for FHA insurance in connection with these defaulted loans that the bank knew failed to meet the FHA loan program parameters, contained an unacceptable level of risk, had not been self-reported to HUD, and were not eligible for HUD insurance.

155. A truthful individual loan certification for FHA endorsement is a condition of payment of FHA insurance on that loan. HUD paid insurance claims, and incurred losses, on these loans that Wells Fargo wrongfully failed to self-report to HUD.

156. By reason of the foregoing, the Government has been damaged in a substantial amount to be determined at trial, and is entitled to treble damages and a civil penalty as required by law for each violation.
FOURTH CLAIM

Violations of the False Claims Act
Use of False Statements in Support of False Claims (Self-Reporting)

157. The Government incorporates by reference each of the preceding paragraphs as if fully set forth in this paragraph.


159. As set forth above, Wells Fargo knowingly, or acting in deliberate ignorance and/or with reckless disregard of the truth, made, used, or caused to be made or used, false records and/or statements material to false or fraudulent claims for FHA insurance with respect to at least the 6,320 loans that Wells Fargo knew failed to meet the FHA loan program parameters, contained an unacceptable level of risk, and were not eligible for HUD insurance.

160. Between January 2002 and December 2010, Wells Fargo made numerous false statements and used numerous false records to get false claims for FHA insurance paid by HUD. The false statements and false records that Wells Fargo made and/or used include, but are not limited to: (1) Wells Fargo’s May 2004 Quality Control Plan submitted to HUD which falsely represented that Wells Fargo’s policy and practice was to self-report loans as required, (2) Wells Fargo’s annual certifications from 2002 through 2010 submitted to HUD in which the bank certified, inter alia, that it conformed to all regulations necessary to maintain its HUD-FHA approval, (3) Wells Fargo’s January 18, 2006 letter to HUD falsely stating that the bank had been self-reporting loans, (4) Wells Fargo’s self-reports of loans to HUD from January 2002 through
December 2010, which knowingly omitted at least 6,320 seriously deficient loans, and (5) Wells Fargo’s loan level certifications for the 6,320 loans which Wells Fargo knew were false after the QA review was performed on these loans and which were used to get false or fraudulent claims for FHA insurance paid for these loans. In addition, Wells Fargo submitted and caused to be submitted false records and statements to HUD in connection with claims that were submitted for FHA insurance for defaulted loans that Wells Fargo had falsely certified were eligible for FHA insurance.

161. A truthful individual loan certification for FHA endorsement is a condition of payment of FHA insurance on that loan. HUD paid insurance claims, and incurred losses, relating to these FHA mortgages that Wells Fargo falsely certified were eligible for HUD insurance and failed to self-report as required.

162. By reason of the foregoing, the Government has been damaged in a substantial amount to be determined at trial, and is entitled to treble damages and a civil penalty as required by law for each violation.

**FIFTH CLAIM**

**Violations of the False Claims Act**


Reverse False Claims (Self-Reporting)

163. The Government incorporates by reference each of the preceding paragraphs as if fully set forth in this paragraph.

165. As set forth above, Wells Fargo knowingly, or acting in deliberate ignorance and/or with reckless disregard of the truth, made, used or caused to be made or used false records and/or statements material to an obligation to pay or transmit money or property to the United States, and/or knowingly, or acting in deliberate ignorance and/or with reckless disregard of the truth, made, used or caused to be made or used false records and/or statements to conceal, avoid, or decrease an obligation to pay or transmit money or property to the United States. The false statements and false records that Wells Fargo made and/or used to avoid its obligation to indemnify HUD for loans that the bank had internally identified as not meeting HUD’s requirements and containing unacceptable risk include, but are not limited to: (1) Wells Fargo’s May 2004 Quality Control Plan submitted to HUD which falsely represented that Wells Fargo’s policy and practice was to self-report loans as required, (2) Wells Fargo’s annual certifications from 2002 through 2010 submitted to HUD in which the bank certified, inter alia, that it conformed to all regulations necessary to maintain its HUD-FHA approval, (3) Wells Fargo’s January 18, 2006 letter to HUD falsely stating that the bank had been self-reporting loans, (4) Wells Fargo’s self-reports of loans to HUD from January 2002 through December 2010, which knowingly omitted at least 6,320 seriously deficient loans, (5) Wells Fargo’s loan level certifications for the 6,320 loans which Wells Fargo knew were false after the QA review was performed on these loans, and (6) Wells Fargo’s filing of claims for FHA insurance on approximately 1,400 of those same loans.

166. A truthful individual loan certification for FHA endorsement is a condition of payment of FHA insurance on that loan. The Government paid insurance claims, and incurred
losses, as a result of Wells Fargo’s false records and false statements that concealed its obligation to indemnify HUD.

167. By virtue of the false records or statements made by Wells Fargo, the Government suffered damages and therefore is entitled to treble damages under the False Claims Act, to be determined at trial, and a civil penalty as required by law for each violation.

**SIXTH CLAIM**

Violations of FIRREA  
(12 U.S.C. § 1833a)  
False Certifications to HUD

168. The Government incorporates by reference each of the preceding paragraphs as if fully set forth in this paragraph.

169. By virtue of the acts described above, and for the purpose of inducing HUD to endorse loans for FHA insurance, Wells Fargo knowingly made, used, or caused to be made or used, false individual loan certifications stating that loans were eligible for FHA insurance and that Wells Fargo had complied with other requirements including maintenance of data integrity and/or due diligence, and further submitted and caused to be submitted false claims in order to receive insurance payments to which it was not entitled. Wells Fargo submitted and caused to be submitted such false certifications and false claims to HUD using the mails and/or the wires in violation of 18 U.S.C. §§ 1001, 1005,3 1014, 1341, and 1343. Further, as part of Wells Fargo’s scheme to avoid informing HUD of the loan quality problems that the bank was experiencing and to avoid requests by HUD for indemnification on individual loans, the bank knowingly made

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3 Wells Fargo’s violations of the fourth paragraph of 18 U.S.C. § 1005 provide the basis for the United States’ allegation of FIRREA violations based upon that predicate statute.
numerous material fraudulent representations to HUD about its self-reporting practices using the mails and/or the wires in violation of 18 U.S.C. §§ 1001, 1005, 1014, 1341, and 1343, including, but not limited to: (1) Wells Fargo’s May 2004 Quality Control Plan submitted to HUD which falsely represented that Wells Fargo’s policy and practice was to self-report loans as required, (2) Wells Fargo’s January 18, 2006 letter to HUD falsely stating that the bank had been self-reporting loans, (3) Wells Fargo’s electronic submission of self-reported loans to HUD from October 2005 through December 2010, which knowingly omitted at least 6,320 seriously deficient loans, and (4) Wells Fargo’s electronic submission of claims for payment, from 2002 through the present, on loans it knew were ineligible for FHA insurance. These misrepresentations and omissions were material to HUD’s decision to insure the loans and pay the insurance claims on defaulted loans.

170. Wells Fargo made these statements to HUD with respect to the loans that it recklessly originated and underwrote between May 2001 and October 2005, and with respect to the loans that Wells Fargo failed to self-report between January 2002 and December 2010, with the intent to defraud or deceive HUD into endorsing loans that were ineligible for FHA insurance, and to defraud or deceive FHA into paying insurance claims for loans that were not eligible for insurance. In connection with this scheme, as holder of record on a significant majority of those loans, Wells Fargo knowingly and intentionally submitted or caused to be submitted FHA insurance claims on thousands of ineligible loans and, as a result, received hundreds of millions of dollars in FHA insurance payments to which it was not entitled. In

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4 With respect to Wells Fargo’s violations of 18 U.S.C. § 1014, the Government only asserts claims based upon false statements and records made after July 30, 2008.
addition, in connection with this scheme, Wells Fargo sold some of those loans that were ineligible for FHA insurance to third parties who submitted claims when the loans defaulted, thereby causing FHA to suffer additional losses.

171. Wells Fargo is a federally insured financial institution. Its fraudulent conduct has affected the bank by exposing it to actual losses and increased risk of loss. Specifically, Wells Fargo has been required to indemnify HUD for specific loans that the bank falsely certified were eligible for FHA insurance and already has entered into hundreds of indemnification agreements for loans it originated and certified for FHA endorsement between May 2001 and October 2005. Wells Fargo’s poor underwriting and loan administration practices, including quality control, risked the safety and security of federally insured bank deposits, exposing the bank to substantial losses. In addition, by engaging in this widespread misconduct, Wells Fargo has exposed itself to substantial civil liability, including potential treble damages and civil penalties under the False Claims Act.

172. Moreover, Wells Fargo’s fraudulent practices that underlie this action also have caused the bank to become a defendant in other lawsuits, and already have resulted in Wells Fargo paying out settlements. For example, according to Wells Fargo & Company’s Year 2011 10-K, in In Re Wells Fargo Mortgage Backed Certificates Litig., 09 Civ. 1376 (SI) (N.D.Cal.), class action plaintiffs asserted claims against Wells Fargo Bank, N.A., among others, alleging that certificate offering documents contained false statements of material fact, or omitted material facts necessary to make the registration statements and accompanying prospectuses not misleading. Similar to this action, the misrepresentations alleged in the Wells Fargo Mortgage Backed Certificates Litigation included that Wells Fargo Bank failed to disclose that it: “(i)
systematically did not follow its stated underwriting standards and that the underwriting standards actually utilized failed to conform to Wells Fargo Bank’s underwriting standards; (ii) allowed pervasive exceptions to its stated underwriting standards in order to generate increased loan volume; and (iii) that “credit risk” and “quality control” were materially disregarded in favor of generating sufficient loan volume as alleged herein and as set forth below.” Amended Cmplt., ¶ 66, *In re Wells Fargo Mortgage Backed Certificates Litig.*, 09 Civ. 1376 (SI) (N.D.Cal.). The plaintiff alleged that “Wells Fargo Bank originated as many mortgage loans as possible without regard to the ability of the borrower to repay such mortgages.” *Id.* § 67.

173. The parties agreed to settle the case on May 27, 2011, for $125 million, with Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) opting out of the settlement.

174. Accordingly, Wells Fargo is liable to HUD for civil penalties as authorized under 12 U.S.C. § 1833a, in the amount of up to the greater of (i) $1 million per violation, (ii) the amount of loss to the United States, or (iii) the amount of gain to Wells Fargo.

**SEVENTH CLAIM**

**Breach of Fiduciary Duty**

175. The Government incorporates by reference each of the preceding paragraphs as if fully set forth in this paragraph.

176. HUD and Wells Fargo have a special relationship of trust and confidence by virtue of Wells Fargo’s participation in the Direct Endorsement Lender program. The Direct Endorsement Lender program empowered Wells Fargo to obligate HUD to insure mortgages it
issued without any independent HUD review. Wells Fargo is therefore in a position of advantage or superiority in relation to HUD and is a fiduciary to HUD.

177. As a fiduciary, Wells Fargo had a duty to act for, and give advice to, the Government for the benefit of the Government as to whether mortgages should be insured by FHA under the direct endorsement lender program.

178. As a fiduciary, Wells Fargo had an obligation to act in the utmost good faith, candor, honesty, integrity, fairness, undivided loyalty, and fidelity in its dealings with the Government.

179. As a fiduciary, Wells Fargo had a duty to exercise sound judgment, prudence, and due diligence on behalf of HUD in endorsing mortgages for FHA insurance.

180. As a fiduciary, Wells Fargo had a duty to refrain from taking advantage of HUD by the slightest misrepresentation, to make full and fair disclosures to HUD of all material facts, and to take on the affirmative duty of employing reasonable care to avoid misleading the Government in all circumstances.

181. As set forth above, Wells Fargo breached its fiduciary duty to HUD.

182. As a result of Wells Fargo’s breach of the fiduciary duty, HUD has paid insurance claims and incurred losses, and will pay additional insurance claims in the future, relating to FHA-insured mortgages certified by Wells Fargo. HUD has paid a significant amount of those insurance claims directly to Wells Fargo.

183. By virtue of the above, the Government is entitled to compensatory damages for these past and future losses, in an amount to be determined at trial.
EIGHTH CLAIM

Gross Negligence

184. The Government incorporates by reference each of the preceding paragraphs as if fully set forth in this paragraph.

185. Wells Fargo owed the Government a duty of reasonable care and a duty to conduct due diligence.

186. As set forth above, Wells Fargo breached its duties to the Government.

187. As set forth above, Wells Fargo recklessly disregarded its duties to the Government.

188. As a result of the gross negligence of Wells Fargo, the Government has paid insurance claims, and incurred losses, relating to FHA-insured mortgages Wells Fargo endorsed. The Government has paid a significant amount of those insurance claims directly to Wells Fargo.

189. As a result of the gross negligence of Wells Fargo, the Government will pay future insurance claims, and incur future losses, relating to FHA-insured mortgages Wells Fargo endorsed.

190. By virtue of the above, the Government is entitled to compensatory and punitive damages, in an amount to be determined at trial.

NINTH CLAIM

Negligence

191. The Government incorporates by reference each of the preceding paragraphs as if fully set forth in this paragraph.
192. Wells Fargo owed the Government a duty of reasonable care and a duty to conduct due diligence.

193. As set forth above, Wells Fargo breached its duties to the Government.

194. As a result of Wells Fargo’s breaches of its duty, the Government has paid insurance claims, and incurred losses, relating to FHA-insured mortgages endorsed by Wells Fargo. The Government has paid a significant amount of those insurance claims directly to Wells Fargo.

195. As a result of the negligence of Wells Fargo, the Government will pay future insurance claims, and incur future losses, relating to FHA-insured mortgages endorsed by Wells Fargo.

196. By virtue of the above, the Government is entitled to compensatory damages, in an amount to be determined at trial.

TENTH CLAIM

Unjust Enrichment

197. The Government incorporates by reference each of the preceding paragraphs as if fully set forth in this paragraph.

198. Wells Fargo submitted, and HUD paid to Wells Fargo, claims for FHA insurance with respect to defaulted mortgage loans that the bank falsely certified were eligible for insurance.

199. By reason of the payments by HUD to Wells Fargo, the bank was unjustly enriched. The circumstances of Wells Fargo’s receipt of those payments are such that in equity
and good conscience Wells Fargo should not retain these payments, in an amount to be
determined at trial.

**ELEVENTH CLAIM**

**Payment Under Mistake of Fact**

200. The Government incorporates by reference each of the preceding paragraphs as if
fully set forth in this paragraph.

201. The United States seeks relief against Wells Fargo to recover payments made
under mistake of fact.

202. Wells Fargo submitted, and HUD paid to Wells Fargo, claims for FHA insurance
with respect to defaulted mortgage loans that the bank falsely certified were eligible for
insurance.

203. HUD made payment to Wells Fargo under the mistaken belief that the defaulted
loans had been eligible for FHA insurance and that the bank had been properly self-reporting
loans as required and exercising due diligence in its underwriting.

204. By reason of the foregoing, the United States has been damaged in a substantial
amount to be determined at trial.

WHEREFORE, the Government respectfully requests that judgment be entered in its
favor and against Wells Fargo as follows:

a. On Counts One, Two, Three, Four, and Five (False Claims Act), judgment for the
   Government, treble the Government’s damages, and civil penalties for the maximum amount
   allowed by law;
b. On Count Six (FIRREA), judgment for the Government and civil penalties up to the maximum amount authorized under 12 U.S.C. § 1833a;

c. On Count Seven (Breach of Fiduciary Duty), judgment for the Government and compensatory damages making the Government whole for past and future losses;

d. On Count Eight (Gross Negligence), judgment for the Government and compensatory damages making the Government whole for past and future losses;

e. On Count Nine (Negligence), judgment for the Government and compensatory damages making the Government whole for past and future losses;

f. On Count Ten (Unjust Enrichment), judgment for the Government and compensatory damages making the Government whole for past and future losses;

g. On Count Eleven (Payment Under Mistake of Fact), judgment for the Government and compensatory damages making the Government whole for past and future losses;

h. For an award of costs pursuant to 31 U.S.C. § 3729(a); and

i. For an award of any such further relief as is proper.
Dated:  New York, New York
December 14, 2012

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UNITED STATES DISTRICT COURT  
southern district of new york  
UNITED STATES OF AMERICA,  

v.  

COUNTRYWIDE FINANCIAL CORPORATION; COUNTRYWIDE  
HOME LOANS, INC.; COUNTRYWIDE  
BANK, FSB; BANK OF AMERICA  
CORPORATION; BANK OF AMERICA,  
N.A.; and REBECCA MAIRONE,  

Defendants.  

12 Civ. 1422 (JSR)  
ECF Case  

AMENDED COMPLAINT OF THE  
UNITED STATES OF AMERICA  

JURY TRIAL DEMANDED  

Plaintiff, the United States of America, by its attorney, Preet Bharara, United States  
Attorney for the Southern District of New York, brings this amended complaint and alleges upon  
information and belief as follows:
INTRODUCTION

1. This is a civil fraud action by the United States against Defendants Bank of America Corporation and Bank of America N.A. (“BANA”) (referred to collectively as “Bank of America”), Countrywide Financial Corporation (“Countrywide Financial” or “CFC”), Countrywide Bank, FSB (“Countrywide Bank”), and Countrywide Home Loans, Inc. (“Countrywide Home Loans” or “CHL”) (collectively, with CFC and Countrywide Bank, referred to herein as “Countrywide”), and Rebecca Mairone (“Mairone”) to recover damages and penalties arising from a scheme to defraud the Federal National Mortgage Association (“Fannie Mae”) and the Federal Home Loan Mortgage Corporation (“Freddie Mac”) (collectively, “government-sponsored enterprises” or “GSEs”) in connection with Countrywide’s residential mortgage lending business. This action seeks to recover treble damages and penalties under the False Claims Act, 31 U.S.C. § 3729 et seq. (“FCA”), and civil penalties under the Financial Institutions Reform, Recovery, and Enforcement Act, 12 U.S.C. § 1833a (“FIRREA”).

2. As set forth more fully below, in 2007, as loan delinquency and default rates rose across the country and the GSEs tightened their underwriting guidelines and loan purchase requirements, Countrywide rolled out a new “streamlined” loan origination model it called the “Hustle.” In order to increase the speed at which it originated and sold loans to the GSEs, Countrywide eliminated every significant checkpoint on loan quality and compensated its employees based solely on the volume of loans originated, leading to rampant instances of fraud and other serious loan defects, all while Countrywide was informing the GSEs (and the public) that it, too, had tightened underwriting guidelines in response to the sobering secondary market. When the loans predictably defaulted, the GSEs incurred more than a billion dollars in losses.
3. Countrywide was once the largest mortgage lender in the United States, having originated over $490 billion in mortgage loans in 2005, over $450 billion in 2006, and over $408 billion in 2007. In the mid-2000’s, Countrywide dominated the subprime lending market, originating subprime loans principally from its Full Spectrum Lending (“FSL”) division. In early 2007, however, when the subprime market collapsed, Countrywide responded to its resulting revenue shortfall in two ways. First, Countrywide shifted the focus of FSL to originating prime, conforming loans that qualified for sale to the GSEs. Second, under the direction of FSL Chief Operating Officer (“COO”) Mairone, Countrywide implemented the “Hustle,” which reduced the amount of time spent processing and underwriting conventional loans (the “turn time” on loans), thereby boosting loan volume and revenue.

4. According to internal Countrywide documents, the aim of the Hustle (or “HSSL,” for “High Speed Swim Lane”) was to process loans from application to closing at lightning speed by having the loans “move forward, never backward” and by removing quality-preserving “toll gates” that slowed down the loan origination process. Whereas the average turn time on an FSL loan was 45-60 days, the HSSL set a turn time goal of 10-15 days. In some cases, HSSL loans moved even faster. One current Bank of America employee has commented that during the period of the HSSL, employees could take an application in the morning and fund the loan in the evening.

5. In furtherance of its high speed goal, Countrywide’s new origination model removed the processes responsible for safeguarding loan quality and preventing fraud. For instance, Countrywide eliminated underwriter review even from higher risk loans such as stated income loans and “dirty prime” loans (those loans with characteristics between prime and subprime). In lieu of underwriter review, Countrywide assigned critical underwriting tasks to
loan processors who were previously considered unqualified even to answer borrower questions. At the same time, Countrywide eliminated previously mandatory checklists (or “job aids”) that provided instructions on how to perform these underwriting tasks. Under the HSSL, such instructions on proper underwriting were considered nothing more than unnecessary forms that would slow the swim lane down.

6. Countrywide also eliminated the position of compliance specialist, an individual previously responsible for conducting a final, independent check on a loan to ensure that all conditions on the loan’s approval were satisfied prior to funding. Finally, to further ensure that loans would proceed as quickly as possible to closing, Countrywide revamped the compensation structure of those involved in loan origination, basing performance bonuses solely on volume. Whereas loan processors and others previously received bonuses based on a combination of the quality and volume of loans they processed, the HSSL added a new bonus for reducing turn time on loans and simultaneously removed any quality factor in compensation, making clear that employees should prioritize production.

7. Although Countrywide management, including Mairone, was informed that the HSSL posed a threat to loan quality at a time when the market would not tolerate high defect rates, and Andrew Gissinger, executive managing director of Countrywide Home Loans, stressed in August of 2007 that “new market realities” required “rigorous underwriting discipline,” the HSSL began that very month and continued through 2009, well after Bank of America’s acquisition of Countrywide in July 2008. The HSSL was never disclosed to the GSEs, although the vast majority of its resulting loans were funneled to the GSEs with the knowing misrepresentation that they were investment-quality loans that complied with GSE requirements. Indeed, in late 2007
and early 2008, after it had fully implemented the HSSL, Countrywide represented to the GSEs and in public filings that it had strengthened its underwriting guidelines and scaled back on riskier loan products.

8. Countrywide also concealed the quality control reports on HSSL loans demonstrating that instances of fraud and other material defects (i.e., defects making the loans ineligible for investor sale) were legion. By the first quarter of 2008, Countrywide’s own quality control reports identified material defect rates of nearly 40% in certain months, rates that were nearly ten times the industry standard defect rate of approximately 4%. In response to these reports, FSL employees commented that they had “the crystal ball” predicting the fallout from the HSSL months earlier, and that those predictions were “holding true as current quality undermines FSL.” But Countrywide failed to report its spike in defect rates to the GSEs or abandon the HSSL even after it was clear that the loans were of a disastrous quality.

9. After the HSSL loans defaulted and the GSEs reviewed them for compliance with their guidelines, Countrywide and Bank of America compounded the harm to the GSEs by refusing for years to repurchase HSSL loans or reimburse the GSEs for losses already incurred, even where the loans admittedly contained material defects or even fraudulent misrepresentations. Although on January 7, 2013, after this action was filed, Bank of America announced that it agreed to pay Fannie Mae billions of dollars to resolve outstanding repurchase requests stemming from loans originated between 2001 and 2008, its settlement cannot repair the damage to the GSEs, the federally-insured institutions that failed as a result of the GSEs’ conservatorship, or the federal government from Defendants’ fraudulent origination and sale of defective loans. Nor does this settlement affect Defendants’ liability to the United States for their fraudulent conduct.
10. The United States seeks the maximum amount of damages and the maximum amount of civil penalties allowed by law. Specifically, the United States seeks treble damages under the False Claims Act and civil penalties under FIRREA for the thousands of HSSL loans sold to the GSEs, including any losses or gains resulting from the fraud.

**JURISDICTION AND VENUE**


12. Venue is proper in this judicial district pursuant to 31 U.S.C. § 3732(a) and 28 U.S.C. §§ 1391(b)(1) and (c) because the Defendants transact business in this judicial district. In addition, HSSL loans included thousands of mortgages on New York properties.

**PARTIES AND RELEVANT ENTITIES**

13. Plaintiff is the United States of America.

14. Relator Edward J. O’Donnell is a resident of the Commonwealth of Pennsylvania. From 2003 to 2009, Relator was employed by Countrywide Home Loans and Countrywide Bank, first as a Senior Vice President, and later as an Executive Vice President.

15. Defendant Countrywide Financial is a Delaware corporation with its principal place of business in Calabasas, California. Countrywide Financial, itself or through its subsidiaries Countrywide Home Loans and Countrywide Bank, was engaged in mortgage lending. On July 1, 2008, Countrywide merged with Bank of America and is now a wholly-owned subsidiary of Bank of America. Countrywide Financial’s remaining operations and employees were transferred to Bank of America, and Bank of America ceased using the Countrywide name in April 2009.
16. Defendant Countrywide Home Loans, a wholly-owned subsidiary of Countrywide Financial, is a New York corporation with its principal place of business in Calabasas, California. Countrywide Home Loans originates and services residential home mortgage loans by itself or through its subsidiaries. Pursuant to the merger on July 1, 2008, Countrywide Home Loans was acquired by Bank of America and now operates under the trade name “Bank of America Home Loans.”

17. Defendant Countrywide Bank, a wholly-owned subsidiary of Countrywide Financial, is a federally-insured financial institution with its headquarters in Colorado. In 2006 and 2007, Countrywide Home Loans transitioned its mortgage loan production business into Countrywide Bank. As Countrywide Financial stated in its Form 10-K for 2007, by the end of 2007, nearly all mortgage loan production occurred in Countrywide Bank rather than Countrywide Home Loans. Pursuant to the merger on July 1, 2008, Countrywide Bank later merged into and with BANA, with BANA as the surviving entity, effective on or about April 27, 2009.

18. Defendant Bank of America Corporation is a Delaware corporation with its principal place of business in Charlotte, North Carolina and offices and branches in New York, New York. Countrywide Financial merged with Bank of America Corporation on July 1, 2008. As explained more fully below, Bank of America Corporation is a successor-in-interest to Countrywide and has thus assumed liability for the conduct of Countrywide alleged herein.

19. Defendant BANA is a federally-insured financial institution and Bank of America’s principal banking subsidiary. BANA has substantial business operations and offices in New York, New York. As explained more fully below, BANA participated in Bank of America’s acquisition of substantially all of Countrywide Financial through a series of
transactions that commenced on July 1, 2008. Together with Bank of America Corporation, it is a successor-in-interest to Countrywide.

20. Defendant Rebecca Mairone was the COO of FSL during 2007 and 2008, and, following the acquisition, was employed by BANA. Mairone is currently a Managing Director at a banking corporation located in New York, New York.

BACKGROUND

A. The Conservatorships of Fannie Mae and Freddie Mac

21. Fannie Mae and Freddie Mac are GSEs chartered by Congress with a mission to provide liquidity, stability, and affordability to the United States housing and mortgage markets. Fannie Mae is located at 3900 Wisconsin Avenue, NW in Washington, D.C. Freddie Mac is located at 8200 Jones Branch Drive in McLean, Virginia.

22. As part of their mission, Fannie Mae and Freddie Mac purchase single-family residential mortgages from mortgage companies and other financial institutions, providing revenue that allows the mortgage companies to fund additional loans. The GSEs then either hold the loans in their investment portfolios or bundle them into mortgage-backed securities (“MBS”) that they sell to investors.

23. The GSEs earn revenue in their single-family business line primarily from “guarantee fees,” i.e., fees received as compensation for guaranteeing the timely payment of principal and interest on mortgage loans pooled into MBS. In general, the GSEs are profitable so long as their income from investments and guarantee fees exceeds the principal and interest that they must pay out on any defaulted loans that they guarantee.
24. Prior to late 2007, GSE preferred stock was widely regarded to be a safe investment. In fact, federal regulators permitted banks to invest up to 100 percent of their investment capital in GSE preferred securities. In the second half of 2007 and the first half of 2008, however, as default rates on defective loans climbed, Fannie Mae lost $9.5 billion and Freddie Mac lost $4.7 billion. Accordingly, Fannie Mae’s Form 10-K for 2007 reported a “material increase in mortgage delinquencies and foreclosures. . .” and expected “increased delinquencies and credit losses in 2008 as compared with 2007.”


26. On September 6, 2008, pursuant to HERA and in response to the insolvency of the GSEs due to mortgage defaults and delinquencies, the Director of FHFA placed Fannie Mae and Freddie Mac into conservatorships and appointed FHFA as conservator. In that capacity, FHFA has the authority to exercise all rights and remedies of the GSEs. 12 U.S.C. § 4617(b)(2).

27. Simultaneous with the placement of Fannie Mae and Freddie Mac into conservatorships, the United States Department of Treasury (“Treasury”) exercised its authority under HERA “to purchase any obligations and other securities” issued by the GSEs and began to purchase preferred stock pursuant to the Senior Preferred Stock Purchase Agreements (“PSPAs”).

28. On September 7, 2008, following the conservatorship of Fannie Mae and Freddie Mac and Treasury’s purchase of GSE preferred stock, the value of the GSEs’ stock was eliminated.
As a result, certain community banks that had concentrated investments in GSE preferred stock failed entirely, and others suffered significant losses. The failure of these community banks has led to billions of dollars in losses to the Deposit Insurance Fund.

29. Since the conservatorship, Treasury has made quarterly capital contributions to each of the GSEs. As of December 31, 2012, Treasury has provided more than $187 billion in support to the GSEs. These federal funds have been used primarily to cover losses from single-family mortgages purchased and guaranteed by the GSEs between 2004 and 2008, but have also been used to purchase mortgages sold in 2009 from lenders including Defendants, and to reimburse losses incurred by the GSEs as a result of their guaranteeing those mortgages. Since 2008, the GSEs have suffered net losses of $208 billion in their single-family mortgage business.

B. Civil Statutes to Combat Mortgage Fraud

30. The False Claims Act provides liability for any person (i) who “knowingly presents, or causes to be presented, a false or fraudulent claim for payment or approval;” or (ii) who “knowingly makes, uses, or causes to be made or used, a false record or statement material to a false or fraudulent claim.” 31 U.S.C. § 3729(a)(1)(A)–(B).

31. The False Claims Act further provides that for persons who violate the Act: “[such person] is liable to the United States Government for a civil penalty of not less than [$5,500] and not more than [$11,000] . . . , plus 3 times the amount of damages which the Government sustains because of the act of that person . . .” 31 U.S.C. § 3729(a).

32. The Fraud Enforcement and Recovery Act of 2009 (“FERA”) amended the False Claims Act to define “claim” to include: “any request or demand, whether under a contract or otherwise, for money or property . . . made to a contractor, grantee, or other recipient, if the money
or property is to be spent or used . . . to advance a Government program or interest, and if the
United States Government (i) provides or has provided any portion of the money or property
requested or demanded; or (ii) will reimburse such contractor, grantee, or other recipient for any
portion of the money or property which is requested or demanded . . .” 31 U.S.C. § 3729(b)(2).

33. Congress enacted FIRREA in 1989 to reform the federal banking system. Toward that end, FIRREA authorizes civil enforcement of enumerated criminal predicate offenses—as established by a preponderance of the evidence—that involve financial institutions and certain government agencies. See 12 U.S.C. § 1833a(e).

34. As relevant to this action, FIRREA authorizes the United States to recover civil penalties for violations of, or conspiracies to violate, two provisions of Title 18 of the United States Code that “affect” federally insured financial institutions:

- **18 U.S.C. § 1341 (Mail Fraud Affecting a Financial Institution),** which proscribes the use of “the Postal Service, or . . . private or commercial interstate carrier” for the purpose of executing, or attempting to execute, “[a] scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises . . .”; and

- **18 U.S.C. § 1343 (Wire Fraud Affecting a Financial Institution),** which proscribes the use of “wire . . . in interstate or foreign commerce” for the purpose of executing, or attempting to execute, “[a] scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises . . .”

35. FIRREA provides that the United States may recover civil penalties of up to $1 million per violation, or, for a continuing violation, up to $5 million or $1 million per day, whichever is less. The statute further provides that the United States can recover the amount of
any gain to the person committing the violation, or the amount of the loss to a person other than the violator stemming from such conduct, up to the amount of the gain or loss.

C. The GSEs’ Single Family Mortgage Guarantee Business

36. In purchasing loans for their single family business, GSEs operate on a “rep and warrant model,” relying on lenders’ representations and warranties that their loans comply in all respects with the standards outlined in the GSE selling guides and lender sales contracts, which set forth underwriting, documentation, quality control, and self-reporting requirements. Specifically, loans sold to Fannie Mae must comply with its Single Family Selling Guide (the “Selling Guide”) and purchase contracts. Loans sold to Freddie Mac must comply with its Single-Family Seller/Servicer Guide (the “Freddie Guide”) and purchase contracts.

37. The purchase contracts between a GSE and a lender include both a long-term master agreement that supplements the relevant selling guide and short-term contracts that grant variances or waivers from the selling guide requirements to permit a lender to sell a specific loan product. The GSEs typically renegotiate such variances on an annual basis based on the performance of the applicable loan product and other factors, and may decide to adjust the pricing on the affected loans for the following year or eliminate the variance altogether.

38. The rep and warrant model operates on the assumption that the sellers of the loans—usually also the originators of the loans—are in a superior position of knowledge about the quality of those loans. Lenders assume certain obligations in accordance with their superior position of knowledge, such as the duty to perform prudent underwriting and quality assurance checks as required by the guidelines, and to self-report loans they identify as fraudulent, noncompliant with GSE guidelines, or otherwise materially defective. The GSEs also delegate
the underwriting of the loans they purchase to the lenders. Although the GSEs reserve the right to sample a portion of loans they purchase to ensure compliance with their guidelines, they generally conduct full file reviews only if a loan goes into default.

39. As set forth in the Mortgage Selling and Servicing Contract (the “Master Contract”) between Countrywide Home Loans and Fannie Mae, the “specific warranties made by the Lender” are (among other things) that “[t]he mortgage conforms to all the applicable requirements in [the] Guides and this Contract” and that “[t]he lender knows of nothing involving the mortgage, the property, the mortgagor or the mortgagor’s credit standing that can reasonably be expected to: [i] cause private institutional investors to regard the mortgage as an unacceptable investment; [ii] cause the mortgage to become delinquent; or [iii] adversely affect the mortgage’s value or marketability.” These representations were first made in a contract executed by Lee Bartlett of Countrywide and Norman Peterson of Fannie Mae in November of 1982 and were reaffirmed through addenda and new contracts executed in 2006, 2007, and 2008, by Kevin Bartlett and Gregory Togneri of Countrywide, and in 2009 by Robert Gaither of BANA (as successor to Countrywide Bank).

40. As set forth in the relevant agreements, Countrywide’s and Bank of America’s representations “appl[ied] to each mortgage sold to [Fannie Mae] . . . in its entirety,” were “made as of the date transfer is made,” and “continue after the purchase of the mortgage.”

41. In representing to Fannie Mae that the loan sold to the GSEs is an acceptable investment, Countrywide (and later Bank of America) further warranted that: (i) all required loan data is true, correct, and complete; (ii) automated underwriting conditions are met for loans processed through an automated underwriting system; and (iii) no fraud or material
misrepresentation has been committed by any party, including the borrower. These requirements were set forth in the 2006, 2007, 2008, and 2009 versions of the Selling Guide, and remain in effect today.

42. Countrywide (and later Bank of America) further warranted that its quality control department takes certain post-closing measures intended to detect problems with loan manufacturing quality, including: (i) reviewing data integrity within automated underwriting systems; (ii) re-verifying underwriting decisions and documents; (iii) re-verifying fieldwork documents (including as to appraisal and title); (iv) reviewing closing and legal documents; and (v) conducting regular reviews of internal controls relating to loan manufacturing quality and fraud prevention. These requirements were set forth in the versions of the Selling Guide operative in 2006, 2007, 2008, and 2009.

43. Similarly, the Freddie Guide provides that “[a]s of the Delivery Date, the Funding Date and the date of any substitution of Mortgages pursuant to the Purchase Documents, the Seller warrants and represents the following for each Mortgage purchased by Freddie Mac: (1) The terms, conditions, and requirements stated in the Purchase Documents [defined to include the guidelines and contracts] have been fully satisfied; (2) All warranties and representations of the Seller are true and correct; (3) The Seller is in compliance with its agreements contained in the Purchase Documents; [and] (4) The Seller has not misstated or omitted any material fact about the Mortgage.” These representations were set forth in the versions of the Freddie Guide operative in 2006, 2007, 2008, and 2009.

44. The Master Agreement between Freddie Mac and Countrywide Home Loans operative in 2006, 2007, and 2008, and signed by Kevin Bartlett and Greg Togneri of
Countrywide, provides that the “Seller must comply with all requirements of the *Freddie Mac Single-Family Seller/Servicer Guide* and the other Purchase Documents, as modified and supplemented by the terms of this Master Commitment.” The 2009 Master Agreement, which contains the same language, was entered into by Freddie Mac, Countrywide Home Loans, Countrywide Bank, and BANA (as successor to Countrywide Bank) and was signed by Gregory Togneri of Countrywide and Robert Gaither of BANA.

45. Countrywide’s (and later Bank of America’s) representations that they were underwriting and delivering investment-quality mortgages according to the GSEs’ selling guides and contractual requirements were material to the GSEs’ decisions to purchase mortgage loans.

46. The GSE guidelines are consistent with Countrywide’s own underwriting guidelines, which are set forth in two main documents: the Loan Program Guides (“LPGs”) and the Countrywide Technical Manual (“CTM”). The LPGs set limits on loan characteristics, such as loan-to-value ratios (“LTVs”), loan amounts, and reserve requirements for specific loan types. The CTM contains processes and instructions for originating loans, such as how to calculate LTVs.

47. The CTM states that Countrywide’s basic policy is to “originate and purchase investment quality loans,” with such a loan defined as “one that is made to a borrower from whom timely payment of the debt can be expected, is adequately secured by real property, and is originated in accordance with Countrywide’s Technical Manual and Loan Program Guides.”

48. When a GSE identifies a material breach of a warranty, usually during a post-default quality review of a loan, it may demand that the lender repurchase the loan and/or reimburse the GSE for any loss incurred.
C. The Loan Origination Process Within Countrywide’s FSL Division in 2007

49. Within FSL as of early 2007, the loan origination process required the involvement of four individuals: the loan specialist (also called a loan processor), the underwriter, the loan funder, and the compliance specialist.

50. The loan specialist within FSL was primarily a data entry clerk who entered borrower information into Countrywide’s automated mortgage underwriting system (called “CLUES”). Based on data entered from a borrower’s application, credit report, and appraisal, CLUES evaluated a loan’s default risk and whether a loan could be approved in compliance with Countrywide’s guidelines. CLUES then generated a report with either an “Accept” for a loan, indicating that the loan had an acceptable level of risk, or a “Refer,” indicating that the loan should be referred to a human being for manual underwriting because of a borrower’s credit score or other risk attributes on the loan.

51. A CLUES report on a particular loan also listed underwriting conditions that were required to be satisfied before a loan could be closed. For example, a CLUES report might condition its “Accept” on obtaining documentation showing that certain of the borrower’s debts had been paid off, documentation of the borrower’s employment and assets, or review of certain assumptions supporting an appraisal.

52. After obtaining a CLUES result, the loan processor forwarded the loan file to an underwriter for review, either for a full manual underwriting (in the event of a CLUES Refer), or for a review of the CLUES conditions (in the event of a CLUES Accept). The loan specialist was not permitted to answer any substantive borrower questions about a loan, and did not have authority to perform any underwriting tasks.
53. The underwriter determined the likelihood that the borrower could repay the mortgage loan, by: (i) verifying that loan documentation was true, complete, and accurate by comparing the underlying loan documentation with data entered into CLUES; (ii) evaluating documentation concerning the borrower’s income, assets, employment, and credit history; (iii) evaluating the appraisal; (iv) analyzing relevant GSE requirements; and (v) reviewing and clearing any conditions listed on a CLUES report until the loan was “cleared to close.”

54. The underwriter also served a valuable fraud detection role. Specifically, the underwriter could detect whether a loan specialist entered fraudulent data into CLUES by comparing the loan documentation with the data entered by the loan specialist. The underwriter was also key to detecting fraud in stated income loans—those in which a borrower is not required to provide documentation supporting his or her income. Where a borrower provides no supporting documentation of income, the determination as to whether the borrower’s stated income is reasonable in view of her employment and other factors is best made by a qualified, experienced underwriter.

55. The loan funder prepared the loan package for closing, coordinated the return of closing documents for review prior to funding, ensured that any unresolved funding conditions were satisfactorily met, and wired funds to title companies or closing agents.

56. The compliance specialist acted as a final “toll gate” prior to funding, by conducting a review of the loan file to: (i) ensure that any conditions imposed by CLUES were properly satisfied; (ii) verify borrower identification and execution of loan documents; (iii) confirm the availability of funds to be paid to the borrower or third parties; and (iv) ensure compliance with relevant state lending requirements.
57. As of early 2007, each of the four individuals involved in the loan origination process received a bonus based both on the quality and on the volume of loans processed.

D. The Shift in Focus to Prime, Conventional Lending in 2007

58. In the spring of 2007, the secondary market for subprime loans collapsed and several subprime lenders announced significant losses, declared bankruptcy, or put themselves up for sale. With the collapse of the subprime market, lenders sought to originate loans that they could then sell to the GSEs.

59. As Countrywide stated in its Form 10-K for 2007, “secondary mortgage market demand for non agency-eligible loans (nonconforming Prime Mortgage Loans, Prime Home Equity Loans and Nonprime Mortgage Loans) was substantially curtailed.” Countrywide further stated that in response to changes in the secondary market, “we have tightened our underwriting and loan program guidelines, including reductions in the availability of reduced documentation loans. . .” Elsewhere in its Form 10-K, Countrywide stated that, as a “result of the changes to our underwriting and program guidelines, the vast majority of loans we now originate are eligible for sale directly to Fannie Mae, Freddie Mac or Ginnie Mae. . .” In addition to its public statements, employees in Countrywide’s secondary marketing unit represented to individuals in the credit risk management groups at both Fannie Mae and Freddie Mac in the fourth quarter of 2007 that it had implemented tighter underwriting guidelines.

60. Consistent with Countrywide’s shift to the prime, conventional lending market—effectively the only secondary market that remained—FSL transitioned from a subprime origination division to one that originated loans for sale to the GSEs. By early 2008 FSL’s
transition was complete, as FSL’s production by the first quarter of 2008 consisted of more than 90% conventional loans and other GSE-approved products.

61. The GSEs, for their part, began to observe escalating default rates in previously-purchased loans and responded by tightening their requirements and curtailing the purchase of riskier loans. The GSEs also communicated these tightened requirements to lenders. For example, Fannie Mae’s 2007 10-K Investor Summary lists several “Management Actions on Credit,” with the top action being “Tightening underwriting standards/reduced participation in riskier segments.”

62. In an attempt to mitigate its anticipated losses, Fannie Mae also stated that it was “[s]trengthening contractual protections” with lenders, placing “[n]ew limits on business with some counterparties,” and “[i]ncreas[ing] depth and frequency of monitoring” of the quality of sellers’ loans. As one former Fannie Mae executive explained the changing expectations in mid-2007, Fannie Mae was nearly the only significant purchaser left in the secondary market and was working hard to provide liquidity to the market, so it demanded that lenders pay closer attention to loan quality.

63. Countrywide was by far the largest seller of single-family loans to Fannie Mae in 2007, accounting for approximately 28% of Fannie Mae’s single-family loan purchases. At the same time, Countrywide’s loans performed far more poorly than those originated by other major lenders. Countrywide-originated loans sold to Fannie Mae in 2007 had a serious delinquency rate (loans that are three months past due or in foreclosure) of more than 21 percent, which was two to three times the rate of other major sellers during that time period.
64. In light of Countrywide’s financial distress in mid-2007, Fannie Mae disclosed its relationship with Countrywide as a material risk to its financial condition in its Form 10-K for 2007. Fannie Mae knew that if Countrywide had failed to repurchase defective loans or defaulted on other significant obligations, it could expose Fannie Mae to significant losses given the volume of Countrywide loans Fannie Mae held and the high serious delinquency rate on those loans. Fannie Mae therefore also initiated a thorough review of the Countrywide portfolio, and directed its employees to “reduce[] the existing level of risk by pulling back on products and variances.” Similarly, as loan default rates continued to climb, Freddie Mac re-priced, then eliminated, approximately half of Countrywide’s riskier loan products in 2007 and 2008.

65. Countrywide was well aware of the tightened underwriting requirements in the secondary market. On August 7, 2007, Andrew Gissinger, executive managing director of Countrywide Home Loans, sent a memo to all employees (the “Gissinger Memo”) stating that “[w]e must ensure that our guidelines are fully in sync with the secondary markets, and therefore we will be continuing to announce guideline changes when we need to align ourselves to the overall market. Our success in the environment is absolutely contingent on our ability to employ rigorous underwriting discipline. We need to adapt our business to new market realities which requires ongoing manufacturing quality enhancement and further operating controls.” One FSL risk manager similarly acknowledged in September of 2009 that “mfg quality is intense focus right now since FNMA delivery products is the only liquidity game in town.”

66. At the same time, however, to alleviate its financial distress, Countrywide sought to quickly boost sales volume and revenue. To achieve this aim, FSL implemented a new
“streamlined” origination model designed to reduce “turn time,” *i.e.*, the amount of time spent underwriting and processing loans.

67. Countrywide did not disclose its new loan origination model to the GSEs.

**COUNTRYWIDE’S SCHEME TO DEFRAUD THE GSEs**

A. **The Hustle Eliminated Quality Control Processes**

68. After a pilot test in late 2006 and early 2007, FSL implemented its new model for loan origination—the “Hustle”—in August of 2007. The Hustle (or HSSL) was the term for FSL’s new “High Speed Swim Lane” model for loan origination. According to an internal FSL presentation on the HSSL, the new model was to have “broad scope and impact, and an aggressive timeline,” with a “rate and magnitude of change [that was] drastic, and beyond most people’s comfort range.” FSL internal presentations also state that the new model would “[f]ocus on FNMA/FHLMC [Fannie/Freddie] loans.”

69. FSL executives, and in particular Mairone, rolled out the HSSL and visited the selected processing centers (called “fulfillment centers”) that were to implement the HSSL in order to promote it. Operating under the motto, “Loans Move Forward, Never Backward,” the HSSL aimed to significantly reduce the amount of turn time on loans. Whereas FSL’s average turn time on a loan prior to the HSSL was 45-60 days, the HSSL aimed to have loans processed in less than half that time. At fulfillment centers in Chandler, Arizona; Richardson, Texas; Rosemead, California; Hatboro, Pennsylvania, and Plano, Texas, the HSSL had a stated turn time goal of 10-15 days. At the largest HSSL center in Richardson, Texas, many loans were processed much more quickly. As a Bank of America employee has commented, FSL employees could receive an application in the morning and fund it in the evening.
70. The HSSL streamlined the loan origination process by removing so-called unnecessary “toll gates” or handoffs, which included processes necessary for originating investment-quality loans and for preventing fraud. First, the HSSL effectively eliminated underwriters from the loan origination process. Under the Hustle, if a loan processed through CLUES generated an “Accept” rating, regardless of the conditions imposed by CLUES, the loan processor could act as the “owner” of the loan from application until “cleared to close.” The loan processor was thus never required to hand off the loan to any underwriter before the loan closed and funded.

71. The HSSL’s removal of underwriters and other “toll gates” extended to a variety of loan products, including such high risk loans as stated income loans. During a pilot test of the Hustle in 2006, FSL initially regarded stated income loans as too risky to be included in an underwriter-free loan origination process. As internal Countrywide loan performance reviews indicate, stated income loans defaulted earlier and more frequently than loan products requiring full documentation of the borrower’s income. For this reason, Countrywide had imposed lower loan amount limits and other restrictions on stated income loans.

72. The GSEs also expected that only experienced underwriters would be entrusted with review of stated income loans. Without documentation of a borrower’s income, an underwriter must apply seasoned judgment in determining whether the borrower’s stated income is reasonable in light of the borrower’s occupation, experience, and other factors. Freddie Mac guidance on preventing stated income fraud thus provides that “[s]tated income loans can be problematic if it is later determined that the stated income was misstated and that the originator knew or should have known about it earlier in the process . . .” and that to prevent such fraud,
lenders should “[e]nsure the most seasoned underwriters on your team underwrite stated income loans.”

73. In 2007, however, stated income products represented nearly 40% of FSL’s overall volume. Consequently, FSL could not achieve its desired production boost unless stated income loans were included in the high speed swim lane. As stated in an email dated August 1, 2007 from an FSL Executive Vice President, “low/no doc deals [albeit risky] are the fastest thru the swim lane, so I really don’t want to cut them out . . .” (brackets in original). FSL therefore included stated income loans in the HSSL rollout in 2007.

74. Although the HSSL was initially promoted as a new origination model only for “prime” loans, this limitation, too, was quickly disregarded in the attempt to process as many loans as possible at high speed. In July 2007 FSL was already pitching a new project name: the “Dirty Prime High-Speed Swim Lane,” whose aim it was to create a similarly high-speed swim lane for “Dirty Prime” loans, those loans that fell between prime and subprime thresholds. Ultimately, however, Mairone decided to add these other loans to the original HSSL.

75. In September of 2007, Mairone emailed that “[w]e need to start to move toward all loans into [the HSSL] process.” As a result, the same month, even Expanded Approval loan products, Fannie Mae’s version of a subprime product, were included in the HSSL. As one Senior Vice President explained in an email, “there will be no ‘exits’ per se from HSSL as a swimlane . . . the original plan was to create separate lanes/teams for different ‘tiers’ of risk (i.e., Prime “dirty” Prime, non-Prime). Now we need to do the same thing, but within a single lane.” The Senior Vice President added that “[a]s of Sept. 12th the HSSL teams will get all loans, regardless of criteria! So nothing will be excluded, including EA [Expanded Approval].” When the “no
exclusions” rule was confirmed, another Senior Vice President responded to a colleague in risk management, “YIKES . . . major risk issues.”

76. With underwriters eliminated from most loan reviews, loan specialists assumed responsibility for a variety of critical underwriting tasks. Although previously regarded as unqualified even to answer borrower questions, loan specialists were suddenly granted underwriting authority, and entrusted with such tasks as assessing the reasonableness of a borrower’s stated income and evaluating the adequacy of an appraisal. At the same time, loan specialists did not report to underwriting and credit risk managers. The HSSL centers in fact maintained no on-site underwriting manager and the loan specialists reported to operations managers and, ultimately, to Mairone.

77. Even while the HSSL gave loan specialists authority previously available only to underwriters, it provided them with less guidance in performing critical underwriting tasks. Prior to the HSSL, FSL required its underwriters to complete certain worksheets—referred to as “job aids”—that served as checklists or how-to forms on performing critical underwriting tasks.

78. Countrywide executives, including Mairone, having determined that these job aids were merely additional, unnecessary toll gates, eliminated them along with the underwriters. Among the job aids deemed unnecessary were worksheets on how to assess the reasonableness of stated income and how to review an appraisal.

79. The HSSL also eliminated the final toll gate in loan origination—the compliance specialist—who had independently checked to ensure that any conditions on the loan were cleared prior to closing and funding the loan. As a result, loans receiving a CLUES “Accept” were handled entirely by loan specialists and funders.
Finally, to further incentivize loan specialists and funders to reduce the time spent processing the loans, FSL changed the compensation structure for both loan specialists and funders. In August of 2007, FSL implemented a “turn time” bonus for loan specialists and others for steadily reducing the turn time on their loans. The loan processors also had quotas of 30 funded loans per month and a minimum of one loan “cleared to close” every day. In a fulfillment center in Richardson, Texas, loan processors were instructed that they were not permitted to leave at night until they cleared at least one loan for closing.

After loan specialists expressed concerns at an FSL town hall meeting in September of 2007 that making underwriting decisions would lead to higher defect rates, and thus negatively impact their compensation, FSL addressed their concerns by eliminating any quality component to loan processors’ compensation. Consistent with this decision, an internal FSL presentation on the HSSL stated that FSL “need[ed] to address cultural issues” with loan specialists, by encouraging them to “[g]et comfortable with exercising authority,” “[g]et comfortable with skipping process steps,” and suspending the “QOG” (quality of grade) findings on the loan specialists’ funded loans that impacted their compensation. Previously, loan specialists and funders whose loan files were revealed to have material defects making their loans ineligible for sale received a reduction in their bonus compensation. Under the HSSL, however, these employees earned bonus compensation based purely on loan volume and had no incentive to safeguard loan quality by preventing defects.

Countrywide knew that the HSSL ran counter to both the GSEs’ requirements, which mandated heightened scrutiny of loan quality, and its own professed commitment to tightened underwriting standards in mid-2007. It also knew that originating loans through such a
model, *i.e.*, without quality and underwriting safeguards, made the resulting loans an unacceptable investment in the now conservative secondary market.

**B. Countrywide Ignored Warnings Raised about the HSSL**

83. As explained below, numerous employees within FSL repeatedly warned FSL executives and senior managers, including Mairone, that the HSSL would generate—and did generate—excessive quantities of fraudulent or otherwise seriously defective loans that were ineligible for sale to the GSEs. In particular, employees warned that the Hustle presented a disastrous layering of risk by: (i) eliminating the toll gates (*e.g.*, underwriters, job aids, and compliance specialists) responsible for loan quality and fraud prevention; (ii) expanding the authority of loan specialists and funders, and (iii) compensating loan specialists and funders solely based on volume. Countrywide management, including Mairone, brushed aside these warnings again and again. Mairone, in particular, responded to such concerns by telling employees that they needed to “get with the program” and reduced the responsibility of those who persisted in criticizing the HSSL.

84. For example, in August of 2007, Michael Thomas, a First Vice President of FSL, forwarded the Gissinger Memo to colleagues and commented that “[t]his note from Drew outlines the reasons that I’m concerned about some parts of the HSSL process . . . Guidelines are contracting and product offerings are disappearing . . . We are hearing the clear directive that we should improve manufacturing quality, not that we are over-manufacturing. This particular statement is in direct conflict with the current HSSL design.”

85. Two months later, an SVP in risk management cautioned that “HSSL must produce compliant and quality/saleable loans to FNMA as there is no tolerance for errors” and “with the
tightening of guidelines/exceptions, buy back pressure will come from poor/sloppy manufacturing.”

86. Notwithstanding the warnings that loan quality could not be compromised, initial quality reports on the HSSL made clear that defects were rampant. On October 8, 2007, FSL’s quality assurance and control group presented its initial findings to the Hustle design team on a sample of loans funded in a three-week period, between August 13, 2007, and September 7, 2007. The quality review sought to identify defects in loans at the pre-funding stage, specifically in loans that had been “cleared-to-close” by loan processors. Of the 42 loans in the sample, 41% were found to have defects creating a high risk, i.e., one that affects the borrower’s ability to repay the loan. The report further noted that loan specialists “were grandfathered in with . . . condition sign off authority without training or HSSL certification requirements. As a result our quality was challenged.”

87. The purpose of doing pre-funding quality reviews is to identify and correct defects in the loans before they close and fund. During the HSSL, FSL had numerous underwriters with little work and who could therefore have assisted with pre-funding quality reviews. Mairone, however, instructed that such pre-funding checks be conducted only on a parallel track with the loan processing, so that they would not “slow[] the swim lane down.” Further, the results of the pre-funding quality reports were ignored and resulted in no changes to the HSSL design.

88. In the ensuing months, the quality reports on the HSSL loans foretold a systemic problem with loan quality. In January of 2008, when the HSSL represented a significant percentage of FSL’s total loan volume, pre-funding reports revealed material defect rates of 57% overall and nearly 70% for stated income loans. In other words, FSL’s own reports showed that
more than half of the loans that were “cleared to close” and slated for sale to the GSEs were ineligible for sale to any investor. The most frequently-cited defects appeared where job aids had been removed, including in the areas of stated income reasonableness and appraisal acceptability. Again, rather than alter or abandon the HSSL model, Mairone instructed those who prepared the reports not to circulate them outside of FSL.

89. In March of 2008, underwriting managers in Richardson, Texas asked for a meeting with Mairone to address their concerns with deteriorating loan quality as a result of the HSSL. The meeting took place the day after Countrywide CEO Angelo Mozilo testified before Congress concerning the mortgage crisis, stating that the company’s “core commitment [wa]s to put people in homes and to keep them there” and that “[i]t just never serves our company to make a bad loan.” Frustrated with the HSSL’s continued emphasis on volume at the expense of quality, one of the underwriting managers asked Mairone how the HSSL fit with Mozilo’s statements just the day before that the company was committed to making only good loans. Mairone responded angrily, in sum or substance, “Son of a bitch. You need to get with the program. We need to keep funding these loans to keep the lights on.”

C. Defendants Concealed the Escalating Rates of Defects and Fraud under the HSSL

90. As warnings about the HSSL went unheeded, Defendants knowingly churned out loans with escalating incidents of fraud and other serious material defects and sold them to the GSEs.

1. Fraudulent Manipulation of Data

91. As Countrywide’s Technical Manual states, a CLUES outcome is “only as good as the data entered into the system.” See CTM 0.3.1 Introduction—Automated Underwriting
Systems, Underwriting with CLUES and CLUES Documentation Levels. CLUES “Accepts” are thus “only valid if the data used to generate the recommendation matches the true and accurate data in the file.” Id. 0.2.1 Introduction—Countrywide’s Underwriting Philosophy.

92. With loan processors and funders encouraged to focus only on the volume of loans they processed, falsification of CLUES data proceeded unchecked. Loan processors were incentivized to, and repeatedly did, manipulate borrower information (e.g., by entering a higher income for the borrower) until they received an “Accept” and the loan could enter the high speed swim lane. Also, no underwriter reviewed the loan to compare the CLUES data with the underlying loan documentation to detect fraudulent manipulation. Even in post-closing audits where fraudulent manipulation of data was found, such a finding was typically recorded as another material defect finding that had no effect on the loan processor’s compensation. As a result, the number of CLUES reports per loan (i.e., reports generated by processing a loan through CLUES that show the result and any conditions attached to the result) escalated dramatically under the HSSL.

93. A few CLUES reports per loan would not be atypical or suspicious because a loan processor was required to enter correct and accurate data into CLUES at all times, requiring updates (and hence additional CLUES reports) if there were changes to the borrower’s information prior to closing. A loan with more than a few CLUES reports, however, indicates that a processor or underwriter is simply altering data to obtain an “Accept” and therefore engaging in fraud.

94. Under the HSSL, and specifically between May 2007 and November 2008 (after the acquisition of Countrywide by Bank of America in July 2008), the average number of CLUES
reports per FSL loan climbed from 8—already a suspiciously high number—to 14. In 2007 alone, nearly 60% of FSL loans sold to Fannie Mae that later defaulted had 10 or more CLUES queries.

95. Countrywide management only intensified the push to obtain a CLUES “Accept” result. As an August 22, 2007 email to FSL management explained in discussing Countrywide’s “Fast & Easy” loan product (a reduced documentation loan), “[t]here is major CHL corporate scrutiny on ensuring prime F&E’s fund as Accept due to market liquidity and ensuring loan is salable to GSE-FNMA . . . all we simply have to do is … fix data pre-fund[ing], re-run CLUES and then [] not run CLUES again so we can fund as CLUES Accept. Please remember the F&E product is key to HSSL . . . but MUST be CLUES Accept AT FUNDING!”

96. As one former FSL Senior Vice President has explained, although manipulation of CLUES data was always a risk, it became an unmitigated risk under the Hustle and, even when detected, loan processors manipulating data typically faced no consequences, monetary or otherwise.

2. Loans Closed with Outstanding Conditions

97. As set forth above, the GSEs required Countrywide and Bank of America to represent that automated underwriting conditions are met for all loans processed through an automated underwriting system. Likewise, Countrywide’s own underwriting guidelines provide that “[a]ll of the conditions imposed by CLUES must be completely fulfilled. The fact that a loan has a CLUES Accept rating does not release the branch from validating that all documentation meets prescribed requirements.” CTM 0.3.1 Introduction—Automated Underwriting Systems (AUSs), Underwriting with CLUES and CLUES Documentation Levels.
98. With volume driving compensation under the HSSL, loan processors had no incentive to obtain and review necessary documents prior to closing.

99. As a result, during the HSSL years, FSL experienced a sharp increase in the percentage of loans closed with a variety of outstanding conditions and a doubling of the percentage of loans closed without required critical documentation, such as documentation supporting income, verifying assets, and verifying employment.

3. Spiking Material Defect Rates

100. Countrywide’s own post-closing quality control reports indicated that the HSSL was a disaster, revealing an alarming spike in defect rates in FSL loans after the HSSL was fully implemented in or around August of 2007. Although FSL’s material defect rates had historically been lower than those in other Countrywide divisions, such as its Consumer Markets Division and Wholesale Lending Division, Countrywide’s internal reports show that FSL’s material defect rates reached double the levels of those in other divisions in 2008.

101. By the first quarter of 2008, FSL’s material defect rate on loans climbed to nearly 40%, far surpassing the industry standard defect rate of 4-5%. Put simply, according to Countrywide’s own internal quality control reviews, more than one-third of the loans FSL originated were ineligible for sale to investors like the GSEs. The quality control reports demonstrating the spiking defect rates were shown to Mairone and other FSL executives.

102. In March of 2008, when the HSSL had been in place for at least six months and the high defects were well known across FSL, Thomas re-sent his initial warnings about the HSSL to O’Donnell and a Vice President in Risk Management, saying “Here’s my plan of attack . . . oh, wait . . . this is what we suggested last August.” The Vice President, in turn, forwarded Thomas’s
email to one of his colleagues, commenting that “we did have the crystal ball, and unfortunately our risk assessments at that time are holding true as current quality undermines FSL.”

4. **Countrywide’s Concealment of Defect Rates**

103. Well aware that its defect rates drastically exceeded the industry standard, Countrywide concealed them from the GSEs with the knowledge that the GSEs would not conduct any meaningful review of the loan files for many months. Although Countrywide had a duty to self-report materially defective loans, Countrywide reported neither its defect rates in FSL nor the vast majority of defective loans to the GSEs. One former Fannie Mae executive responsible for Countrywide purchases has explained that he could not recall ever hearing instances at Fannie Mae of such high defect rates, and added that had he known about such defect rates, he would have asked what Countrywide was originating and whether there were any quality checkpoints at all in the origination process. Another former Fannie Mae executive responsible for the Countrywide account commented that, whereas many customers trying to sell to Fannie Mae would self-report a problem they identified, he could not recall Countrywide ever reporting a single issue as to quality to Fannie Mae.

104. Indeed, at the same time FSL’s defect rates soared to approximately 37%, Countrywide was advised that its poor loan quality could threaten the Bank of America acquisition. A report prepared in February 2008 by Countrywide’s Enterprise Risk Management unit alerted executives that the number two credit risk that could disrupt the Bank of America acquisition was Countrywide’s material defect rates, which were described across divisions as “significantly above acceptable levels, with the most common [defect] being unreasonable stated income.” The number one credit risk cited by the report was Countrywide’s high rates of early
payment defaults, i.e., loans defaulting within the first six months, which are also correlated with material defects and fraud.

105. Despite its knowledge that its defect rates were well above acceptable levels, FSL took no action to address the root cause of its staggering defect rates. Instead, FSL created a one-time bonus incentive for quality control employees to rebut material defect findings in the first quarter of 2008 down to a more standard rate.

106. In a typical rebuttal process, an initial quality review would be conducted of a loan by Countrywide’s corporate quality control department. When a defect finding was made, the quality control team within the division that originated the loan had an opportunity to address the finding by, e.g., attempting to locate a key document missing from the loan file.

107. In FSL, however, where under the Sprint Incentive employees were paid to rebut the defect findings of the corporate quality control department, FSL employees could “rebut” defect findings even without taking any corrective action or showing that the finding was made in error. For example, FSL employees could “rebut” defect findings of “unreasonable stated income” simply by arguing that the stated income was reasonable. In such cases, unless the corporate quality control employee could prove the stated income was false, the defect finding was overturned.

108. Indeed, one former corporate quality control employee previously testified that she could not recall any instances when a finding of “unreasonable stated income” was not overturned.

109. The FSL bonus incentive had its desired effect. Internal FSL quality control reports show that the defect rate for February 2008, for example, went from approximately 37% to purportedly 13%.
110. Countrywide also concealed its bonus incentive from the GSEs. As a former Fannie Mae Vice President of Credit Risk explained, he had never heard of any lender that incentivized a quality control team to rebut quality control findings. Another former Fannie Mae executive commented that it was misleading for Countrywide to be representing, on the one hand, that it was tightening its underwriting controls, while simultaneously engaging in a game of “catch me if you can” on the quality control side.

111. Additionally, in the first quarter of 2008, Mairone instructed O’Donnell to remove certain slides from a loan quality presentation to Countrywide executives because the slides revealed the downward trend in FSL’s loan quality. After O’Donnell refused to remove the slides, Mairone said that if he was not willing to follow her instructions and remove them, she would find someone who was. Thereafter, Mairone excluded O’Donnell from management meetings that he previously regularly attended with Countrywide senior executives relating to loan quality and performance.

D. Defendants Misrepresented that Their Loans Complied with GSE Requirements

112. In selling HSSL loans to the GSEs, Defendants knew that numerous representations about the loans were false at the time of sale, including that the loan complied with all applicable guidelines and contracts, and that the lender knew of nothing involving the mortgage, the property, the mortgagor or the mortgagor’s credit standing that could reasonably be expected to: (i) cause private institutional investors to regard the mortgage as an unacceptable investment; (ii) cause the mortgage to become delinquent; or (iii) adversely affect the mortgage’s value or marketability. Additionally, in many cases, Defendants knew, or were deliberately ignorant or reckless in not knowing, that numerous more specific representations about the loans were false, including that (i)
all required loan data was true, correct, and complete; (ii) all CLUES conditions were met prior to closing; and (iii) no fraud or material misrepresentation had been committed by any party, including the borrower.

113. Even more fundamentally, according to Countrywide’s Guidelines, “[t]he basic question that the underwriter should ask on every loan is, ‘Does this loan make sense?’” CTM 0.6

Introduction—Loan Fraud. The loans described below are just a small fraction of HSSL loans that fail this basic test. A sample of additional HSSL loans that funded in 2008 and 2009, were sold to Fannie Mae and Freddie Mac, and later defaulted, are identified in Exhibit A. These defaults relate to properties throughout the country, including but not limited to properties in the State of New York. Although each of the described loans contained obvious and easily detectable material defects, each one was sold to Fannie Mae with the representation that it was an investment-quality loan and was therefore not reviewed by Fannie Mae until after its default.

1. The Fort Lauderdale, Florida Property

114. Fannie Mae loan number 1706212724 relates to a property in Fort Lauderdale, Florida. The mortgage closed on or about January 31, 2008. Countrywide sold the loan to Fannie Mae representing that it complied with the applicable GSE requirements.

115. Contrary to Countrywide’s representation, the loan did not comply with the most basic representations that the loan file contains no fraud or misrepresentation. A post-default quality review revealed a misrepresentation of income, where the loan application represented that the borrower earned $13,000 per month as a doorman, but the borrower’s employer stated that he earned $5,023 per month.
116. The quality review also revealed that although the mortgage was delivered as an owner-occupied property, the borrower was not residing at the subject property.

117. Countrywide’s representation at the time of sale that this loan complied with GSE requirements was material to Fannie Mae’s decision to purchase the loan and bore upon the likelihood that the borrower would make mortgage payments.

118. The loan defaulted less than eighteen months after closing. According to Countrywide’s (later Bank of America’s) internal fraud tracking system, which recorded the results of internal investigations of possible cases of loan fraud, the investigation confirmed fraud in connection with the loan.

2. The Copperas Cove, Texas Property

119. Fannie Mae loan number 1705138406 relates to a property in Copperas Cove, Texas. The mortgage closed on or about October 9, 2007. Countrywide sold the loan to Fannie Mae representing that it complied with the applicable GSE requirements.

120. Contrary to Countrywide’s representation, the loan did not comply with the most basic requirements concerning the accuracy of information and the absence of misrepresentations. The loan was run through CLUES 12 times. A post-default quality review revealed a misrepresentation of credit and undisclosed liability, as the credit report revealed three additional, undisclosed mortgages obtained four and five months prior to the mortgage that was sold to Fannie Mae. These three additional mortgages resulted in $315,000 of undisclosed borrower debt.

121. Countrywide’s representation at the time of sale that this loan complied with GSE requirements was material to Fannie Mae’s decision to purchase the loan and bore upon the likelihood that the borrower would make mortgage payments.
122. The loan defaulted within twenty-two months of closing. Countrywide’s (later Bank of America’s) internal fraud investigation confirmed fraud in connection with the loan.

3. The Williamstown, New Jersey Property

123. Fannie Mae loan number 1705710735 relates to a property in Williamstown, New Jersey. The mortgage closed on or about December 11, 2007. Countrywide sold the loan to Fannie Mae representing that it complied with the applicable GSE requirements.

124. Contrary to Countrywide’s representation, the loan did not comply with the most basic representations that the loan file contains no fraud or misrepresentation. A post-default quality review revealed a misrepresentation of income, where the loan application represented that the borrower earned $5,600 per month as a wire operator, but a bankruptcy petition filed in 2009 reported the borrower’s monthly income at the time of closing as $2,535.

125. The quality review also revealed an unacceptable appraisal based on misrepresentations of improvements to the property and a failure to use appropriate comparable sales.

126. Countrywide’s representation at the time of sale that this loan complied with GSE requirements was material to Fannie Mae’s decision to purchase the loan and bore upon the likelihood that the borrower would make mortgage payments.

127. The loan defaulted less than eight months after closing.

4. The Birmingham, Alabama Property

128. Fannie Mae loan number 1704789372 relates to a property in Birmingham, Alabama. The mortgage closed on or about August 31, 2007. Countrywide sold the loan to Fannie Mae representing that it complied with the applicable GSE requirements.
129. Contrary to Countrywide’s representation, the loan did not comply with the most basic requirements concerning accuracy of loan data and the absence of misrepresentations. A post-default quality review found inadequate documentation of income, where the loan file stated that the borrower earned $10,000 per month as a self-employed real estate investor, but contained no requisite verification of the borrower’s business.

130. The quality review also found a misrepresentation of the borrower’s credit, as a credit report revealed that the borrower had obtained an additional mortgage the same month as the mortgage sold to Fannie Mae, resulting in an additional $81,000 of undisclosed borrower debt. Finally, the quality review found an inadequate documentation of assets, where the loan file contained no requisite evidence of the borrower’s source of funds to close the loan.

131. Countrywide’s representation at the time of sale that this loan complied with GSE requirements was material to Fannie Mae’s decision to purchase the loan and bore upon the likelihood that the borrower would make mortgage payments.

132. The loan defaulted within eighteen months of closing. Countrywide’s (later Bank of America’s) internal fraud investigation confirmed fraud in connection with the loan.

5. The Tampa, Florida Property

133. Fannie Mae loan number 1705152888 relates to a property in Tampa, Florida. The mortgage closed on or about October 22, 2007. Countrywide sold the loan to Fannie Mae representing that it complied with the applicable GSE requirements.

134. Contrary to Countrywide’s representation, the loan did not comply with the most basic requirements concerning the accuracy of data and the absence of misrepresentations. The loan was run through CLUES 10 times. A post-default quality review revealed a
misrepresentation of income, where the loan file stated that the borrower earned $8,000 per month as a nurse, but the borrower in fact earned $4,112 per month.

135. The quality review also revealed an unacceptable appraisal based on a misrepresentation of the number of square feet of the subject property, a misrepresentation of the declining home values in the neighborhood, and a failure to use appropriate comparable sales.

136. Countrywide’s representation at the time of sale that this loan complied with GSE requirements was material to Fannie Mae’s decision to purchase the loan and bore upon the likelihood that the borrower would make mortgage payments.

137. The loan defaulted within twenty months of closing. Countrywide’s (later Bank of America’s) internal fraud investigation confirmed fraud in connection with the loan.

6. The Westlake Village, California Property

138. Fannie Mae loan number 1705144610 relates to a property in Westlake Village, California. The mortgage closed on or about October 12, 2007. Countrywide sold the loan to Fannie Mae representing that it complied with the applicable GSE requirements.

139. Contrary to Countrywide’s representation, the loan did not comply with the most basic requirements concerning the accuracy of information and the absence of misrepresentations. The loan was run through CLUES 12 times. A post-default quality review revealed a misrepresentation of credit and undisclosed liability, as the credit report revealed an additional, undisclosed mortgage that closed just one month before the mortgage that was sold to Fannie Mae. The additional mortgage resulted in approximately $287,000 of undisclosed borrower debt.
140. Countrywide’s representation at the time of sale that this loan complied with GSE requirements was material to Fannie Mae’s decision to purchase the loan and bore upon the likelihood that the borrower would make mortgage payments.

141. The loan defaulted within twenty months of closing. Countrywide’s (later Bank of America’s) internal fraud investigation confirmed fraud in connection with the loan.

7. The Midlothian, Texas Property

142. Fannie Mae loan number 1705909951 relates to a property in Midlothian, Texas. The mortgage closed on or about January 16, 2008. Countrywide sold the loan to Fannie Mae representing that it complied with the applicable GSE requirements.

143. Contrary to Countrywide’s representation, the loan did not comply with the most basic requirements concerning the accuracy of information and the absence of misrepresentations. The loan was run through CLUES 18 times. A post-default quality review revealed a misrepresentation of occupancy, as the mortgage was represented to be an owner-occupied property but was in fact an investment property.

144. The quality report also found that, although the loan at issue—a stated income loan—required Countrywide to verify the borrower’s employment through a Verification of Employment with a minimum two-year history, the documentation in the file inadequately supported that history.

145. As of August of 2012, Countrywide’s (later Bank of America’s) internal fraud department listed the status of its decision on whether there was fraud in connection with the loan as “pending.”
E. Countrywide and Bank of America Intentionally Thwarted the Repurchase Process

146. Countrywide, and later Bank of America, compounded the financial harm to the GSEs by refusing to repurchase loans even where the GSEs identified obvious misrepresentations of income, unacceptable appraisals, and other material defects in HSSL loans.

147. For example, even where Fannie Mae confirmed instances of misrepresentation of stated income, Countrywide and Bank of America refused to repurchase loans, contending that the stated income, even though fraudulently misrepresented, was reasonable. And even where Fannie Mae’s quality reviews revealed inflated or otherwise faulty appraisals on the basis of misrepresentations about the subject property, Countrywide and Bank of America refused to repurchase loans, contending that Fannie Mae failed to demonstrate that the faulty appraisal caused the loan to default. As a former Fannie Mae senior manager during the relevant time period stated, Countrywide’s attitude was one of total intransigence, refusing to repurchase loans even when it was clear that there was fraud in connection with the loan.

148. Countrywide’s refusal to repurchase materially defective loans extended well beyond HSSL loans and rendered meaningless the contractual protections that existed for the GSEs’ protection in the rep and warrant model. As a June 15, 2007 memo to the former Fannie Mae CEO noted regarding the Countrywide relationship, a “major continuing problem is Countrywide’s refusal to repurchase or make us whole on loans which have suffered losses due to their admitted defects.” And as a former Fannie Mae senior manager previously testified, Countrywide had always exhibited a “blatant disregard for just ignoring the repurchase requests.”

149. While Countrywide loans comprised approximately 28% of Fannie Mae’s single-family loan purchases in 2007, the high defect rates and poor performance of those loans,
along with Countrywide’s refusal to repurchase defective loans, saddled Fannie Mae with
approximately $14 billion in outstanding repurchase requests, representing the majority of all
outstanding repurchase requests to lenders.

150. Since the filing of this lawsuit, after years of recalcitrance, Bank of America has
finally begun to address the thousands of outstanding repurchase requests from the GSEs for
Countrywide’s and Bank of America’s defective loans. Specifically, Bank of America recently
announced that it has agreed to pay Fannie Mae billions of dollars to resolve outstanding
repurchase requests from Fannie Mae for loans originated between 2001 and 2008, including
HSSL loans. Bank of America, however, cannot undo the harm to the GSEs, the federally-insured
financial institutions, or the federal government from Countrywide’s and Bank of America’s
fraudulent origination and sale of defective loans. Nor does the settlement affect Defendants’
liability to the United States for their fraudulent conduct.

F. Defendants’ Fraud Affected Federally Insured Financial Institutions

151. The knowing and intentional fraud perpetrated by Countrywide and Bank of
America affected the federally-insured financial institutions that invested in the GSEs. The GSEs
purchased a greater percentage of loans from Countrywide and Bank of America than from any
other lender and incurred massive and disproportionate losses from those loans when they
defaulted. As a result, the federally-insured financial institutions that invested in the GSEs
likewise incurred massive losses.

152. On September 7, 2008, when the GSEs became insolvent and had to be placed into
conservatorship, the value of their preferred stock was eliminated. Following the
conservatorship, certain federally-insured community banks that held concentrated investments in
GSE preferred stock lost nearly the entire value of their investments, could not recover from the loss, and failed, resulting in the Federal Deposit Insurance Corporation ("FDIC") acting as receiver for the failed community banks and causing losses to the Deposit Insurance Fund.

153. The community banks that held substantial investments in GSE stock included certain subsidiaries of First Bank of Oak Park Corporation ("FBOP"), a privately held bank holding company headquartered in Oak Park, Illinois. The subsidiaries of FBOP that invested in the GSEs were California National Bank, Park National Bank, San Diego National Bank, Pacific National Bank, North Houston Bank, Madisonville State Bank, BANK USA, Community Bank of Lemont, and Citizens National Bank.

154. At the end of the second quarter of 2008, the nine subsidiary banks held approximately $17.3 billion in assets and held preferred stock in the GSEs amounting to $900 million dollars. The largest of the FBOP banks, California National Bank, held approximately $434 million—64 percent of its core capital—in GSE preferred securities. San Diego National Bank held approximately $171 million—54 percent of its core capital—in GSE preferred securities. And Park National Bank held approximately $112 million—38 percent of its total core capital—in GSE preferred securities.

155. As a result of the conservatorship, which was triggered in part by Defendants’ fraud, these three banks lost nearly the entire value of their investments in the GSEs’ preferred securities and immediately fell below “well capitalized” standards. Subsequently, certain cross-guarantees in effect among all nine of the FBOP subsidiary banks imperiled the remaining FBOP subsidiaries as well.
156. On October 30, 2009, the nine bank subsidiaries of FBOP were closed due to inadequate capitalization and the FDIC was appointed as their receiver. A material loss report prepared by the Office of the Inspector General for the FDIC cites the banks’ concentrated investment in GSE preferred stock as the cause of the banks’ losses. The FDIC estimates that the failure of these nine banks will result in a loss to the Deposit Insurance Fund of more than $2.3 billion.

157. Similarly, National Bank of Commerce, a federally-insured financial institution in Berkeley, Illinois, held assets of $445 million at the end of the second quarter of 2008. As of September 30, 2007, National Bank of Commerce held GSE preferred stock with a book value $98 million, representing approximately 74 percent of its total investment capital. As a result of the conservatorship, which was triggered in part by Defendants’ fraud, National Bank of Commerce lost nearly the entire value of its investment in the GSEs’ preferred securities.

158. On January 16, 2009, the OCC closed the National Bank of Commerce and appointed the FDIC as receiver. A material loss report prepared by the Office of the Inspector General for the OCC cites the bank’s concentrated investment in GSE preferred stock as the cause of its failure. The FDIC estimates that the failure of National Bank of Commerce will result in a loss to the Deposit Insurance Fund of approximately $92.5 million.

159. Additionally, BANA and Countrywide Bank, themselves federally-insured financial institutions, were affected by Defendants’ fraud. Defendants’ fraudulent conduct has resulted in significant liabilities to the GSEs for, among other things, repurchase claims. To date, BANA and/or Countrywide Bank has directly or indirectly paid billions to settle repurchase demands from the GSEs on defective loans, including HSSL loans.
160. Defendants executed their scheme to defraud the GSEs through the use of interstate mail and wires, specifically through repeated mail and electronic transmission of loan files and telephonic and electronic misrepresentations of loan quality to the GSEs.

161. Countrywide, Bank of America Corporation, and BANA are vicariously liable for the conduct of Mairone and any other employee who participated in the fraud.

**BANK OF AMERICA IS LIABLE BOTH DIRECTLY AND AS SUCCESSOR TO COUNTRYWIDE**

162. Bank of America is directly liable for the conduct alleged above that occurred after July 1, 2008, and liable as the successor to Countrywide for the conduct alleged above that occurred prior to July 1, 2008, as a result of direct merger and under the doctrines of *de facto* merger, substantial continuity, and assumption of liabilities.

A. **Countrywide’s Merger Into Bank of America**

163. On January 11, 2008, Countrywide Financial and Bank of America announced that they had entered into a Merger Agreement. In the six months following the announcement of the planned merger, Bank of America developed a plan to integrate Countrywide’s businesses into Bank of America through a series of transactions by which Bank of America would acquire control over, then transfer to itself, all of Countrywide’s productive assets, operations, and employees (the “Plan”).

164. The goal of the Plan was to consolidate as much of the mortgage business of Countrywide and Bank of America as possible. In April of 2008, Bank of America stated before the Federal Reserve that it would “run the combined mortgage business” under the “Bank of
America brand” and that Calabasas, California would “be the national headquarters for the combined mortgage business.”

165. As set forth below, the execution of the Plan began just after the July 1, 2008 merger. The Plan continued the former Countrywide Financial stockholders’ ownership over Countrywide Financial’s assets, then transferred all mortgage-related assets of the Countrywide entities into Bank of America entities through a series of transactions in July and November 2008.

166. Following the merger, the Plan was completed in several steps because some transactions required regulatory approval while others could be completed immediately.

1. The Red Oak Merger

167. On July 1, 2008, Countrywide Financial merged into a specially-formed Bank of America Corporation subsidiary named Red Oak Corporation, which was then renamed Countrywide Financial Corporation (the “Red Oak Merger”). The Red Oak Merger was a stock-for-stock transaction by which former Countrywide Financial shareholders became Bank of America Corporation shareholders.

168. Since the Red Oak Merger, Countrywide Financial and its other wholly-owned subsidiaries have been owned by the shareholders of Bank of America Corporation (which then included former Countrywide Financial shareholders through their ownership of stock in Bank of America Corporation). Also, as of the Red Oak Merger, both before and after the July and November 2008 transactions, Bank of America Corporation was the sole shareholder of Countrywide Financial and its subsidiaries.
169. Since the Red Oak Merger, Bank of America Corporation has controlled Countrywide Financial, Countrywide Home Loans, and all other former subsidiaries of Countrywide Financial.

170. As Bank of America has acknowledged in recent briefing, it was required by Fannie Mae guidelines to obtain Fannie Mae’s consent to the Red Oak Merger “[t]o ensure [its] protection in a sale of a mortgage servicer that was servicing mortgage loans that Fannie Mae . . . owned.” As a condition to its consent to the Red Oak Merger, Fannie Mae required that BANA guarantee the obligations of Countrywide Home Loans Servicing LP (“CHLS”), a Countrywide Home Loans subsidiary, to service loans that Fannie Mae had purchased.

2. The July 2008 Transactions

171. Between July 1 and July 3, 2008, Countrywide Financial and Bank of America engaged in a number of transactions by which Countrywide Financial and its subsidiaries sold assets and subsidiaries to Bank of America Corporation and certain of its subsidiaries.

172. On July 1, 2008, Countrywide Home Loans sold two pools of residential mortgage loans to NB Holdings Corporation (“NB Holdings”), a wholly-owned subsidiary of Bank of America Corporation, and novated a portfolio of derivative securities contracts to BANA, also a wholly-owned subsidiary of Bank of America Corporation, under which BANA assumed Countrywide Home Loans’s positions under the contracts.

173. On July 2, 2008, Countrywide Home Loans sold to NB Holdings two entities that owned all of the partnership interests in CHLS, Countrywide’s mortgage-servicing business. NB Holdings subsequently transferred CHLS to its subsidiary, BANA.

3. The November 2008 Transactions

175. On November 7, 2008, pursuant to a Stock Purchase Agreement and an Asset Purchase Agreement, Bank of America Corporation purchased Countrywide Financial’s 100% equity ownership of Effinity, a Countrywide Financial subsidiary that owned Countrywide Bank, and substantially all of Countrywide Home Loans’ remaining mortgage-related assets and operations, including all assets associated with mortgage-origination operations, such as: mortgage loans; mortgage-servicing rights; the technology platform (including CLUES) used in the mortgage operations; furniture, fixtures, and equipment; contract rights with third parties; real property; mortgage servicing advance receivables; and other assets used in Countrywide’s mortgage business. Bank of America Corporation subsequently transferred these assets to BANA.

176. The net result of the November 2008 transactions was a transfer of substantially all of the remaining operating assets of Countrywide Financial, including Countrywide Bank and Countrywide Home Loans, to BANA and NB Holdings. Bank of America Corporation subsequently contributed the purchased assets and subsidiaries to its non-Countrywide Financial subsidiaries, and BANA immediately contributed billions in excess capital created by the transfers back to Bank of America Corporation. As Bank of America explained in recent briefing, “the remnants of Countrywide’s mortgage business—including remaining managers, personnel, assets, and operations. . . are. . . in BANA.”
4. Merger of Countrywide Bank and CHLS Into BANA

177. On April 27, 2009, Countrywide Bank converted to a national bank with the name Countrywide Bank, N.A., and merged with and into BANA with BANA as the surviving entity.

178. Also in April 2009, CHLS was renamed Bank of America Home Loans Servicing, L.P., a wholly-owned subsidiary of BANA. In July 2011, the former CHLS merged into BANA.

179. On February 13, 2009, in seeking Freddie Mac’s approval for the April 2009 merger between BANA and Countrywide Bank, Bank of America stated that “CWB [Countrywide Bank] will be merged with and into BANA, with BANA as the surviving entity.” Bank of America further stated to Freddie Mac that “the merger will entail the restructuring of CWB’s existing retail and wholesale lending platforms under BANA” and that “CWB officers and key personnel will remain in their respective or comparable positions with BANA following the consolidation.”

180. In March of 2009, Countrywide Home Loans, Countrywide Bank, BANA and Freddie Mac executed a new Master Agreement governing their seller-servicer relationship, which provides that “[f]rom and after April 27, 2009, when Countrywide Bank is merged into BANA, this [Master] Agreement will apply to Mortgages originated by BANA using the origination systems and platforms that, immediately prior to the merger, were owned by or licensed to Countrywide Bank, which include the following systems and platforms: CLUES, EDGE, ADVANT EDGE, GEMS, GRANITE, ROSS, LYNX, and any other platform or system that ties into or is used in connection with any of the foregoing . . . BANA acknowledges that the . . . Master Commitments taken down under this Agreement were previously executed by Countrywide Bank, and that from and after the date of the merger between BANA and Countrywide Bank, BANA, as
successor by merger to Countrywide Bank, is as fully obligated under such Master Commitments as Countrywide Bank had been . . . .”

181. Similarly, an Addendum to the Mortgage Selling and Servicing Contract (the “Contract”) between Fannie Mae and BANA (the “Lender”) executed in April of 2009 provides that “(i) effective as of April 27, 2009, Lender has merged with Countrywide Bank, FSB (the ‘Non-Surviving Corporation’); (ii) Lender is the surviving corporation in that merger, (iii) Lender is responsible for and has assumed all assets of Non-Surviving Corporation to Fannie Mae, and (iv) Lender ratifies all assignments of mortgage from each of Lender and Non-Surviving Corporation to Fannie Mae and the endorsements on the related mortgage notes by each of Lender and Non-Surviving Corporation.”

182. In October of 2010, in response to an audit request directed to Countrywide Bank from the United States Department of Housing and Urban Development (“HUD”), Office of Inspector General, a representative of Bank of America responded that “Countrywide Bank, FSB (“CWB”) merged into Bank of America, N.A. (“BANA”) on April 27, 2009. As a result, BANA is the successor to the rights, obligations, and liabilities of CWB with respect to HUD and FHA [the Federal Housing Administration], including any seller/servicer numbers issued by these agencies.”

183. Through the series of transactions set forth above, Bank of America Corporation transferred all of the operating assets of Countrywide Financial, including Countrywide Bank, Countrywide Home Loans, and other Countrywide Financial subsidiaries to itself and its non-Countrywide Financial subsidiaries.
5. Merged Mortgage Business

184. At the time the HSSL was implemented, employees in FSL acted as agents for Countrywide Bank, subject to the control and management of Countrywide Bank. Countrywide Bank held customer deposits, invested in mortgage loans originated through Countrywide Home Loans, and by the end of 2007, originated and funded the vast majority of Countrywide’s mortgages, including FSL mortgages. By 2007, employees in FSL became employees of Countrywide Bank.

185. As a result of the merger of Countrywide Bank and BANA, Bank of America became successor to the rights, obligations, and liabilities of loans originated through FSL.

186. Bank of America is also liable as successor-in-interest to Countrywide for the alleged conduct that occurred prior to July 1, 2008, because it substantially continued Countrywide’s mortgage business operations, including the HSSL, using the same facilities, personnel, equipment, technology, and know-how relating to the mortgage business.

187. Through the November 2008 transactions, Bank of America purchased substantially all of Countrywide’s assets and continues to use these assets in Bank of America’s mortgage business today. Countrywide Financial’s core business was originating, purchasing, selling, and servicing loans, and was primarily housed within Countrywide Home Loans and Countrywide Bank. Countrywide Home Loans and Countrywide Bank owned all of the assets necessary for the operations of the mortgage business, including the non-banking financial centers, technology platform, physical offices, call centers, and equipment used in the mortgage origination and servicing business.
188. Bank of America integrated the former mortgage-origination business of Countrywide Financial, including Countrywide Bank and Countrywide Home Loans, into its own mortgage business and externally branded it as Bank of America Home Loans. Countrywide Home Loans and Countrywide Bank employees became employees of Bank of America, and the current Bank of America CEO testified that Bank of America “ended up with the largest [mortgage] servicing platform in the country.”

189. On April 27, 2009, the same day that Countrywide Bank merged with and into BANA, Bank of America announced that the combined Bank of America Home Loans mortgage operations would be based in Calabasas, California, at the former headquarters of Countrywide Financial and Countrywide Home Loans. An April 27, 2009 Bank of America press release explained, “[t]he Bank of America Home Loans brand represents the combined operations of Bank of America’s mortgage and home equity business and Countrywide Home Loans, which Bank of America acquired on July 1, 2008. The Countrywide brand has been retired.”

190. Today, Bank of America determines whether a Countrywide-originated loan can be repurchased, and repurchase requests by the GSEs on Countrywide-originated loans are made directly to BANA. Bank of America funds repurchases on Countrywide-originated loans and absorbs losses on any such loans. Bank of America employees also control the negotiation and resolution of litigation involving Countrywide.

191. Through the due diligence that preceded the merger of Countrywide entities into Bank of America, the series of transactions that followed the announcement of the Merger Agreement, and the substantial continuing of Countrywide’s mortgage business operations, using the same personnel, technology, and business practices, Bank of America acquired notice of the
HSSL and the liabilities it created. Accordingly, Bank of America is liable as a successor-in-interest to Countrywide under the test for substantial continuity.

192. Additionally, Bank of America effected, *inter alia*, a *de facto* merger with Countrywide because: (i) former Countrywide shareholders became Bank of America shareholders, and remained owners of Countrywide Financial and its subsidiaries following the merger; (ii) Bank of America assumed the ordinary business liabilities necessary for the ongoing operations of Countrywide’s core businesses, including mortgage origination and servicing; and (iii) Bank of America continues to operate the combined mortgage business out of the same offices formerly occupied by Countrywide, has employed a substantial number of former Countrywide employees to continue to manage and operate the businesses, and continues to use Countrywide’s operational assets in the combined business.

B. **Bank of America’s Assumption of Countrywide’s Liabilities**

1. **Bank of America’s Public Admissions of Liability**

193. In the months leading up to and following the Red Oak Merger, Bank of America’s most senior executives and spokespersons made public statements admitting that Countrywide’s liabilities were factored into the purchase of Countrywide Financial, and that Bank of America intended to “clean[] up” those liabilities.

194. For example, on March 1, 2008, a Bank of America spokesperson said that Countrywide’s liabilities were factored into the purchase of Countrywide: “We bought the company and all of its assets and liabilities . . . We are aware of the claims and potential claims against the company and have factored those into the purchase.”
In an interview with the New York Times for an article discussing the impact of mortgage-related loss exposure on banks, Bank of America’s former CEO confirmed that Bank of America was aware of Countrywide Financial’s legal liabilities and accepted them as part of the cost of the acquisition: “We did extensive due diligence. . . . It was the most extensive due diligence we have ever done. So we feel comfortable with the valuation. We looked at every aspect of the deal, from their assets to potential lawsuits and we think we have a price that is a good price.”

Addressing investor questions in November 2010, Bank of America’s current CEO addressed Bank of America’s plans to deal with repurchase claims and lawsuits against Countrywide by stating, “[t]here’s a lot of people out there with a lot of thoughts about how we should solve this, but at the end of the day, we will pay for the things that Countrywide did.” One month later, he told a New York Times reporter, for an article concerning Bank of America’s financial woes, that “[o]ur company bought it [Countrywide] and we’ll stand up, we’ll clean it up.” Finally, when deposed recently about his public statements, he testified that his comment to the New York Times was truthful and accurate, that “[w]e want to clean it up absolutely,” and that that “was our intention then and that is our intention now.”

2. Bank of America Has Paid or Funded Payment of Countrywide’s Liabilities

Consistent with its public statements acknowledging its plan to satisfy Countrywide’s liabilities, Bank of America (and/or BANA) has been actively engaged in negotiating and funding the resolution of disputes with the contingent creditors of Countrywide Financial and Countrywide Home Loans, including funding payments to the GSEs in January of 2011 in partial settlement of repurchase claims on loans originated by Countrywide, and to the
United States Department of Justice in February 2012, to settle claims that Countrywide defrauded the FHA in connection with its residential mortgage loan business.

198. Most recently, on January 7, 2013, Bank of America entered into a multi-billion dollar settlement with Fannie Mae to resolve repurchase requests stemming from loans originated by Countrywide, including many HSSL loans.

199. Bank of America has therefore assumed the liabilities of Countrywide based on its public statements by its senior officers, including its CEO, and its payment of Countrywide’s contingent liabilities, contributing substantial funds to cover Countrywide’s costs in connection with litigations and settlements, including the settlement of representation and warranty exposure stemming from loans originated by Countrywide Home Loans and sold to the GSEs.

CLAIMS FOR RELIEF

COUNT I: FOR DAMAGES AND PENALTIES UNDER THE FALSE CLAIMS ACT

200. The Government incorporates by reference the allegations in each of the preceding paragraphs as if fully set forth in this paragraph.

201. As set forth above, Defendants Bank of America Corporation, BANA, Countrywide Financial, Countrywide Home Loans, and Countrywide Bank (the “Bank Defendants”) knowingly, or acting in deliberate ignorance and/or with reckless disregard of the truth, made false representations about the quality of their loans at the time of their sale of the loans to the GSEs, including that the loans were of investment quality and complied with the GSE selling guides and purchase contracts.
202. The Bank Defendants made a demand for payment at the time of their sale of the HSSL loans to the GSEs.

203. The Bank Defendants’ misrepresentations about loan quality were capable of influencing, and thus were material to, the GSEs’ payment decisions about purchasing and/or pricing Countrywide, and later Bank of America, loans.

204. The GSEs have incurred losses as a result of the Bank Defendants’ misrepresentations in the form of paying guarantees to third parties after the HSSL loans defaulted.

205. Treasury funds have been used to purchase the Bank Defendants’ loans and to reimburse the losses incurred by the GSEs as a result of paying out guarantees to third parties after guaranteed HSSL loans defaulted.

206. Treasury funds paid to the GSEs were used to “advance a Government program or interest,” within the meaning of 31 U.S.C. § 3729(b)(2), specifically, to prevent disruptions in the availability of mortgage finance.

207. By virtue of the acts described above, and in violation of 31 U.S.C. § 3729(a)(1)(A), for each of the loans sold to the GSEs in violation of GSE requirements after the effective date of FERA, the Bank Defendants knowingly, or acting in deliberate ignorance and/or with reckless disregard of the truth, presented a fraudulent claim for payment or approval.

208. Pursuant to the False Claims Act, 31 U.S.C. § 3729(a)(1), the Bank Defendants are liable to the United States under the treble damage and civil penalty provisions for a civil penalty of not less than $5,500 and not more than $11,000 for each of the false or fraudulent claims herein, plus three (3) times the amount of damages which the GSEs have sustained because of the Bank Defendants’ actions.
COUNT II: FOR DAMAGES AND PENALTIES UNDER THE FALSE CLAIMS ACT

209. The Government incorporates by reference the allegations in paragraphs 1-199 as if fully set forth in this paragraph.

210. As set forth above, the Bank Defendants knowingly, or acting in deliberate ignorance and/or with reckless disregard of the truth, made false representations about the quality of their loans at the time of their sale of the loans to the GSEs, including that the loans were of investment quality and complied with the GSE selling guides and purchase contracts.

211. The Bank Defendants made a demand for payment at the time of their sale of the HSSL loans to the GSEs.

212. The Bank Defendants’ misrepresentations about loan quality were capable of influencing, and thus were material to, the GSEs’ decisions about purchasing and/or pricing Countrywide, and later Bank of America, loans.

213. The GSEs have incurred losses as a result of the Bank Defendants’ misrepresentations in the form of paying guarantees to third parties after the HSSL loans defaulted.

214. Treasury funds have been used to purchase the Bank Defendants’ loans and to reimburse the losses incurred by the GSEs as a result of paying out guarantees to third parties after guaranteed HSSL loans defaulted.

215. Treasury funds to the GSEs were used to “advance a Government program or interest,” within the meaning of 31 U.S.C. § 3729(b)(2), specifically, to prevent disruptions in the availability of mortgage finance.
216. By virtue of the acts described above, and in violation of 31 U.S.C. § 3729(a)(1)(B), for each of the loans sold to the GSEs in violation of GSE requirements after the effective date of FERA, the Bank Defendants knowingly, or acting in deliberate ignorance and/or with reckless disregard of the truth, made, used, or caused to be made or used, false records and/or statements material to a false or fraudulent claim presented for payment or approval.

217. Pursuant to the False Claims Act, 31 U.S.C. § 3729(a)(1), the Bank Defendants are liable to the United States under the treble damage and civil penalty provisions for a civil penalty of not less than $5,500 and not more than $11,000 for each of the false or fraudulent claims herein, plus three (3) times the amount of damages which the GSEs have sustained because of the Bank Defendants’ actions.

**COUNT III: FOR CIVIL PENALTIES UNDER FIRREA**

(12 U.S.C. § 1833a)

218. The Government incorporates by reference the allegations in paragraphs 1-199 as if fully set forth in this paragraph.

219. For purposes of fraudulently obtaining money from the GSEs, from at least 2006 through 2010, the Bank Defendants knowingly, or acting in deliberate ignorance and/or with reckless disregard of the truth, executed a scheme and artifice to defraud, using interstate mail carriers and interstate wires, in violation of 18 U.S.C. §§ 1341 and 1343. Specifically, the Bank Defendants knowingly, or acting in deliberate ignorance and/or with reckless disregard of the truth, originated loans in violation of GSE guidelines; concealed the Hustle model and the resulting defect rates on Hustle loans; and sold loans originated under the Hustle model to the
GSEs while knowingly, or acting in deliberate ignorance and/or with reckless disregard of the truth, misrepresenting that they complied with the guidelines.

220. The Bank Defendants have gained substantial profits from their fraudulent scheme, having originated billions of dollars in loans under the Hustle.

221. This scheme to defraud has affected numerous federally insured financial institutions that held preferred stock in the GSEs, including the nine subsidiaries of FBOP Corporation that were closed due to inadequate capitalization in October of 2009.

222. Accordingly, the Bank Defendants are liable for civil penalties to the maximum amount authorized under 12 U.S.C. § 1833a.

**COUNT IV: FOR CIVIL PENALTIES UNDER FIRREA (AGAINST REBECCA MAIRONE)**

223. The Government incorporates by reference the allegations in paragraphs 1-199 as if fully set forth in this paragraph.

224. For purposes of fraudulently obtaining money from the GSEs, from at least 2007 through 2009, Defendant Mairone knowingly, or acting in deliberate ignorance and/or with reckless disregard of the truth, executed a scheme and artifice to defraud, using interstate mail carriers and interstate wire, in violation of 18 U.S.C. §§ 1341 and 1343. Specifically, Mairone knowingly, or acting in deliberate ignorance and/or with reckless disregard of the truth, participated in the design and management of the HSSL model knowing that the resulting loans violated GSE guidelines; directed and/or participated in the origination of loans in violation of GSE guidelines; concealed the Hustle model and the resulting defect rates on Hustle loans; and directed the sale of loans originated under the Hustle model to the GSEs while knowing, or acting
in deliberate ignorance and/or with reckless disregard of the truth, that they would be sold with the misrepresentation that they complied with the guidelines.

225. Defendant Mairone directed and/or participated in the fraudulent scheme in order to protect FSL’s revenues, and, in turn, her own personal compensation and career advancement, which was based in significant part on boosting loan production volume.

226. Defendant Mairone’s scheme to defraud has affected numerous federally insured financial institutions.

227. Accordingly, Mairone is liable for civil penalties to the maximum amount authorized under 12 U.S.C. § 1833a.

WHEREFORE, the Government respectfully requests judgment against Defendants as follows:

a. On Counts One and Two (FCA), a judgment against the Bank Defendants for treble damages and civil penalties for the maximum amount allowed by law;

b. On Count Three (FIRREA), a judgment against the Bank Defendants imposing civil penalties up to the maximum amount allowed by law;

c. On Count Four (FIRREA), a judgment against Mairone imposing civil penalties up to the maximum amount allowed by law;

d. For an award of costs pursuant to 31 U.S.C. § 3729(a); and

e. For such further relief that the Court deems just.
Dated: New York, New York
January 11, 2013

PREET BHARARA
United States Attorney for the
Southern District of New York
Attorney for the United States

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This is a Report of the Staff of the U.S. Securities and Exchange Commission. The Commission has expressed no view regarding the analysis, findings, or conclusions contained herein.

November 2011
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Appendix A: Whistleblower Tips by Allegation Type

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I. **Introduction**

Section 922 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”), amended the Securities Exchange Act of 1934 (the “Exchange Act”) by, among other things, adding Section 21F, entitled “Securities Whistleblower Incentives and Protections.” Section 21F directs the Commission to make monetary awards to eligible individuals who voluntarily provide original information that leads to successful Commission enforcement actions resulting in the imposition of monetary sanctions over $1,000,000, and certain related successful actions. Awards are required to be made in the amount of 10% to 30% of the monetary sanctions collected. Awards will be paid from the Commission’s Investor Protection Fund (the “Fund”). In addition, Dodd-Frank Act § 924(d) directs the Commission to establish a separate office within the Commission to administer the whistleblower program.

Section 924(d) of the Dodd-Frank Act requires the Commission’s Office of the Whistleblower to report annually to Congress on its activities, whistleblower complaints, and the response of the Commission to such complaints. In addition, Exchange Act § 21F(g)(5) requires the Commission to submit an annual report to Congress that addresses the following subjects:

- the whistleblower award program, including a description of the number of awards granted and the types of cases in which awards were granted during the preceding fiscal year;
- the balance of the Fund at the beginning of the preceding fiscal year;
- the amounts deposited into or credited to the Fund during the preceding fiscal year;

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• the amount of earnings on investments made under Section 21F(g)(4) during the preceding fiscal year;

• the amount paid from the Fund during the preceding fiscal year to whistleblowers pursuant to Section 21F(b);

• the balance of the Fund at the end of the preceding fiscal year; and

• a complete set of audited financial statements, including a balance sheet, income statement and cash flow analysis.

This report has been prepared by the Commission’s Office of the Whistleblower to satisfy the reporting obligations of Dodd Frank Act § 924(d) and Exchange Act § 21F(g)(5). Parts II, III, and IV of the report primarily address the requirements of Dodd Frank Act § 924(d), and Parts V and VI of the report, along with the financial statements of the Investor Protection Fund that are included in the Commission’s 2011 Performance Annual Report, primarily address the requirements of Exchange Act § 21F(g)(5).

II. Implementation of the Whistleblower Award Program

A. Adoption of Implementing Regulations

Exchange Act § 21F(b) provides that whistleblower awards shall be paid under regulations prescribed by the Commission. Shortly after the enactment of the Dodd-Frank Act, the Commission formed a cross-disciplinary working group to draft proposed rules to implement the Act’s whistleblower provisions. In addition, before publishing proposed rules and commencing formal notice-and-comment rulemaking, the Commission provided an e-mail link on its website to facilitate public input about the whistleblower award program. On November 3, 2010, the Commission proposed Regulation 21F to implement Exchange Act § 21F. The Commission received more than


In response to the comments, the Commission made a number of revisions and refinements to the proposed rules in order to better achieve the goals of the statutory whistleblower program and to advance effective enforcement of the federal securities laws.

On May 25, 2011, the Commission adopted final Regulation 21F, which became effective on August 12, 2011 (the “Final Rules”). Among other things, the Final Rules define certain terms essential to the operation of the whistleblower program; establish procedures for submitting tips and applying for awards, including appeals of Commission determinations whether or to whom to make an award; describe the criteria the Commission will consider in making award decisions; and implement the Dodd-Frank Act’s prohibition against retaliation for whistleblowing.

B. Establishment and Activities of the Office of the Whistleblower

Section 924(d) of the Dodd-Frank Act directs the Commission to establish a separate office within the Commission to administer and to enforce the provisions of Exchange Act § 21F. On February 18, 2011, the Commission announced the appointment of Sean X. McKessy to head the newly-created Office of the Whistleblower in the Division of Enforcement. In addition to Mr. McKessy, the Office is currently staffed by five attorneys and one senior paralegal on detail from various Commission Divisions and Offices, each serving a 12-month detail in the Office of the Whistleblower. These details started in May 2011. The Office of the Whistleblower is in the process of recruiting and hiring a Deputy Chief.

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6 The public comments are available at http://www.sec.gov/comments/s7-33-10/s73310.shtml.


Since its establishment, the Office of the Whistleblower has focused primarily on establishing the office and implementing the whistleblower program. During fiscal year 2011, the Office’s activities included the following:

- Providing extensive training on the Dodd-Frank statute and Final Rules to the Commission’s staff;
- Establishing and implementing internal policies, procedures, and protocols;
- Establishing a publicly-available Whistleblower hotline for members of the public to call with questions about the program. Office of the Whistleblower attorneys return calls within 24 business hours. Since the hotline was established in May 2011, the Office has returned over 900 phone calls from members of the public;
- Redesigning and launching an Office of the Whistleblower website dedicated to the whistleblower program (www.sec.gov/whistleblower). The website includes detailed information about the program, copies of the forms required to submit a tip or claim an award, notices of covered actions, links to helpful resources, and frequently asked questions;
- Meeting with whistleblowers, potential whistleblowers and their counsel, and consulting with the relevant subject matter experts in the Division of Enforcement to provide guidance to whistleblowers and their counsel concerning expectations and follow up;
- Conferring with regulators from other agencies’ whistleblower offices, including the Internal Revenue Service, Commodity Futures Trading Commission, Department of Justice, and Department of Labor (OSHA), to discuss best practices and experiences;
- Publicizing the program actively through participation in webinars, presentations, speeches, press releases, and other public communications;9
- Assisting in updating the Commission’s web-based system for submitting tips, complaints, and referrals (https://denebleo.sec.gov/TCRExternal/index.xhtml) to conform to the Final Rules;
- Providing ongoing guidance to staff throughout the Commission regarding various aspects of the program, including the development of internal policies for the handling of confidential whistleblower identifying information; and
- Working with Enforcement staff to identify and track all enforcement cases involving a whistleblower to assist in the documentation of the whistleblower’s participation in anticipation of an eventual claim for award.

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III. **Whistleblower Tips Received During Fiscal Year 2011**

The Final Rules specify that individuals who would like to be considered for a whistleblower award must submit their tip to the Office of the Whistleblower on Form-TCR either via facsimile or mail or via the Commission’s online TCR questionnaire portal. Concurrently with the effectiveness of the Final Rules on August 12, 2011, the Commission updated its Tips, Complaints and Referrals System (the “TCR System”) to conform the online questionnaire to the substantive requirements in the Final Rules and to provide enhanced whistleblower functionality. The updated online TCR questionnaire allows whistleblowers to make online submissions that satisfy Regulation 21F, including making the required declarations. In addition, the TCR System allows the Commission to comprehensively and centrally track all whistleblower tips submitted to the Commission online or via hard copy by mail or facsimile.

Because the Final Rules became effective August 12, 2011, only 7 weeks of whistleblower tip data is available for fiscal year 2011. Appendix A lists, by subject matter and month, the 334 whistleblower tips received from August 12, 2011 through September 30, 2011. The most common complaint categories were market manipulation (16.2%), corporate disclosures and financial statements (15.3%), and offering fraud (15.6%).

The Commission received whistleblower submissions from individuals in 37 states, as well as from several foreign countries, including China (10) and the United Kingdom (9). Appendices B and C set forth tabular presentations of the sources of domestic and international whistleblower tips.

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10 Of course, the Commission also receives TCRs from individuals who do not wish or are not eligible to be considered for an award under the whistleblower program. The data in this report is limited to those TCR’s that include the required whistleblower declaration and does not reflect all TCRs received by the Commission during the fiscal year.

11 This breakdown reflects the categories selected by whistleblowers in their online questionnaire or hard copy TCR submissions and, thus, the data represents the whistleblower’s own characterization of the violation type. The Office of the Whistleblower will work to synchronize the categories enumerated in the online and hard copy TCR forms with the categories of cases the Division of Enforcement uses in its case tracking database. As the program evolves, the Office of the Whistleblower will use this data to calculate metrics, identify trends and evaluate the overall program.
As a result of the relatively recent launch of the program and the small sample size, it is too early to identify any specific trends or conclusions from the data collected to date. We expect that the Annual Report for 2012 – with the benefit of a full year’s worth of data – will yield such trends and conclusions.  

IV. Processing of Whistleblower Tips During Fiscal Year 2011

The Office of the Whistleblower leverages the resources and expertise of the Commission’s Office of Market Intelligence to triage incoming whistleblower TCRs and to assign specific, timely and credible TCRs to appropriate members of the Enforcement staff.

During the triage process, several layers of staff in the Office of Market Intelligence examine each submitted tip to identify those that are sufficiently specific, timely and credible to warrant the further allocation of Commission resources, or a referral to another law enforcement or regulatory agency. Complaints that relate to an existing investigation are generally forwarded to the staff assigned to the existing matter. Complaints that involve the specific expertise of another Division or Office within the Commission are generally forwarded to staff in that particular Division or Office for further analysis. When appropriate, complaints that fall within the jurisdiction of another federal or state agency are forwarded to the Commission contact at that agency, provided this can be done without violating the confidentiality of whistleblower-identifying information contained in the complaint. Complaints that relate to the private financial affairs of an investor or a discrete investor group are usually forwarded to the Office of Investor Education and Advocacy (“OIEA”).

Pursuant to Dodd-Frank Act § 924(b), information regarding possible federal securities law violations submitted to the Commission in writing after the Dodd-Frank Act became law and prior to the adoption of the Final Rules implementing Exchange Act § 21F is considered original information, and thus, is potentially eligible for a whistleblower award. Although these tips are not included in the numbers reported herein, individuals who submitted them will be eligible to apply for an award in connection with covered actions and related actions if they submit claims pursuant to the claims process described in the Final Rules.
Comments or questions about agency practice or the federal securities laws are also forwarded to OIEA.

The Office of the Whistleblower participates in the tip allocation and investigative processes in several ways. When callers to the Office of the Whistleblower’s voicemail provide information of any allegation or statement of concern about possible violations of the federal securities laws or conduct that poses a possible risk of harm to investors (either as a message or during a return call), members of the Office of the Whistleblower staff enter that information in the TCR System so it can be triaged. During triage, the Office of the Whistleblower may contact the whistleblower to glean additional information or may participate in the qualitative assessment of the best course of action to take in response to a whistleblower tip. During an investigation, the Office of the Whistleblower is available as needed to serve as a liaison between the whistleblower (and his or her counsel) and investigative staff. On occasion, the Office of the Whistleblower arranges meetings between whistleblowers and subject matter experts on the Enforcement staff to assist in better understanding the whistleblowers’ submissions and developing the specific facts of a case. Staff in the Office of the Whistleblower also communicates frequently with Enforcement staff with respect to the timely documentation of information regarding the staff’s interactions with whistleblowers, the value of the information provided by whistleblowers, and the assistance provided by whistleblowers as the potential securities law violation is being investigated.

V. Whistleblower Incentive Awards Made During Fiscal Year 2011

The Final Rules set out the procedures for applying for a whistleblower award. The award process begins following the entry of a final judgment or order for monetary sanctions that, alone or jointly with judgments or orders previously entered in the same action or an action based on the same nucleus of operative facts, exceeds $1 million. Following the entry of such a judgment or
order, the Office of the Whistleblower publishes a Notice of Covered Action on the Commission's website. Once a Notice of Covered Action is posted, individuals have 90 calendar days to apply for an award by submitting a completed whistleblower award application, which is known as Form WB-APP, to the Office of the Whistleblower.\textsuperscript{13} It is anticipated that as the program evolves, the Office of the Whistleblower’s standard practice will be to provide individualized notice to whistleblowers who may have contributed to the success of a Commission action resulting in monetary sanctions exceeding $1 million.

On August 12, 2011, the Office of the Whistleblower posted Notices of Covered Actions for the 170 applicable enforcement judgments and orders issued from July 21, 2010 through July 31, 2011 that included the imposition of sanctions exceeding the statutory threshold of $1 million.\textsuperscript{14} Analysis of claims submitted in connection with any of these Covered Actions requires, as a preliminary matter, identifying all claimants who submit an application for an award in connection with the Covered Action before the deadline. The 90-day deadline for all applications for the initial list of Covered Actions is November 11, 2011.\textsuperscript{15} Because the 90-day application period had not passed with respect to any Notices of Covered Actions as of the end of the fiscal year, applications for awards had not yet been processed. Accordingly, the Commission did not pay any whistleblower awards during fiscal year 2011.

\textsuperscript{13} Rule 21F-10(a)-(b), 17 C.F.R. § 240.21F-10(a)-(b).

\textsuperscript{14} By posting a Notice of Covered Action for a particular case, the Commission is not making any determinations either that (i) a whistleblower tip, complaint or referral led to the Commission opening an investigation or filing an action with respect to the case or (ii) an award to a whistleblower will be paid in connection with the case.

\textsuperscript{15} On October 5, 2011, the Office of the Whistleblower posted Notices of Covered Actions for fifteen additional cases that met the eligibility requirements for a potential whistleblower award. The deadline for applications for this second round of notices is January 3, 2012. On October 31, 2011, the Office of the Whistleblower posted Notices of Covered Actions for six additional cases. The deadline for award applications for these cases is January 30, 2012.
VI. Securities and Exchange Commission Investor Protection Fund

Section 922 of the Dodd-Frank Act established the Securities and Exchange Commission Investor Protection Fund ("Fund") to provide funding for the Commission's whistleblower award program, including the payment of awards in related actions.\(^{16}\) In addition, the Fund is used to finance the operations of the SEC Office of the Inspector General’s suggestion program.\(^{17}\) The suggestion program is intended for the receipt of suggestions from Commission employees for improvements in the work efficiency, effectiveness, and productivity, and use of resources at the Commission, as well as allegations by Commission employees of waste, abuse, misconduct, or mismanagement within the Commission.\(^{18}\)

As of September 30, 2011, the Fund was fully funded, with an ending balance of $452,788,043.74.

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<th></th>
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<th>FY 2010</th>
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<td>$451,909,854.07</td>
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16 See Exchange Act §21F(g)(2)(A)

17 See Exchange Act §21F(g)(2)(B), which provides that the Fund shall be available to the Commission for “funding the activities of the Inspector General of the Commission under section 4(i).” The Office of the General Counsel has interpreted section 21F(g)(2)(B) to refer to Section 4D of the Exchange Act, which establishes the Inspector General's suggestion program. Subsection (e) of that section provides that the “activities of the Inspector General under this subsection shall be funded by the Securities and Exchange Commission Investor Protection Fund established under section 21F.”

18 See Exchange Act §4D(a).
The audited financial statements for the Fund, including a balance sheet, income statement and cash flow analysis are included in the Commission’s 2011 Performance and Accountability Report, separately submitted to Congress and accessible at www.sec.gov/about/secpar2011.shtml.
Appendix A: Whistleblower Tips by Allegation Type

*The 79 TCRs that whistleblowers identified as “Other,” relate to those instances when the whistleblower chose not to use one of the predefined complaint categories in the online questionnaire.*
Appendix B: Whistleblower Tips Received by Geographic Location – Domestic 8/12/2011 – 9/30/2011

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<tr>
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Appendix C: Whistleblower Tips Received by Geographic Location – Overseas 8/12/2011 – 9/30/2011

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<td>China</td>
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<tr>
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<tr>
<td><strong>Total:</strong></td>
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<td>100.0%</td>
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</tbody>
</table>
U.S. Securities and Exchange Commission

Annual Report on the Dodd-Frank Whistleblower Program

Fiscal Year 2012

This is a Report of the Staff of the U.S. Securities and Exchange Commission. The Commission has expressed no view regarding the analysis, findings, or conclusions contained herein.

November 2012
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Appendix A: Whistleblower Tips by Allegation Type – Fiscal Year 2012

Appendix B: Whistleblower Tips Received by Geographic Location – United States and its
Territories – Fiscal Year 2012

Appendix C: Whistleblower Tips Received by Geographic Location – International – Fiscal Year
2012
I. Introduction

Section 922 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”), amended the Securities Exchange Act of 1934 (the “Exchange Act”) by, among other things, adding Section 21F, entitled “Securities Whistleblower Incentives and Protection.” Section 21F directs the Commission to make monetary awards to eligible individuals who voluntarily provide original information that leads to successful Commission enforcement actions resulting in the imposition of monetary sanctions over $1,000,000, and certain successful related actions. Awards are required to be made in the amount of 10% to 30% of the monetary sanctions collected. Awards will be paid from the Commission’s Investor Protection Fund (the “Fund”). In addition, § 924(d) of the Dodd-Frank Act directs the Commission to establish a separate office within the Commission to administer and to effectuate the whistleblower program.

Section 924(d) of the Dodd-Frank Act requires the Commission’s Office of the Whistleblower (the “Office” or “OWB”) to report annually to Congress on OWB’s activities, whistleblower complaints, and the response of the Commission to such complaints. In addition, Exchange Act § 21F(g)(5) requires the Commission to submit an annual report to Congress that addresses the following subjects:

- the whistleblower award program, including a description of the number of awards granted and the types of cases in which awards were granted during the preceding fiscal year;
- the balance of the Fund at the beginning of the preceding fiscal year;
- the amounts deposited into or credited to the Fund during the preceding fiscal year;

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• the amount of earnings on investments made under Section 21F(g)(4) during the preceding fiscal year;

• the amount paid from the Fund during the preceding fiscal year to whistleblowers pursuant to Section 21F(b);

• the balance of the Fund at the end of the preceding fiscal year; and

• a complete set of audited financial statements, including a balance sheet, income statement and cash flow analysis.

This report has been prepared by OWB to satisfy the reporting obligations of Dodd-Frank Act § 924(d) and Exchange Act § 21F(g)(5). Parts II, III, and IV of this report primarily address the requirements of Dodd-Frank Act § 924(d), and Parts V and VI of this report, along with the financial statements of the Investor Protection Fund that are included in the Commission’s annual Agency Financial Report, primarily address the requirements of Exchange Act § 21F(g)(5).

II. Activities of The Office of The Whistleblower

Section 924(d) of the Dodd-Frank Act directs the Commission to establish a separate office within the Commission to administer and to enforce the provisions of Exchange Act § 21F. On February 18, 2011, the Commission announced the appointment of Sean X. McKessy to head OWB in the Division of Enforcement (“Enforcement”). On January 17, 2012, the Commission named Jane A. Norberg as the Office’s Deputy Chief. In addition to Mr. McKessy and Ms. Norberg, the Office is currently staffed by eight attorneys, three paralegals, and one program support specialist.

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6 Additionally, as of the date of this report, the Office has extended an offer to one additional attorney who is expected to join OWB shortly.
Since its establishment, OWB has focused primarily on establishing the office and implementing the whistleblower program. During Fiscal Year 2012, the Office’s activities included the following:

- Communicating with whistleblowers who have sent tips, additional information, claims for awards, and other correspondence to OWB. OWB also meets with whistleblowers, potential whistleblowers and their counsel, and consults with the staff in Enforcement to provide guidance to whistleblowers and their counsel concerning expectations and follow up;

- Reviewing and processing applications for awards;

- Working with staff in Enforcement to identify and track all enforcement cases potentially involving a whistleblower to assist in the documentation of the whistleblower’s information and cooperation in anticipation of an eventual claim for award;

- Maintaining and updating the OWB website to better inform the public about the whistleblower program (www.sec.gov/whistleblower). The website includes two videos by Mr. McKessy providing an overview of the program and information about how tips, complaints and referrals are handled. The website also contains detailed information about the program, copies of the forms required to submit a tip or claim an award, notices of covered actions, links to helpful resources, and answers to frequently asked questions;

- Supporting the initiative of the Residential Mortgage Backed Securities (RMBS) Fraud Working Group, a working group of the Financial Fraud Enforcement Task Force established by President Obama in November 2009, by establishing an online link to the OWB website from the member agencies of the RMBS Fraud Working Group for the public to submit tips and complaints about possible illegal activity in the offering and sale of residential mortgage-backed securities. The OWB website was also updated in connection with this initiative to include a page providing an overview of the RMBS Fraud Working Group and a direct link to report RMBS fraud. OWB further supported the initiative by helping to implement procedures, consistent with the confidentiality requirements of Exchange Act § 21F(h)(2), to permit the Enforcement staff to share whistleblower tips with the member agencies of the RMBS Fraud Working Group;

- Providing extensive training on the Dodd-Frank Act and the Commission’s implementing rules (the “Final Rules”)\(^7\) to the Commission’s staff. This included in-person training and educational sessions in seven of the eleven Regional Offices, video-linked training to the entire Enforcement staff, as well as training in the Home Office;

\(^7\) 240 C.F.R. § 21F-1 through 21F-17.
• Establishing and implementing internal policies, procedures, and protocols;

• Manning a publicly-available whistleblower hotline for members of the public to call with questions about the program. OWB attorneys return all calls within 24 business hours. During the 2012 fiscal year, the Office returned over 3,050 phone calls from members of the public;8

• Reviewing and entering whistleblower tips received by mail and fax into the Commission’s Tips, Complaints, and Referrals System (the “TCR System”);

• Conferring with regulators from other agencies’ whistleblower offices, including the Internal Revenue Service, Commodity Futures Trading Commission, Department of Justice, and Department of Labor (OSHA), to discuss best practices and experiences;

• Publicizing the program actively through participation in webinars, media interviews, presentations, press releases, and other public communications;9 and

• Providing ongoing guidance to Commission staff regarding various aspects of the program, including the development of internal policies for the handling of confidential whistleblower identifying information.

III. Whistleblower Tips Received During Fiscal Year 2012

The Final Rules specify that individuals who would like to be considered for a whistleblower award must submit their tip to OWB on Form-TCR either via facsimile or mail or via the Commission’s online TCR questionnaire portal. All whistleblower tips received by the Commission are entered into the TCR System, the Commission’s centralized database for the prioritization, assignment, and tracking of TCRs received from the public.

In Fiscal Year 2012, 3,001 whistleblower TCRs were received. Appendix A lists, by subject matter and month, the number of whistleblower tips received during the 2012 fiscal year. The most common complaint categories reported by whistleblowers were Corporate Disclosures and

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8 Since the hotline was established in May 2011, the Office returned approximately 3,700 phone calls from members of the public through the end of the 2012 fiscal year.

Financials (18.2%), Offering Fraud (15.5%), and Manipulation (15.2%). The Commission received whistleblower submissions from individuals in all 50 states, the District of Columbia and the U.S. territory of Puerto Rico, as well as 49 countries outside the United States. Appendices B and C set forth tabular presentations of the sources of foreign and domestic whistleblower tips.

IV. **Processing of Whistleblower Tips During Fiscal Year 2012**

OWB currently leverages the resources and expertise of the Commission’s Office of Market Intelligence (“OMI”) to evaluate incoming whistleblower TCRs and to assign specific, timely, and credible TCRs to members of the Enforcement staff for further investigation.

During the evaluation process, both staff and supervisors in OMI examine each tip to identify those that are sufficiently specific, timely, and credible to warrant the further allocation of Commission resources. Tips that relate to an existing investigation are generally forwarded to the staff working the existing matter. Tips that could benefit from the specific expertise of another Division or Office within the Commission are generally forwarded to staff in that Division or Office for further analysis. When appropriate, tips that fall within the jurisdiction of another federal or state agency are forwarded to the Commission contact at that agency, provided this can be done consistent with the confidentiality requirements of Exchange Act § 21F(h)(2). Tips that relate to the financial affairs of an individual investor or a discrete investor group, and that are determined not to be strong candidates for further expenditure of the Commission’s investigative resources, are usually forwarded to the Office of Investor Education and Advocacy (“OIEA”). Comments or questions about agency practice or the federal securities laws are also forwarded to OIEA.

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10 The Commission also receives TCRs from individuals who do not wish or are not eligible to be considered for an award under the whistleblower program. The data in this report is limited to those TCRs that include the required whistleblower declaration and does not reflect all TCRs received by the Commission during the fiscal year.
OWB supports the tip allocation and investigative processes in several ways. When whistleblowers submit tips on Form TCR in hard copy via mail or fax, OWB enters this information into the TCR System so it can be evaluated. During the evaluation process, OWB may assist by contacting the whistleblower to obtain additional information, or may participate in the qualitative assessment of the best course of action to take in response to a whistleblower tip. During an investigation, OWB is available as needed to serve as a liaison between the whistleblower (and his or her counsel) and investigative staff. On occasion, OWB arranges meetings between whistleblowers and subject matter experts on the Enforcement staff to assist in better understanding the whistleblowers’ submissions and developing the facts of specific cases. OWB staff also communicates frequently with Enforcement staff with respect to the timely documentation of information regarding the staff’s interactions with whistleblowers, the value of the information provided by whistleblowers, and the assistance provided by whistleblowers as the potential securities law violation is being investigated.

V. Whistleblower Incentive Awards Made During Fiscal Year 2012

OWB posts a Notice of Covered Action for each Commission enforcement action where a final judgment or order, by itself or together with other prior judgments or orders in the same action issued after July 21, 2010, results in monetary sanctions exceeding $1 million. Once a Notice of Covered Action is posted, individuals have 90 calendar days to apply for an award by submitting a completed Form WB-APP to OWB by the claim due date listed for that action.

Timely submitted applications are reviewed by the staff designated by the Director of Enforcement (“Claims Review Staff”) in accordance with the criteria set forth in the Dodd-Frank

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11 Tips that are submitted by whistleblowers through the Commission’s online Tips, Complaints and Referrals questionnaire are automatically forwarded to OMI for evaluation.
Act and Final Rules. The Claims Review Staff is currently comprised of four senior officers in Enforcement and a senior attorney in the Office of the General Counsel. To assist the Claims Review Staff in its review, OWB prepares a binder of relevant documents and a recommendation concerning the appropriate disposition of the award claim. The Claims Review Staff then makes a Preliminary Determination setting forth its assessment as to whether the claim should be allowed or denied and, if allowed, setting forth the proposed award percentage amount. If a claim is denied and the applicant does not object, then the Preliminary Determination of the Claims Review Staff becomes the Final Order of the Commission. However, an applicant can ask for reconsideration of the Preliminary Determination, in which event the Claims Review Staff considers the issues and grounds advanced in the applicant’s response, along with any supporting documentation provided. After this additional review, the Claims Review Staff issues a Proposed Final Determination, and the matter is forwarded to the Commission for its decision. In addition, all Preliminary Determinations of the Claims Review Staff that involve an award of money are forwarded to the Commission as Proposed Final Determinations irrespective of whether the applicant objected to the Preliminary Determination. These procedures ensure that all claims for which a monetary award is recommended and all preliminary denials of claims to which the applicant objects are put before the Commission for final decision. Within 30 days of receiving notice of the Proposed Final Determination, any Commissioner may request that the Proposed Final Determination be reviewed by the full Commission. If no Commissioner requests such a review within the 30-day period, then the Proposed Final Determination will become the Final Order of the Commission. In the event a Commissioner requests a review, the Commission reviews the record that the Claims Review Staff relied upon in making its determinations and issues its Final Order.
During Fiscal Year 2012, the Commission made its first award under the whistleblower program. On August 21, 2012, a whistleblower who had helped the Commission stop an ongoing multi-million dollar fraud received an award of 30 percent -- the maximum percentage payout allowed by law -- of the amount collected in the Commission’s enforcement action against the perpetrators of the scheme.\(^{12}\) The award recipient in this matter submitted a tip concerning the fraud and then provided documents and other significant information that allowed the Commission’s investigation to move at an accelerated pace and ultimately led to the filing of an emergency action in federal court to prevent the defendants from ensnaring additional victims and further dissipating investor funds.\(^{13}\) The whistleblower’s assistance led to the court ordering more than $1 million in sanctions, of which approximately $150,000 had been collected by the end of the fiscal year. In accordance with the 30 percent award determination, on August 21, 2012, the whistleblower was paid nearly $50,000. Motions for additional judgments are currently pending before the court and any additional collections or increase in the sanctions ordered and collected will increase the amount paid to the whistleblower.\(^{14}\) As noted below, whistleblowers receive their awards from the Securities and Exchange Commission Investor Protection Fund (“Fund”) established pursuant to Section 922 of the Dodd-Frank Act.

During the 2012 fiscal year, OWB posted 143 Notices of Covered Action for enforcement judgments and orders issued during the applicable period that included the imposition of sanctions

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\(^{12}\) Exchange Act Release No. 67698 (Aug. 21, 2012). The Commission also denied a claim from a second individual seeking an award in this same matter because the information provided did not lead or significantly contribute to the Commission’s successful enforcement action, as required under the Dodd-Frank Act and the Final Rules for a whistleblower award.

\(^{13}\) The statutory obligation under the Dodd-Frank Act to protect the identity of whistleblowers under the program precludes us from providing additional details as to the whistleblower who was paid and the covered action to which payment related.

\(^{14}\) An additional payment of over $500 was made to the whistleblower in September, 2012, representing 30 percent of additional sanctions collected in connection with the case.
exceeding the statutory threshold of $1 million. OWB is continuing to review and process applications for awards received during the 2012 fiscal year.

VI. Securities and Exchange Commission Investor Protection Fund

Section 922 of the Dodd-Frank Act established the Fund to provide funding for the Commission's whistleblower award program, including the payment of awards in related actions. In addition, the Fund is used to finance the operations of the SEC Office of the Inspector General’s suggestion program. The suggestion program is intended for the receipt of suggestions from Commission employees for improvements in the work efficiency, effectiveness, and productivity, and use of resources at the Commission, as well as allegations by Commission employees of waste, abuse, misconduct, or mismanagement within the Commission.

The following table provides certain of the information required by Exchange Act § 21F(g)(5) for the 2012 fiscal year (October 1, 2011 through September 30, 2012). As of

15 By posting a Notice of Covered Action for a particular case, the Commission is not making any determinations either that (i) a whistleblower tip, complaint or referral led to the Commission opening an investigation or filing an action with respect to the case or (ii) an award to a whistleblower will be paid in connection with the case.


17 See Exchange Act §21F(g)(2)(B), which provides that the Fund shall be available to the Commission for “funding the activities of the Inspector General of the Commission under section 4(i).” The Office of the General Counsel has interpreted section 21F(g)(2)(B) to refer to Section 4D of the Exchange Act, which establishes the Inspector General's suggestion program. Subsection (e) of that section provides that the “activities of the Inspector General under this subsection shall be funded by the Securities and Exchange Commission Investor Protection Fund established under Section 21F.”

18 See Exchange Act §4D(a).
September 30, 2012, the Fund was fully funded, with an ending balance of $453,429,825.58.

<table>
<thead>
<tr>
<th>FY 2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance of Fund at beginning of fiscal year</td>
</tr>
<tr>
<td>$452,788,043.74</td>
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<tr>
<td>Amounts deposited into or credited to Fund</td>
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<tr>
<td>during fiscal year</td>
</tr>
<tr>
<td>$0.00(^\text{19})</td>
</tr>
<tr>
<td>Amount of earnings on investments during</td>
</tr>
<tr>
<td>fiscal year</td>
</tr>
<tr>
<td>$757,248.07</td>
</tr>
<tr>
<td>Amount paid from Fund during fiscal year</td>
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<tr>
<td>to whistleblowers</td>
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<tr>
<td>($45,739.16)</td>
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<tr>
<td>Amount disbursed to Office of the Inspector</td>
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<td>General during fiscal year</td>
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<tr>
<td>($69,727.07)</td>
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<tr>
<td>Balance of Fund at end of the fiscal year</td>
</tr>
<tr>
<td>$453,429,825.58</td>
</tr>
</tbody>
</table>

The audited financial statements for the Fund, including a balance sheet, income statement, and cash flow analysis are included in the Commission’s Agency Financial Report, separately submitted to Congress and accessible at http://www.sec.gov/about/secafr2012.shtml.

\(^{19}\) Pursuant to Exchange Act § 21F(g)(3), no monetary sanctions are deposited into or credited to the Fund if the balance of the Fund exceeds certain thresholds at the time the monetary sanctions are collected.
Appendix A: Whistleblower Tips by Allegation Type – Fiscal Year 2012

![Graph showing whistleblower tips by allegation type and month for Fiscal Year 2012.](image)

<table>
<thead>
<tr>
<th>WB TCR Allegation Type by Month</th>
<th>Corporate Disclosure and Financials</th>
<th>Offering Fraud</th>
<th>Manipulation</th>
<th>Insider Trading</th>
<th>Trading and Pricing</th>
<th>FCPA</th>
<th>Unregistered Offerings</th>
<th>Market Event</th>
<th>Municipal Securities and Public Pension</th>
<th>Other*</th>
<th>Blank</th>
<th>Total</th>
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<tr>
<td>11-Oct</td>
<td>41</td>
<td>38</td>
<td>30</td>
<td>13</td>
<td>13</td>
<td>12</td>
<td>8</td>
<td>9</td>
<td>3</td>
<td>45</td>
<td>4</td>
<td>216</td>
</tr>
<tr>
<td>11-Nov</td>
<td>42</td>
<td>21</td>
<td>23</td>
<td>13</td>
<td>5</td>
<td>7</td>
<td>2</td>
<td>2</td>
<td>5</td>
<td>43</td>
<td>3</td>
<td>166</td>
</tr>
<tr>
<td>11-Dec</td>
<td>34</td>
<td>28</td>
<td>26</td>
<td>12</td>
<td>17</td>
<td>5</td>
<td>4</td>
<td>5</td>
<td>7</td>
<td>59</td>
<td>12</td>
<td>209</td>
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<tr>
<td>12-Jan</td>
<td>31</td>
<td>30</td>
<td>39</td>
<td>8</td>
<td>12</td>
<td>4</td>
<td>8</td>
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<td>33</td>
<td>42</td>
<td>16</td>
<td>13</td>
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<td>10</td>
<td>7</td>
<td>2</td>
<td>52</td>
<td>19</td>
<td>253</td>
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<tr>
<td>12-Mar</td>
<td>51</td>
<td>35</td>
<td>34</td>
<td>15</td>
<td>7</td>
<td>17</td>
<td>7</td>
<td>9</td>
<td>6</td>
<td>81</td>
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<td>275</td>
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<td>12-Apr</td>
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<td>11</td>
<td>8</td>
<td>13</td>
<td>10</td>
<td>2</td>
<td>3</td>
<td>72</td>
<td>9</td>
<td>278</td>
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<tr>
<td>12-May</td>
<td>62</td>
<td>44</td>
<td>60</td>
<td>27</td>
<td>16</td>
<td>7</td>
<td>14</td>
<td>6</td>
<td>16</td>
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<td>10</td>
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<td>12-Jun</td>
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<td>7</td>
<td>3</td>
<td>67</td>
<td>10</td>
<td>257</td>
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<tr>
<td>12-Jul</td>
<td>52</td>
<td>40</td>
<td>36</td>
<td>23</td>
<td>11</td>
<td>6</td>
<td>5</td>
<td>16</td>
<td>2</td>
<td>46</td>
<td>8</td>
<td>245</td>
</tr>
<tr>
<td>12-Aug</td>
<td>43</td>
<td>81</td>
<td>29</td>
<td>21</td>
<td>13</td>
<td>10</td>
<td>18</td>
<td>4</td>
<td>4</td>
<td>60</td>
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<td>299</td>
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<tr>
<td>12-Sep</td>
<td>36</td>
<td>45</td>
<td>44</td>
<td>17</td>
<td>14</td>
<td>11</td>
<td>6</td>
<td>10</td>
<td>1</td>
<td>78</td>
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<td>270</td>
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<tr>
<td>FY 2012 Total</td>
<td>547</td>
<td>465</td>
<td>457</td>
<td>190</td>
<td>144</td>
<td>115</td>
<td>100</td>
<td>85</td>
<td>64</td>
<td>703</td>
<td>131</td>
<td>3001</td>
</tr>
<tr>
<td>Percent</td>
<td>18.20%</td>
<td>15.50%</td>
<td>15.20%</td>
<td>6.30%</td>
<td>4.80%</td>
<td>3.80%</td>
<td>3.30%</td>
<td>2.80%</td>
<td>2.10%</td>
<td>23.40%</td>
<td>4.40%</td>
<td>100.00%</td>
</tr>
</tbody>
</table>

* “Other” indicates that the submitter has identified their WB TCR as not fitting into any allegation category that is listed on the online questionnaire.
Appendix B: Whistleblower Tips Received by Geographic Location – United States and its Territories – Fiscal Year 2012*

The total number of WB TCRs originating within the United States and its territories for Fiscal Year 2012 was 2507, which constitutes 83.5% of total WB TCRs received for this period. Additionally, 170 WB TCRs constituting 5.7% of total WB TCRs received for Fiscal Year 2012 were submitted without any foreign or domestic geographical categorization.
The total number of Whistleblower Tips Received by Geographic Location – International - Fiscral Year 2012.
Evaluation of the SEC’s Whistleblower Program
MEMORANDUM

January 18, 2013

TO: Robert S. Khuzami, Director, Division of Enforcement
(Enforcement)

FROM: Jon T. Rymer, Interim Inspector General, Office of Inspector General (OIG)

SUBJECT: Evaluation of the SEC’s Whistleblower Program, Report No. 511

This memorandum transmits the U.S. Securities and Exchange Commission (SEC) OIG’s final report detailing the results of our audit of the SEC’s whistleblower program. Our audit was conducted pursuant to Section 922 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

The final report contains two recommendations which if fully implemented should strengthen the SEC’s whistleblower program. Enforcement concurred with both recommendations. Your written response to the draft report is included in Appendix VI.

Within the next 45 days please provide OIG with a written corrective action plan (CAP) that addresses each agreed upon recommendation. The CAP should include information such as the name of the designated responsible official or point of contact for the recommendations, estimated timeframes for completing required actions, and milestones identifying how each recommendation will be addressed.

Should you have any questions regarding this report, please do not hesitate to contact me.
We appreciate the courtesy and cooperation that your staff extended to us during this audit.

Attachment

cc: Erica Y. Williams, Deputy Chief of Staff, Office of the Chairman
    Luis A. Aguilar, Commissioner
    Troy A. Paredes, Commissioner
    Daniel M. Gallagher, Commissioner
    George S. Canellos, Deputy Director, Division of Enforcement
    Sean X. McKessy, Chief, Office of the Whistleblower, Division of Enforcement
    Jeff Heslop, Chief Operating Officer, Office of the Chief Operating Officer
Evaluation of the SEC’s Whistleblower Program

Executive Summary

Background. Section 922 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), amended the Securities Exchange Act of 1934 (Exchange Act) by adding Section 21F, “Securities Whistleblower Incentives and Protection.” Section 21F directs the U.S. Securities and Exchange Commission (SEC or Commission) to make monetary awards to eligible individuals who voluntarily provide original information that leads to successful Commission enforcement actions resulting in the imposition of monetary sanctions over $1,000,000, and certain related successful actions. The SEC can make awards ranging from 10 to 30 percent of the monetary sanctions collected, which are paid from the SEC’s Investor Protection Fund (IPF). In addition, Section 924(d) of Dodd-Frank directed the SEC to establish a separate office within the Commission to administer the whistleblower program. In February 2011, the Commission established the Office of the Whistleblower (OWB) to carry out this function.

On May 25, 2011, the Commission adopted final Regulation 21F to implement the provisions of Section 21F of the Exchange Act. Regulation 21F became effective on August 12, 2011. Among other things, Regulation 21F defines terms that are essential to the whistleblower’s program operations, establishes procedures for submitting tips and applying for awards – including appeals of Commission determinations, and whether and to whom to make an award; describes the criteria the SEC will consider in making award decisions, and implements Dodd-Frank’s prohibition against retaliation for whistleblowing.

OIG met with OWB’s Chief and Deputy Chief to discuss how the office handles whistleblower complaints from the initial submission of a complaint, to the eligible whistleblower receiving a monetary award. Our audit included a review of OWB’s procedures, decision points, whistleblower personnel practices, and its communications with the whistleblower.

The whistleblower process includes the following phases which are discussed in the report:

1. Phase 1 - Intake/Triage.
2. Phase 2 - Tracking.
3. Phase 3 - Claim for an Award.
Congressional Requirement. Section 922 of Dodd-Frank required the Office of Inspector General (OIG) to conduct a review of the whistleblower protections that were established under the amendments made by the section and to submit a report of findings not later than 30 months after Dodd-Frank’s enactment to the (1) Senate Committee on Banking, Housing, and Urban Affairs, and (2) House Committee on Financial Services. Dodd-Frank further required that OIG make this report available to the public on our website.

Objectives. Section 922 of the Dodd-Frank Act required OIG to evaluate the SEC’s Whistleblower Program and answer the questions as described below. OIG will examine whether the:

1. Final rules and regulation issued under the amendments of Section 922 have made the whistleblower protection program (program) clearly defined and user-friendly.
2. Program is promoted on the SEC’s website and has been widely publicized.
3. Commission is prompt in:
   a) responding to information provided by whistleblowers;
   b) responding to applications for awards filed by whistleblowers;
   c) updating whistleblowers about the status of their applications; and
   d) otherwise communicating with the interested parties.
4. Minimum and maximum reward levels are adequate to entice whistleblowers to come forward with information, and whether the reward levels are so high as to encourage illegitimate whistleblower claims.
5. Appeals process has been unduly burdensome for the Commission.
6. Funding mechanism for the Investor Protection Fund established by Section 922 is adequate.
7. In the interest of protecting investors and identifying and preventing fraud, it would be useful for Congress to consider empowering whistleblowers or other individuals, who have already attempted to pursue a case through the Commission, to have a private right of action to bring suit based on the facts of the same case, on behalf of the government and themselves, against persons who have committed securities fraud.
8. The Freedom of Information Act (FOIA) exemption established in Section 21 F(h)(2)(A) of the Securities and Exchange Act of 1934, as added by the Dodd-Frank Act,
   a) Aids whistleblowers in disclosing information to the Commission.
   b) What impact the FOIA exemption described above has had on the ability of the public to access information about the
regulation and enforcement by the Commission of securities;
and
(c) Any recommendations on whether the exemption described
above should remain in effect.

The Inspector General was also given the discretion to review other matters
related to the program as appropriate.

Prior OIG Audit Reports. In March 2010, OIG conducted an audit of SEC’s now
defunct bounty program and issued *Assessment of the SEC’s Bounty Program*,
Report No. 474 on March 29, 2010. The objectives of this audit were to:

(1) Assess whether necessary management controls have been
established and operate effectively to ensure bounty applications
are routed to appropriate personnel and are properly processed
and tracked; and

(2) Determine whether other government agencies with similar
programs have best practices that could be incorporated into the
SEC bounty program.

Although the SEC had an established bounty program for more than 20 years
that rewarded whistleblowers for insider trading tips and complaints, OIG’s report
found there were very few payments made under the program and the
Commission received very few applications from individuals seeking a bounty.
The report also found that the program was not widely recognized inside or
outside the Commission. Finally, the report determined the SEC’s bounty
program was not fundamentally well-designed to be successful.

Results. The implementation of the final rules made the SEC’s whistleblower
program clearly defined and user-friendly for users that have basic securities
laws, rules, and regulations knowledge. The whistleblower program is promoted
on the SEC’s website and the public can access OWB’s website from the site in
four or more possible ways to learn about the whistleblower program or to file a
complaint with the SEC. Additionally, OWB outreach efforts have been strong
and the SEC’s whistleblower program can be promptly located using internet
search engines such as Google, Yahoo, and Bing.

The SEC generally is prompt in responding to information that is provided by
whistleblowers, applications for whistleblower awards, and in communicating with
interested parties. However, the whistleblower program’s internal controls need
to be strengthened by adding performance metrics.

The SEC’s whistleblower program’s award levels are comparable to the award
levels of other federal government whistleblower programs, and range from 10 to
a maximum 30 percent. Based on our review of past experience of other
whistleblower programs and practical concerns in the administration of the SEC’s program, we determined the SEC’s award levels are reasonable and should not change at this time.

Currently no whistleblower appeals have been filed with the Federal Court of Appeals. However, one whistleblower has appealed a preliminary determination made by the Claims Review Staff. Based on our analysis of the appeals process we do not anticipate that it has been unduly burdensome for the Commission.

Further, we determined that the funding mechanism for the Investor Protection Fund established by Section 922 is adequate. However, we found at this time it is too premature to introduce a private right of action into the SEC’s whistleblower program because it has only been in place since August 2011. A fundamental change in approach would disrupt the system currently in place. Upon collecting additional data and assessing the effectiveness of the program after a reasonable amount of time has passed, OIG will be in a better position to opine on the usefulness of adding a private right of action to the SEC’s whistleblower program.

Finally, we found the FOIA exemption that was added by Dodd-Frank aids whistleblowers in disclosing information to the Commission by providing an additional safeguard for whistleblower confidentiality. This exemption essentially had no impact on the public’s ability to access information regarding the SEC’s regulation and enforcement of federal securities laws. Therefore, we determined the exemption should be retained.

Summary of Recommendations. This report contains two recommendations that were developed to aid the SEC in establishing performance metrics for key processes in its whistleblower program and to facilitate the Commission’s monitoring of the whistleblower program’s performance.

Management’s Response to the Report’s Recommendations. OIG provided Enforcement with the formal draft report on January 11, 2013. Enforcement concurred with both recommendations in this report. OIG considers the report recommendations resolved. However, the recommendations will remain open until documentation is provided to OIG that supports each recommendation has been fully implemented.

Enforcement’s response to each recommendation and OIG’s analysis of their responses are presented after each recommendation in the body of this report.
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Background and Objectives

Background

Section 922 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) amended the Securities Exchange Act of 1934 (Exchange Act) by adding Section 21F, “Securities Whistleblower Incentives and Protection.” Section 21F directs the U.S. Securities and Exchange Commission (SEC or Commission) to make monetary awards to eligible individuals who voluntarily provide original information that leads to successful Commission enforcement actions resulting in the imposition of monetary sanctions over $1,000,000, and certain related successful actions. The SEC can make awards ranging from 10 to 30 percent of the monetary sanctions collected, which are paid from its Investor Protection Fund (IPF). In addition, Section 924(d) of Dodd-Frank directed the SEC to establish a separate office within the Commission to administer the whistleblower program. In February 2011, the Commission established the Office of the Whistleblower (OWB) to carry out this function.

Section 922 of Dodd-Frank required the Office of Inspector General (OIG) to conduct a review of the whistleblower protections that were established under the amendments made by the section and to submit a report of findings not later than 30 months after Dodd-Frank’s enactment to the:

- Senate Committee on Banking, Housing and Urban Affairs; and
- House Committee on Financial Services.

Dodd-Frank further required that OIG make this report available to the public on our website.

Overview of the SEC’s Whistleblower Program. On May 25, 2011, the Commission adopted final Regulation 21F to implement the provisions of Section 21F of the Exchange Act. Regulation 21F became effective on August 12, 2011. Among other things, Regulation 21F defines terms that are essential to the whistleblower program’s operations, establishes procedures for submitting tips and applying for awards including appeals of Commission determinations whether/or to whom to make an award, describes the criteria the SEC will consider in making award decisions, and implements Dodd-Frank’s prohibition against retaliation for whistleblowing.

OIG met with OWB’s Chief and Deputy Chief to discuss how the office handles whistleblower complaints from the initial submission to an eligible whistleblower receiving a monetary award. Our audit consisted of reviewing OWB’s

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procedures, decision points, whistleblower personnel practices, and its communications with whistleblowers.

The whistleblower process includes the phases shown below and are discussed in the section that follows.

(1) Phase 1 - Intake/Triage.
(2) Phase 2 - Tracking.
(3) Phase 3 - Claim for an Award.

Phase 1 – Intake/Triage

During Phase 1 of intake and triage, whistleblowers submit a complaint to the SEC. Designated Division of Enforcement (Enforcement) staff review the complaint to determine whether it should be assigned for further investigation or based on their initial review no further action (NFA) is warranted. Whistleblowers can submit a complaint to the SEC through its public website, by mail, or by fax. Online submissions are automatically uploaded into the SEC’s Tips, Complaints, and Referrals (TCR) system. Complaints received by mail and fax are manually entered into the TCR system by the TCR intake group.

The Office of Market Intelligence (OMI), located within Enforcement, reviews all TCRs and whistleblower complaints Enforcement receives. OMI also triages all TCRs received by Enforcement. When OMI determines a complaint warrants further investigation, OMI assigns the complaint to one of the SEC’s 11 regional offices, an Enforcement specialized unit, or an Enforcement Associate Director group located in the SEC’s Headquarters. Conversely, when it is determined that a complaint does not warrant further investigation or the complaint does not fall into Enforcement’s priorities, OMI will designate the complaint as NFA. NFAs get a second review before a final decision is made to close the complaint. In some cases NFAs may be referred to an external government agency or other agency for action.

On occasion the OWB Chief will determine that a whistleblower TCR is sufficiently specific, timely and credible which results in the TCR being expedited through the triage process and assigned to investigative staff by OMI.

Communication with the Whistleblower. OWB sends an acknowledgement or deficiency letter to whistleblowers for all complaints that are received by mail or fax. This letter includes a TCR submission number and if applicable, a discussion of any deficiencies the office identified such as a missing TCR form.

\[2\] While OMI reviews all TCRs submitted through the public portal and most TCRs submitted internally, some internally-entered TCRs are routed, as appropriate, to the Office of Compliance Inspections and Examinations or the Office of Investor Education and Advocacy directly and not reviewed by OMI.
(which is required), missing signatures, etc. The letter further provides guidance to the whistleblower regarding resolving the issue.

OWB also sends whistleblowers an acknowledgement letter when they subsequently submit additional information that is used to supplement their complaint.

Whistleblowers that use the SEC’s website to submit a complaint through the TCR system receive a computer generated online confirmation receipt and are provided a TCR submission number.

Additionally, phone calls to the whistleblower hotline are returned within 24 business hours.

**Phase 2 – Tracking**

During Phase 2, OWB personnel monitor whistleblower submissions that are assigned to investigative staff. Also, during this Phase, OWB––tracks whistleblower cases to document the whistleblower’s cooperation and the content and helpfulness of whistleblower information, answers questions, and aids Enforcement staff by providing subject matter expertise regarding the whistleblower program.

Furthermore, OWB documents information needed to process whistleblower awards. The office conducts quarterly conference calls with investigative staff to reconcile items that are tracked, with work that is assigned and resourced, and to discuss the quality of each whistleblower complaint.

A whistleblower complaint results in a successful action against a defendant if the monetary sanctions:

- Exceed $1 million. The whistleblower may then be eligible for a monetary award if all statutory criteria are met.
- Do not exceed $1 million the whistleblower is not immediately eligible for a monetary award. However, if the case is aggregated with related SEC actions that arise out of a common body of operative facts and the total monetary sanctions in the related SEC actions collectively exceed $1 million, then the whistleblower may be eligible for an award.

**Communication with the Whistleblower.** Enforcement’s policy requires its staff neither confirm nor deny that an investigation has been initiated in relation to whistleblower complaints the SEC receives. However, to further OWB’s outreach

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3 The final rules specify that a whistleblower complaint must be either submitted online through the Commission’s website, or the Form TCR must be either mailed or faxed to the SEC Office of the Whistleblower. Form TCR is located in the 17 CFR Section 249.100 final rules.
efforts to whistleblowers, the Commission gave OWB authority to communicate with whistleblowers in limited circumstances. Pursuant to this authority, OWB works closely with Enforcement and OMI staff to engage in discretionary communication with whistleblowers when appropriate, under the following circumstances:

- If NFA is determined, OWB can contact the whistleblower regarding the status of their complaint.
- If a whistleblower complaint has been assigned, OWB can inform the whistleblower their complaint has been reviewed and assigned to Enforcement staff.

Communication in these circumstances is not mandatory and is left to OWB’s discretion. Per Enforcement's policy, OWB will not tell the whistleblower whether an investigation has been initiated, based on information the whistleblower has provided to the SEC.

**Phase 3 – Claim for an Award**

During Phase 3 a whistleblower can claim an award if information he or she provided to OWB leads to, or significantly contributes to a successful SEC action. This action could result in the whistleblower receiving a monetary award if the sanctions ordered are over $1 million.\(^4\) OWB posts a Notice of Covered Action on its website for cases that result in monetary sanctions over $1 million.\(^5\) Whistleblowers have 90 days to submit a claim for an award using the Form WB-APP (application). OWB’s website provides a notice date and a claim due date for each covered whistleblower action.

When OWB or Enforcement staff know that a whistleblower has provided a tip that led or significantly contributed to a successful action, they contact the whistleblower and inform him or her that a Notice of Covered Action has been posted on its website in connection with the tip or information he or she provided. OWB also advises the whistleblower on the process and timeline to apply for the award.

When a claimant submits an application, OWB reviews it to determine if it is procedurally complete and has the information needed to fully process the application. When the application does not have all the required information, OWB works with the whistleblower to ensure he or she successfully completes the application within the 90-day required timeframe by calling and/or sending a

\(^4\) For the whistleblower program, a Commission action is considered a “covered action” under these circumstances. See Securities and Exchange Act of 1934, Section 21F(a)(1).

\(^5\) A Notice of Covered Action serves as a public notification that a particular case is potentially eligible for a whistleblower award, and it begins a 90-day deadline for any interested parties to file an application for a whistleblower award.
letter to the whistleblower that identifies deficiencies and advising the whistleblower on processes and deadlines.

OWB staff analyze the claims for awards to assess whether the whistleblower satisfied the eligibility and definitional requirements for an award. When a whistleblower is determined to have satisfied these criteria, OWB then uses four positive and three negative factors to derive a recommended award range between 10 to 30 percent of the dollar amount that was collected in the action.

OWB’s process for its analyses includes reviewing and comparing the facts of a claim to the whistleblower statute and regulations, reviewing relevant databases for information regarding the case and subsequent enforcement action, interviewing Enforcement staff regarding the case and the whistleblower’s actions, interviewing the whistleblower and/or their counsel, and conducting due diligence and legal research to ensure proper consideration is given to each award claim.

The positive factors considered in recommending an award’s percentage include the significance of the whistleblower information, assistance and cooperation from the whistleblower in the investigation and proceedings, any law enforcement interest advanced by a potentially higher award, and whether the whistleblower cooperated with the company’s internal compliance system in connection with the matter. The negative factors considered include the whistleblower’s culpability, an unreasonable delay in reporting wrongdoing, and the whistleblower’s interference with the company’s internal compliance system. Though OWB considers both these positive and negative factors, the office has discretion in making award recommendations.

When making an award recommendation OWB submits a recommendation package to Enforcement’s Claims Review Staff. They then meet with the Claims Review Staff. A preliminary determination is prepared and forwarded to the whistleblower. A whistleblower has 30 days to request a copy of the record the Claims Review Staff based its decision on; and/or to request a meeting with OWB staff.

Whistleblowers can file an appeal with OWB within 60 calendar days of the later of:

(i) The date of the preliminary determination; or
(ii) The date when OWB made materials available for the whistleblower’s review.

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Pursuant to SEC Regulation 21F (the final rules for the whistleblower program) Section 240.21F-10, members of the Claims Review Staff are designated by Enforcement’s Director to evaluate all timely whistleblower award claims in accordance with the criteria established in the final rules. Based on this evaluation, the Claims Review Staff will decide on a preliminary determination and consider appeals of their decision if submitted timely. The Claims Review Staff currently has five members, including Enforcement representatives from the home office, regional offices, and a representative from the Office of General Counsel.
When a whistleblower’s claim is denied in the preliminary determination phase and the whistleblower fails to submit a timely response, the preliminary determination becomes the SEC’s final order. If the whistleblower submits a timely response to appeal the preliminary determination decision, OWB’s staff will assess the appeal and make a recommendation to the Claims Review Staff. OWB then meets again with the Claims Review Staff and the Claims Review Staff makes a proposed final determination. OWB then notifies the Commission of the proposed final determination. The Commission has 30 days to review this determination. Any Commissioner can request within 30 days of receiving the proposed final determination notification, that the proposed final determination be reviewed by the Commission. If no Commissioner objects during the 30-day window, the proposed final determination becomes the final order and OWB then provides a copy of the final order to the whistleblower.

After the final order has been issued, if a whistleblower has gotten an award that falls between 10 to 30 percent of the monetary sanctions collected in the action, the process is complete and the amount is not subject to appeal. However, if the whistleblower did not receive an award, or the award percentage is outside the statutory 10 to 30 percent that is collected from an action, the whistleblower may appeal the decision at the Federal Court of Appeals level. The Office of the General Counsel (OGC) handles these appeals for the Commission.

Whistleblower awards are paid out of the IPF that was established in the Dodd-Frank Act. Payments from the IPF are made through the SEC’s Office of Financial Management (OFM) and are based on amounts that were collected from each individual case. A single payment can be made to the whistleblower if all monies are collected at the time the final order is issued, or the payment can occur on a rolling basis if the monies are collected over time, after the final order is issued.

**Communication with Whistleblowers.** To the extent a whistleblower is known to have participated in a covered action, OWB contacts the whistleblower to advise him or her that a Notice of Covered Action was posted on OWB’s website and provide guidance on the processes and timeline to apply for an award.

An acknowledgement or deficiency letter is sent to anyone who submits a claim for an award to the SEC. The OWB may discuss with the whistleblower the evidence that was presented when assembling the claims recommendation package for the Claims Review Staff.

Whistleblowers have the right to review the record, to request a meeting with OWB, and/or to appeal a preliminary determination decision. A copy of the preliminary determination, proposed final determination, if applicable, and the final order is sent to the whistleblower.
Objectives

Objectives. Section 922 of the Dodd-Frank Act required OIG to evaluate the SEC’s Whistleblower Program and answer the questions described below. OIG will examine whether the:

1. Final rules and regulation issued under the amendments of Section 922 have made the whistleblower protection program (program) clearly defined and user-friendly.
2. Program is promoted on the SEC’s website and has been widely publicized.
3. Commission is prompt in:
   a) responding to information provided by whistleblowers;
   b) responding to applications for awards filed by whistleblowers;
   c) updating whistleblowers about the status of their applications; and
   d) otherwise communicating with the interested parties.
4. Minimum and maximum reward levels are adequate to entice whistleblowers to come forward with information, and whether the reward levels are so high as to encourage illegitimate whistleblower claims.
5. Appeals process has been unduly burdensome for the Commission.
6. Funding mechanism for the Investor Protection Fund established by Section 922 is adequate.
7. In the interest of protecting investors and identifying and preventing fraud, it would be useful for Congress to consider empowering whistleblowers or other individuals, who have already attempted to pursue a case through the Commission, to have a private right of action to bring suit based on the facts of the same case, on behalf of the government and themselves, against persons who have committed securities fraud.
8. The Freedom of Information Act (FOIA) exemption established in Section 21 F(h)(2)(A) of the Securities and Exchange Act of 1934, as added by the Dodd-Frank Act,
   a) Aids whistleblowers in disclosing information to the Commission.
   b) What impact the FOIA exemption described above has had on the ability of the public to access information about the regulation and enforcement by the Commission of securities; and
   c) Any recommendations on whether the exemption described above should remain in effect.
The Inspector General was also given the discretion to review other matters related to the program as appropriate for this audit.

**Omission of Sensitive Information.** Pursuant to Section 21F(h)(2) of the Exchange Act, we have not included any information in this report that could potentially reveal the identity of a whistleblower.
OIG’s Audit and Response to the Dodd-Frank Wall Street Reform and Consumer Protection Act’s Questions and Our Recommendations

Question 1: Determine Whether Final Rules and Regulation Issued Under the Amendments of Section 922 Have Made the Whistleblower Protection Program Clearly Defined and User-Friendly

Pursuant to the Dodd-Frank Act, Section 922(d)(1)(A), we assessed whether the final rules and regulations issued under the amendments of Section 922 have made the whistleblower protection program clearly defined and user-friendly. OIG determined that the implementation of the final rules have made the SEC’s whistleblower program clearly defined and user-friendly for users that have basic securities laws, rules, and regulations knowledge.

Final Rules Primary Audience Has Some Knowledge of Securities Laws, Rules, and Regulations

According to the OWB Chief, the final rules were primarily written for potential whistleblowers, compliance officers, corporate counsel, and law firms that are engaged in whistleblower litigation. The final rules generally exclude certain people from receiving awards under the whistleblower program such as directors, corporate officers, compliance officers, and auditors with some exceptions. The primary demographic for prospective whistleblowers include middle management personnel, controllers, finance department personnel, and other employees who are involved in international transactions. Prospective whistleblowers may submit tips or complaints related to securities law violations to the SEC. Prospective whistleblowers generally have some securities laws, rules,

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8 17 CFR 240 Section 21F-4(b)(4) excludes information from several sources as meeting the definition of providing “original information” required in the definition of a whistleblower. Some examples include information obtained under attorney-client privilege, if you obtain information because you were an officer, director, trustee, compliance officer, internal auditor, public accountant in an engagement required by the securities laws, etc. The rules provide for some exceptions whereby the above classes of people may submit original information as a whistleblower.
9 Employees involved in international transactions may have knowledge about the Foreign Corrupt Practices Act violations which is a reportable violation under the SEC’s whistleblower program.
regulations knowledge and an understanding of the SEC’s role in the financial markets.

The OWB has a hotline telephone number on its website that potential whistleblowers can call to inquire about the SEC’s whistleblower program. OWB’s Chief informed us that most hotline callers did not indicate they did not understand the rules, but instead, wanted reassurance from OWB’s staff regarding the filing process concerning their cases, before filing a formal complaint with the SEC.

OIG reviewed the final rules from the perspective of an individual having basic knowledge of securities laws, rules, and regulations to determine whether they were clearly defined and user-friendly. Clearly defined final rules are specific, straightforward, and unambiguous. User-friendly final rules are easy to learn, use, understand, and navigate. OIG identified attributes of the final rules that make SEC’s whistleblower program “clearly defined” and “user-friendly.” As shown below, Tables 1 and 2 illustrate our review and assessment of the final rules.

Table 1: OIG’s Review and Assessment of Final Rules – Clearly Defined

<table>
<thead>
<tr>
<th>Clearly Defined Attributes</th>
<th>Text of Final Rules</th>
</tr>
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<tbody>
<tr>
<td>Defines a whistleblower.</td>
<td>You are a <strong>whistleblower</strong> if, alone or jointly with others, you provide the Commission with information pursuant to the procedures set forth in Section 240.21F-9(a) of this chapter, and the information relates to a possible violation of the federal securities laws (including any rules or regulations thereunder) that has occurred, is ongoing, or is about to occur. A whistleblower must be an individual. A company or another entity is not eligible to be a whistleblower.</td>
</tr>
<tr>
<td>Explains the conditions required to receive an award.</td>
<td>The Commission will pay an <strong>award</strong> or awards to one or more whistleblowers who: (1) Voluntarily provide the Commission (2) With original information (3) That leads to the successful enforcement by the Commission of a federal court or administrative action (4) In which the Commission obtains monetary sanctions totaling more than $1,000,000.</td>
</tr>
<tr>
<td>Clearly explains the pertinent terms related to receiving an award.</td>
<td>The terms <strong>voluntarily</strong>, <strong>original information</strong>, leads to successful enforcement, action, and monetary sanctions are defined in Section 240.21F-4 of this chapter.</td>
</tr>
</tbody>
</table>

Source: 17 CFR Parts 240 and 249
Table 2: OIG’s Review and Assessment of the Final Rules – User-Friendly

<table>
<thead>
<tr>
<th>User-Friendly Attributes</th>
<th>Text of Final Rules</th>
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<tbody>
<tr>
<td>Outlines procedures for submitting original information.</td>
<td>To be considered a whistleblower . . . , you must submit your information about a possible securities law violation by either of these methods: (1) Online, through the Commission’s website located at <a href="http://www.sec.gov">www.sec.gov</a>; or (2) By mailing or faxing a Form TCR (Tip, Complaint or Referral) (referenced in Section 249.1800 of this chapter) to the SEC Office of the Whistleblower, 100 F Street NE, Washington, DC 20549-5631, Fax (703) 813-9322.</td>
</tr>
<tr>
<td>Outlines procedures for making a claim for a whistleblower award.</td>
<td>A claimant will have ninety (90) days from the date of the Notice of Covered Action to file a claim for an award based on that action, or the claim will be barred. To file a claim for a whistleblower award, you must file Form WB-APP, Application for Award for Original Information Provided Pursuant to Section 21F of the Securities Exchange Act of 1934 (referenced in Section 249.1801 of this chapter). You must sign this form as the claimant and submit it to the Office of the Whistleblower by mail or fax.</td>
</tr>
</tbody>
</table>

Source: 17 CFR Parts 240 and 249

OIG determined that an individual with basic securities laws, rules, and regulations knowledge can easily understand the SEC’s whistleblower program requirements by reading the final rules and information the SEC provides on its website. Further, the procedures for submitting original information (i.e., a whistleblower complaint) or an application for an award are easy to understand and navigate. 10 Finally, OWB’s website, which is discussed in-depth in the next section, enhances the “user-friendliness” of the program by providing a direct link to the final rules and answering commonly asked questions about the program. The OWB hotline is also available to address questions about the SEC’s whistleblower program. Therefore, OIG determined that the final rules as implemented by OWB have made the program clearly defined and user-friendly for individuals having basic securities laws, rules, and regulations knowledge.

10 The final rules state that the whistleblower must submit “original information” in order to be eligible for a whistleblower award. In order for a whistleblower submission (or complaint) to be considered original information, it must be: (i) derived from the whistleblower’s independent knowledge or analysis; (ii) not already known to the Commission from any other source, unless the whistleblower is the original source of the information; (iii) not exclusively derived from an allegation made in a judicial or administrative hearing, in a government report, hearing, audit, or investigation, or from the news media, unless the whistleblower is a source of the information; and (iv) provided to the Commission for the first time after July 21, 2010, Dodd-Frank Wall Street Reform and Consumer Protection Act enactment date.
Question 2: Determine Whether the Whistleblower Program is Promoted on the SEC’s Website and has been Widely Publicized

Pursuant to the Dodd-Frank Act, Section 922(d)(1)(B), OIG determined that the whistleblower program is promoted on the SEC’s website, that OWB’s website is readily accessible from the SEC’s website and the program has been widely publicized by a strong internet presence and OWB’s outreach efforts.

The Whistleblower Program on the SEC’s Website and Accessibility to OWB’s Website

OIG tested the ease of accessing whistleblower information on the SEC's website to determine if this information is prominently displayed and promoted. We determined that information about the whistleblower program is prominently displayed on the SEC’s website and OWB’s website is easily accessible. SEC’s website includes images related to SEC programs that rotate on its website every few seconds. One image consists of a large whistle with the caption “Whistleblower Information” that has a hyperlink to OWB’s website. The SEC’s website also includes a “Submit a Tip or File a Complaint” hyperlink that takes users to a “Questions and Complaints” webpage. This webpage also includes hyperlinks that take the public directly to OWB’s website.

Overall, OWB’s website can be accessed from SEC’s website in several different ways. See Appendix V for detailed information on accessing OWB’s website.

OIG’s review of the SEC’s website activity determined that OWB’s website received 135,906 hits from August 2011 to September 2012. From July 2012 to September 2012, OWB’s website was ranked in the top 100 most viewed SEC uniform resource locators (URL).11

The SEC’s whistleblower program has been promoted on OWB’s website since August 12, 2011, when the whistleblower final rules went into effect.12 The website includes two videos from OWB’s Chief—a welcome video and a video explaining what happens to a whistleblower’s tip once the SEC receives it. OWB also coordinates with the Office of Investor Education and Advocacy and the Office of Public Affairs and “tweets” to approximately 200,000 followers each time a new group of Notices of Covered Actions is posted to its website. Also, OWB sends email alerts to GovDelivery13 when its website is updated.14

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11 In 2012, the website won the Chairman’s Award for Excellence in Information Technology.
12 See www.sec.gov/whistleblower.
13 GovDelivery is a vendor that provides communications services for public sector clients.
14 Request to close audit recommendation one from OIG’s report “Assessment of the SEC’s Bounty Program,” Report No 474.
OWB Website Presence on Major Internet Search Engines

OIG conducted an internet search using the key word “securities whistleblower” to evaluate the SEC’s whistleblower program’s online presence and found OWB’s website on the first page of our Google, Yahoo, and Bing searches. Further, our use of the key word “whistleblower” found OWB’s website was located on the first page of Google15 and Yahoo’s16 internet search engines and on the second page for Bing.17

Outreach Efforts by the OWB

**Internal Training.** OWB posted training and guidance on both the Enforcement and the Commission intranet sites regarding whistleblower issues and rules. OWB provided training to various SEC divisions, offices, and internal groups who are likely to be involved in whistleblower matters.

OIG reviewed a list of 40 different presentations that OWB personnel gave to SEC staff and others from May 2011 to November 2012. Eleven of these 40 presentations were used in internal training sessions. Our review of the slides for the Miami Regional Office internal training given on April 30, 2012 included amongst other things, the OWB Chief’s background, office structure, office priorities, program creation, detailed overview of the program, and OWB staff’s contact information.

**Public Speaking Appearances.** OWB has a written policy regarding its staff accepting public speaking appearances to guard against the SEC appearing to favor the interests of one constituency over another. OWB’s three main constituencies are:

1. Whistleblowers (general public);
2. Corporate counsel and compliance personnel; and
3. Plaintiff’s counsel.

In deciding whether to make a public appearance, OWB’s policy requires a balance of factors such as, the expected size and constituency of the audience, the feasibility of participating remotely via video link or webinar, geography, and whether the group is considered an educational or lobby group.

OIG found that of the 29 external presentations OWB gave from May 2011 to November 2012, four consisted of interviews for publications and 25 were for panels, summits, conferences and other professional events.

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15 See www.google.com.
Conclusion

Because of the accessibility of OWB’s website from the SEC’s website, the program’s promotion through various social media methods, prominent presence on major internet search engines, and OWB’s internal and external outreach efforts, we determined the SEC’s whistleblower program is effectively promoted on its website and is widely publicized.

Question 3: Determine Whether the Commission is Prompt in Responding to Information Provided by Whistleblowers; Responding to Applications for Awards Filed by Whistleblowers; Communicating with Interested Parties

Pursuant to the Dodd-Frank Act, Section 922(d)(1)(C), OIG determined the SEC was generally prompt in responding to information provided by whistleblowers, in responding to applications for whistleblower awards, and communicating with interested parties. However, the program’s internal controls need to be strengthened by adding performance metrics.

The SEC, Enforcement, OWB and OMI have written policies and manuals that cover TCR processing which includes whistleblower TCRs, manual triage, whistleblower tracking and other procedures its staff use in processing whistleblower complaints that are submitted to the SEC.18

Whistleblower TCR Testing Attributes and Results

To determine the Commission’s promptness in responding to information that whistleblowers provide, OIG tested a statistical sample of 74 whistleblower TCRs that were submitted to the SEC from April 12, 2011 to September 30, 2012 using the following attributes:19

- Date TCR was submitted.
- Who submitted the TCR (General public or SEC staff).20
- Date of initial review.

18 Manual triage is the process by which a TCR is evaluated to: (i) determine whether the information submitted suggests a possible violation of the federal securities laws; (ii) identify the relevant parties; and (iii) gather additional information to assess the credibility and potential risk associated with the TCR. Manual triage also includes making an initial determination as to whether and where the TCR should be assigned for resolution.
19 See Appendix II for our sampling methodology.
20 SEC staff manually enters TCRs into the TCR system received from whistleblowers in hard copy or facsimile.
• Time elapsed between TCR submission and initial review.
• Date TCR was designated for No Further Action (NFA).
• Time elapsed between initial review and NFA.
• Date TCR was assigned to a point of contact (POC).
• Time elapsed between initial review and assigned to POC.
• Percentage of TCRs that were NFA and active Matters Under Inquiry (MUI)/Investigation.
• Whether active MUIs/Investigations were being tracked in OWB’s Case Tracking System.

The SEC, Enforcement, OWB, and OMI further have policies that govern how TCRs will be reviewed and allocated. The SEC’s promptness in responding to information whistleblowers provide is primarily determined by how quickly the TCR is processed while in Phase 1 manual triage. Although OMI generally responds promptly to whistleblower’s submissions and it has detailed written procedures for manual triage, OIG determined it has not established written timeliness standards for these processes. We found the average time TCR’s are in the manual triage process before it is either assigned to a POC or is designated as NFA is acceptable.21 Although OWB tracks the progress of whistleblower TCRs in manual triage, OMI owns the process and is responsible for its performance.

Our testing also revealed some general characteristics of the TCR whistleblower population such as:

• The percentage of whistleblower TCRs submitted online by the public;
• The percentage of whistleblower TCRs that were designated as NFA or were assigned to investigative staff; and
• Whether OWB was actively tracking whistleblower cases.

Additionally our testing found that of 74 whistleblower TCR submissions in our sample, 85 percent (63 of 74) were submitted online and 15 percent (11 of 74) were submitted to the SEC in another format such as, through the mail or by fax.22 In the later cases OMI or OWB staff manually entered the complaints into the TCR.

Average Timeline for OMI Staff’s Initial Review. The average time it takes OMI staff to initially review a whistleblower TCR once OMI has received it, is less than one day. Moreover, our review of 74 complaints found that 53 percent (39 of 74) of complaints were reviewed the same day the SEC received it; 31 percent (23 of

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21 Based on their initial review, OMI determines that some complaints require NFA. The complaint is designated NFA and is closed in TCR. Every TCR is reviewed by two OMI attorneys before it is designated NFA.
22 The public may submit tips or complaints directly into TCR through the SEC’s public website. The SEC’s website has a hyperlink the public can use to submit tips and complaints that leads to the TCR portal.
74) were reviewed in a day; 9 percent (7 of 74) were reviewed in 2 days; and 7 percent (5 of 74) were reviewed in 3 days of being submitted to the SEC.

**Average Timeline for Initial NFA Determination.** OIG’s review of 51 NFA determinations found the average time from when the complaint is initially reviewed by SEC staff, to when a NFA determination was made, was 31 days. Our sample included a NFA determination being made the same day the TCR was submitted to the SEC, to one that was made 249 days after the TCR was submitted to the SEC. Overall, most NFA determinations were made in less than 30 days.

Our testing further found that 63 percent (32 of 51) of NFA determinations were made in less than 30 days. Twenty of the 32 were determined in less than 10 days, while 37 percent (19 of 51) were made in 30 days or more.

**POC Assignment Timeline.** Whistleblower TCRs are assigned a POC when OMI staff determines the TCR warrants further investigation. Based on OMI’s allocation principles, the TCR is forwarded to a regional office, a specialized investigative unit, or a Headquarters Associate Director group in Enforcement. The average length of time from when the complaint is initially reviewed to a POC being assigned by OMI staff was 10 days.

The range of our testing consisted of a review of 38 POC assignments to include those made the same day the SEC received the complaint and assignments that were made 44 days after the SEC received the complaint. Overall, OIG found that 92 percent (35 of 38) of complaints were assigned a POC in less than 30 days after the SEC received it. Further, 25 of the 35 were assigned POCs in less than 10 days. Finally, 8 percent (3 of the 38) were assigned a POC in 30 days or more, after the SEC received the complaint.

**NFA and Active MUIs/Investigations in Case Tracking System.** OIG’s testing of whistleblower TCRs found that 69 percent (51 of 74) of complaints were designated NFA by OMI staff and 31 percent (23 of the 74) were still being actively worked on.23

OIG further reviewed and tested 18 TCRs that were identified as being related to active MUIs/Investigations and found 94 percent (17 of 18) were in OWB’s Case Tracking System.24

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23 Designating a WB-TCR NFA does not necessarily reflect a negative assessment of the quality of information provided. Some TCRs may be designated NFA, if, for example, the tip related to a matter that is currently being investigated, or is more appropriate to be investigated by another regulatory law enforcement agency.

24 OWB’s system is used to track the progress of whistleblower cases and it helps ensure OWB attorneys maintain communication with investigative groups working whistleblower cases. The TCR from our sample that was not in the case tracking system is located in HUB, which is Enforcement’s tracking system for MUIs and investigations.
Documented Metrics. OIG requested documented metrics to support the number of days a TCR should be in manual triage before it is designated as NFA, or is assigned to a POC. The Acting Chief of OMI informed OIG that the office does not have written policy covering the number of days a TCR should remain in manual triage. She indicated the average length of time in the last year or so, was approximately 4 to 5 business days. However, some timeframes are much longer due to unusual circumstances, such as a TCR requiring independent privilege review prior to being assigned to investigative staff or additional information being needed from the complainant. OMI tracks the age of work items through weekly aging reports. Other than TCRs requiring privilege review, OMI encourages staff to act on work items within 60 days.

Although OMI is generally very responsive to TCRs in the manual triage process, there is no standard to determine whether the response time is prompt or not. Performance metrics are needed to strengthen the internal controls of the manual triage process. This is needed to ensure consistency in the SEC’s processes as new personnel are assigned to the office and as turnover occurs. A lack of performance metrics may result in the degradation of performance and pertinent to this review, unnecessarily long response times to whistleblower information.

Whistleblower Application Response

The final rules specify timelines and procedures for whistleblower award applications. When a Notice of Covered Action is posted to OWB’s website, whistleblowers have 90 days to submit an application for an award to the SEC using the Form WB-APP (application). When the application is received an OWB attorney logs it into a tracking sheet and then conducts a preliminary review of the application to determine its initial disposition. Each application receives either an acknowledgement or deficiency letter. If all the required information is properly addressed in the application, an acknowledgement letter is issued to the whistleblower applicant. If additional information is needed for the application, a deficiency letter is issued to the whistleblower applicant.

Our review of 10 acknowledgement and deficiency letters found on average, OWB staff sent these letters to whistleblower applicants within 27 days after the whistleblower’s application was received. Table 3 shown below, illustrates the results of our review of deficiency letters. When the 122 day outlier is removed from our sample, the average number of days the acknowledgment or deficiency letter is sent to whistleblowers drops to 16.
Table 3: Length of Time OWB Takes to Issue Acknowledgement and Deficiency Letters to Whistleblower Applications

<table>
<thead>
<tr>
<th>Sample Number</th>
<th>Application Received</th>
<th>Letter Sent</th>
<th>Days Elapsed</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>10/19/11</td>
<td>11/18/11</td>
<td>30</td>
</tr>
<tr>
<td>2</td>
<td>2/7/12</td>
<td>6/8/12</td>
<td>122</td>
</tr>
<tr>
<td>3</td>
<td>2/24/12</td>
<td>3/6/12</td>
<td>11</td>
</tr>
<tr>
<td>4</td>
<td>8/6/12</td>
<td>8/28/12</td>
<td>22</td>
</tr>
<tr>
<td>5</td>
<td>2/8/12</td>
<td>2/15/12</td>
<td>7</td>
</tr>
<tr>
<td>6</td>
<td>10/28/11</td>
<td>11/18/11</td>
<td>21</td>
</tr>
<tr>
<td>7</td>
<td>11/9/11</td>
<td>11/18/11</td>
<td>9</td>
</tr>
<tr>
<td>8</td>
<td>2/22/12</td>
<td>2/27/12</td>
<td>5</td>
</tr>
<tr>
<td>9</td>
<td>2/2/12</td>
<td>2/27/12</td>
<td>25</td>
</tr>
<tr>
<td>10</td>
<td>4/24/12</td>
<td>5/8/12</td>
<td>14</td>
</tr>
<tr>
<td><strong>Average Days</strong></td>
<td></td>
<td></td>
<td><strong>27</strong></td>
</tr>
</tbody>
</table>

Source: OWB Whistleblower Application Log and Acknowledgement/Deficiency Letters

In general, OWB is prompt in responding to applications for awards that are filed by whistleblowers. However, this is another area in the whistleblower program that OIG determined had no performance metrics. Although there were no adverse consequences for delayed response time shown in Table 3, sample number 2, there could have been adverse consequences. For example, if the whistleblower’s application was deficient, the deficiency letter would have arrived after the deadline for an award application (e.g., 90 days after the Notice of Covered Action was posted). This would have resulted in the whistleblower being ineligible for an award, unless special consideration was given by SEC.

**Updating Whistleblowers About the Status of Their Applications**

Below are the ways OWB communicates with whistleblowers after they submit an award application to the SEC:

- An acknowledgement or deficiency letter is sent to all applicants indicating whether the whistleblower’s application is procedurally correct.
- An OWB attorney who conducts a full review of a covered action generally communicates with whistleblowers who have submitted award applications under a covered action.
- A written notification of the Claims Review Staff’s preliminary determination and whistleblower rights in the awards claims process are sent to the applicant.
- There’s an opportunity for the whistleblower to request the record that was used by the Claims Review Staff in making the preliminary determination.
- There’s an opportunity for the whistleblower to request a meeting with OWB to discuss the preliminary determination.
- If a claim is appealed to the Claims Review Staff, (1) a written acknowledgment of receipt of appeal and (2) the results of the appeal (i.e., proposed final determination), will be sent to the whistleblower.

- If the preliminary determination is not appealed to the Claims Review Staff and no award is made, OWB sends a letter enclosing the final order of the Commission to the whistleblower.

- Written notification of a proposed final determination being issued (whether pursuant to an appeal to the Claims Review Staff or by virtue of the preliminary determination becoming a proposed final determination under the statute in the case of an award being recommended).

- Notification of the Commission’s final order.

OWB uses different methods to update whistleblowers on the status of their applications. In most cases this communication is event-driven, (e.g., after a preliminary determination has been issued by the Claims Review Staff), rather than timeline driven. Our review determined that OWB’s communication with whistleblowers who submit award applications is effective and appropriate.

**Communications with the Interested Parties**

OWB’s communication with interested parties (the whistleblower and/or counsel for the whistleblower) is detailed in earlier sections of this report and was shown to be generally prompt. However, the whistleblower hotline voicemail offers another means whereby interested parties can communicate with OWB. OWB’s written policies specify that all voicemails received on its public telephone line are to be returned within 24 business hours and at least two OWB staff should be on the call.

We selected a sample of all calls that were received from various dates and tested them against OWB’s phone policy. Our testing included whether: (1) calls were returned within 24 business hours, and (2) calls were made with less than two OWB staff on the call. OWB’s callback hotline performance is shown in Table 4.
As illustrated in Table 4, OWB complied with its policy to have two staff on hotline call backs 100 percent of the time. Four percent (5 of 126) of OWB hotline calls were not returned within 24 business hours. Therefore, 96 percent of the time OWB complied with its call-back policy. For the 5 exceptions found in our sample, call backs were made within 48 hours after the calls were received. It should be noted that for some calls in OWB’s log such as hang ups, unintelligible messages, no call back number, and frequent/abusive callers—OWB did not return the call.

Based on our review of OWB’s response to information provided by whistleblowers, their communication with whistleblowers and their prompt response to calls made on OWB’s hotline, we determined OWB promptly communicated whistleblower information to interested parties in whistleblower cases.

### Internal Controls for the Whistleblower Program

The Office of Management and Budget (OMB) Circular A-123, *Management’s Responsibility for Internal Control*, requires management to establish and maintain internal control to achieve the objectives of effective and efficient operations, reliable financial reporting, and compliance with applicable laws and regulations. Monitoring the effectiveness of internal control should occur in the normal course of business. In addition, periodic reviews, reconciliations or comparisons of data should be included as part of the duties of regular assigned personnel. We determined that adding metrics for certain key performance areas of the whistleblower program will assist OWB in monitoring program performance and making corrections as necessary.

In two particular areas OIG found that OWB and OMI have not established any performance metrics. First, with respect to OMI, there is no standard on how long a TCR should remain in manual triage. Our sample testing indicated the
average time a TCR is designated as NFA in the manual triage process is 31 days. This included a TCR designated as NFA on the same day it was received, as well as a TCR that was designated as NFA 249 days after it was submitted to the SEC. On average TCRs assigned to a POC were in manual triage for 10 days. These timelines may be appropriate; however there is no standard by which performance can be measured. Thoughtfully chosen performance metrics will strengthen the whistleblower program’s internal controls and ensure consistency in its processes and procedures as new personnel are assigned to OMI and turnover occurs. A lack of performance metrics may result in the degradation in performance and unnecessary long response times to whistleblower information.

OWB did not have a performance metric for the maximum length of time staff should respond to applications for awards filed by whistleblowers. Our audit found OWB sent an acknowledgement letter to a whistleblower applicant 122 days after the application was submitted. Though there were no adverse consequences for this delayed response, there could have been consequences. For example, if the whistleblower application was deficient, the deficiency letter would have arrived after the award application deadline, which is 90 days after a Notice of Covered Action is posted. This would have resulted in the whistleblower being ineligible for an award, unless special consideration was given by the SEC.

Conclusion

OWB has developed an internal control plan that identifies several quantitative and qualitative key performance measures. An example of the quantitative performance measure is “average length of time to respond to applications of awards filed by whistleblowers.” OWB and OMI should take this measure one step further and use the data collected on key performance measures to establish meaningful performance metrics that will enable the office to objectively measure the whistleblower program’s performance. For example, OWB could establish a policy that the office will send either an acknowledgement or deficiency letter to a whistleblower within 30 days after receiving the whistleblower’s award application. OMI could also establish a policy that TCRs should remain in manual triage no longer than 30 days unless a justification is provided to the OMI Chief. These examples are not intended to be prescriptive; however, they are the types of metrics OWB and OMI should establish.

Recommendation 1:

The Division of Enforcement should ensure that the Office of Market Intelligence (OMI) assesses the manual triage process and establishes key performance metrics that can be used to measure process performance. These performance metrics should be documented in OMI’s written policies and procedures.
Management Comments. Enforcement concurred with this recommendation. See Appendix VI for management’s full comments.

OIG Analysis. We are pleased Enforcement concurred with this recommendation.

Recommendation 2:

The Division of Enforcement should ensure that the Office of the Whistleblower (OWB) assesses the key performance measures that are contained in their internal control plan and develop performance metrics where appropriate. These performance metrics should be added to OWB’s internal control plan.

Management Comments. Enforcement concurred with this recommendation. See Appendix VI for management’s full comments.

OIG Analysis. We are pleased Enforcement concurred with this recommendation.

Question 4: Determine Whether Minimum and Maximum Award Levels are Adequate

Pursuant to the Dodd-Frank Act, Section 922(d)(1)(D), our assessment of whether the minimum and maximum reward levels are adequate to entice whistleblowers to come forward with information and the reward levels are high enough to encourage illegitimate whistleblower claims found the SEC’s whistleblower award levels are comparable to other federal government agencies with the maximum award level being 30 percent in all the programs we reviewed. Based on the past experience of other whistleblower programs and practical concerns in the administration of the SEC’s program, we determined the SEC’s whistleblower minimum and maximum award levels are reasonable.

Review of Academic Literature on Minimum and Maximum Award Levels for Whistleblower Programs

Dodd-Frank Act allows qualifying whistleblowers to receive 10 to 30 percent of collected sanctions from successful lawsuits that are brought by the Commission, based on original information the whistleblower provided to the SEC. Since whistleblower award amounts were not a debated part of the Dodd-Frank Act, it appears the award levels may be based on the percentages used by other federal government agencies with whistleblower programs. Additionally, few empirical studies have been done on how monetary award levels influence whistleblowing behavior. The two most detailed studies we reviewed concluded
high rewards can motivate potential whistleblowers to come forward because the monetary amount may mitigate the cost of professional and social sanctions that can result.

**OWB Staff’s Views**

The OWB Chief informed OIG that it is important to have an award floor to incentivize whistleblowers to come forward. A guaranteed award amount mitigates the risk to whistleblowers’ employment prospects or reputation. Although he believes there’s no theoretical need for a ceiling on awards, OWB’s Chief feels it is useful for the office, for practical purposes to limit awards to 30 percent. Since OWB recommends the amount of each award based on merits without relation to other awards that are granted, this process is made simpler when limited to a clearly stated award range. The Chief further told OIG that the SEC’s current 10 to 30 percent range appears to be appropriate.

**Views of Other Federal Government Agencies’ Whistleblower Programs**

We solicited views from other federal government agencies with whistleblower programs on the minimum and maximum award levels that are established in their programs. Respondents typically indicated they did not have an opinion on award levels since the award levels were statutorily mandated. Further, respondents were not particularly concerned that award levels could induce illegitimate claims since they were confident their review process would weed out illegitimate claims through independent corroboration of asserted facts. One respondent suggested that a hard cap on whistleblower awards may be appropriate in cases where the recovery is substantial. However, the respondent also believed that whistleblower attorneys and advocacy groups would strongly oppose such caps.

**Comparison of Whistleblower Award Levels**

As shown below, Table 5 compares the SEC’s whistleblower award levels to the award levels that are established at the U.S. Commodity Futures Trading Commission (CFTC), U.S. Internal Revenue Service (IRS), and Department of Justice (DOJ).
Table 5: Comparison of Award Levels for Federal Whistleblower Programs

<table>
<thead>
<tr>
<th>Government Agency</th>
<th>Minimum Award Collected</th>
<th>Maximum Award Collected</th>
</tr>
</thead>
<tbody>
<tr>
<td>SEC</td>
<td>10%</td>
<td>30%</td>
</tr>
<tr>
<td>CFTC</td>
<td>10%</td>
<td>30%</td>
</tr>
<tr>
<td>IRS</td>
<td>15%</td>
<td>30%</td>
</tr>
<tr>
<td>DOJ (Government)*</td>
<td>15%</td>
<td>30%</td>
</tr>
<tr>
<td>DOJ (Non-government)*</td>
<td>25%</td>
<td>30%</td>
</tr>
</tbody>
</table>

Source: OIG Questionnaire

* DOJ’s False Claim Act has two scenarios under which an individual may collect an award when the government: (1) intervenes; and (2) does not intervene.

Whistleblower award levels are comparable across federal government whistleblower programs. As shown in Table 5, the maximum whistleblower award level is 30 percent for each agency we identified. Based on the past experience of other whistleblower programs and practical concerns in administering the SEC’s program, we concluded the SEC’s minimum and maximum award levels are consistent with other federal agencies and appear to be reasonable.

Conclusion

We determined the SEC’s minimum and maximum award levels are reasonable. Since there are few empirical studies on whistleblower award levels, to obtain cross-cutting results it may be beneficial if the Government Accountability Office would conduct a long-term, government-wide study on how whistleblower motivations are affected by award levels.

Question 5: Determine Whether Appeals Process has been Unduly Burdensome for the Commission

Pursuant to the Dodd-Frank Act, Section 922(d)(1)(E), OIG’s assessment of whether the appeals process has been unduly burdensome on the Commission found that, currently no whistleblower appeals have been filed with the Federal Court of Appeals. However, one whistleblower has appealed a preliminary determination that the Claims Review Staff made.25 Based on our analysis of the appeals process we do not believe it has been unduly burdensome on the Commission.

25 The date of the whistleblower appeal was November 6, 2012.
Rights of Appeal in SEC’s Whistleblower Program

Section 21F of the Exchange Act provides the whistleblower with the opportunity to appeal SEC whistleblower final orders within 30 days after the order is issued to the Federal Court of Appeals under the following conditions:

- If the whistleblower has received an award that falls between 10 to 30 percent of the monetary sanctions collected in the action, the process is complete and the amount is not subject to appeal.
- If the whistleblower was found to be ineligible for an award, or the award amount is outside of the statutory 10 to 30 percentage that is established for monetary sanctions, the whistleblower may appeal the decision at the Federal Court Of Appeals level.\(^{26}\)

The final rules also give the whistleblower a right to appeal a preliminary determination made by the Claims Review Staff.

- Once the Claims Review Staff has issued a preliminary determination, the whistleblower has 30 days to request a copy of the record the Claims Review Staff used to make their decision and/or request a meeting with OWB staff to discuss their case.
- The claimant may file an appeal within 60 calendar days of the later of (i) the date of the preliminary determination, or (ii) the date when OWB made materials available for review.

Status of Appeals

To date no actual appeals of the Commission’s final order in a whistleblower case have been filed with the Federal Court of Appeals. Four whistleblowers (includes two that submitted multiple applications for awards) have requested a copy of the record that the Claims Review Staff used in making preliminary determinations in their particular cases. One whistleblower sent an email to the OWB staff declaring their intention to appeal the preliminary determination. The OWB staff anticipates that the four whistleblowers who requested copies of the records will also appeal their preliminary determinations. To date, one appeal to the Claims Review Staff has been submitted to OWB.

Appeals Process

When a whistleblower requests a copy of the record that the Claims Review Staff made a preliminary determination on, the OWB staff must review the record to

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\(^{26}\) OGC handles the appeal for the Commission.
ensure sensitive information is not released and OWB redacts the record as appropriate. OWB staff coordinates with the whistleblower and has them sign a non-disclosure agreement before the record is released to them. In the event that an appeal of the SEC’s final order is filed in the Federal Court of Appeals, OWB would need to collect pertinent records to assist OGC with the litigation. These efforts by the Commission are reasonable and are generally expected in a regulatory agency.

Conclusion

OIG determined that potential whistleblower appeals have not been unduly burdensome on the Commission.

Question 6: Determine Whether the Funding Mechanism for the Investor Protection Fund is Adequate

Pursuant to the Dodd-Frank Act, Section 922(d)(1)(F), OIG determined that the funding mechanism for the IPF, which was established by Section 922, is adequate. The IPF was established at a funding level that has not required replenishment in over two years. If the IPF balance drops below $300 million, Enforcement and OFM will replenish it by identifying qualifying receipts for deposit. Currently, the fund is earning interest through short-term investments with the Bureau of Public Debt.

Establishment of the Fund

The IPF was established in the fourth quarter of fiscal year 2010 to be available to the Commission, without further appropriation or fiscal year limitation for paying awards to whistleblowers and funding the work activities of OIG’s employee suggestion program. The SEC is required to annually request and obtain apportionments from OMB to use these funds. OFM has developed policies and procedures for IPF that include a description of the whistleblower awards process, financial reporting requirements, budget request procedures, and procedures for replenishing the IPF.

The IPF was first established in August 2010 with approximately $452 million of non-exchange revenue that was transferred to the fund from the SEC’s disgorgement and penalties deposit fund. In the SEC’s fiscal year 2013 apportionment, nearly $452 million was still available in IPF. Since its establishment the IPF’s balance has not fallen below $300 million and no additional qualifying collections have been deposited into it.
Ongoing Funding Mechanism

The IPF can be replenished in the following ways:

- If the balance falls below $300 million, qualified collections identified by Enforcement and OFM’s Treasury Operations Branch can be used to replenish the fund.27

- The SEC has authority to invest amounts in the IPF in overnight and short-term market-based Treasury bills through the Bureau of the Public Debt. The interest earned on the investments is a component of the balance of the IPF and is available to be used for the fund’s expenses.

Use of the Investor Protection Fund

In 2012, the IPF was used to pay one whistleblower award which amounted to approximately $46,000. As previously mentioned, the fund is also used to pay for OIG’s employee suggestion program activities which amounted to $112,000 in fiscal year 2011 and $70,000 in fiscal year 2012.28 Even though some expenditures were paid from the fund, its balance has not substantially changed since the fund was established.

Conclusion

OIG determined that the funding mechanism for the IPF established by Section 922 of the Dodd-Frank Act is adequate for three reasons. First, the IPF was initially established at a funding level that has not required replenishment since its inception. Secondly, if the IPF balance ever drops below $300 million Enforcement and OFM can replenish the fund by identifying qualifying receipts for deposit. Finally, interest earned on the IPF through short-term investments with the Bureau of Public Debt amounted to an additional contribution of $990,000 into the fund in fiscal year 2011, and $757,000 in fiscal year 2012. These contributions exceeded the total expenditures for both years.

27 Exchange Act Section 21F(g)(3).
28 Exchange Act Section 21F(g)(2)(B).
Question 7: Determine Whether a Private Right of Action Should be Added to SEC’s Whistleblower Program

Pursuant to the Dodd-Frank Act, Section 922(d)(1)(G), OIG’s assessment of whether, in the interest of protecting investors and identifying and preventing fraud it would be useful for Congress to consider empowering whistleblowers or other individuals, who have already attempted to pursue a case through the Commission, to have a private right of action to bring suit based on the facts of the same case on behalf of the government and themselves, against persons who have committed securities fraud—found that it is premature to introduce a private right of action into the SEC’s whistleblower program at this time, since the program is still relatively new and has only been in place since August 2011. Any fundamental changes in approach would disrupt the system that is currently in place. Upon collecting additional data and assessing the effectiveness of the program after a reasonable amount of time, the OIG will be in a better position to opine on the usefulness of adding a private right of action to the SEC’s whistleblower program.

Review of Academic Literature on Private Rights of Action for Whistleblower Programs

Since this provision of Dodd-Frank contemplates the possibility of a qui tam-type action for securities violations, our review of academic literature focused on the private rights of action under Rule 10b-5 of the securities regulation and the False Claims Act (FCA) qui tam provision. An overview of Rule 10b-5 offers insight into the issues that arise in the context of private enforcement of securities laws and the qui tam provision of FCA, which provides a procedural standard comparison to the right of action contemplated in Dodd-Frank. Critics of private rights of action argue the private enforcement of broad regulations is likely to result in wasteful deterrence. Public entities may adjust enforcement levels, as well as the types of sanctions that are imposed on corporations in response to market realities, but private actors bring suit for the sole purpose of seeking monetary damages. Since qui tam actions could attract unscrupulous bounty hunters, a regulatory regime that relies on private enforcement may result in undesirable outcomes such as frivolous litigation,

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29 In the context of SEC’s whistleblower program a private right of action would allow an individual to sue a company or individual that violated the federal securities laws on behalf of themselves and the SEC.
30 The text of Dodd-Frank asks OIG to study whether it would be useful “for Congress to consider empowering whistleblowers or other individuals, who have already attempted to pursue the case through the Commission, to have a private right of action to bring suit based on the facts of the same case, on behalf of the government and themselves,” which suggests a qui tam right of action. Dodd-Frank Wall Street Reform and Consumer Protection Act Section 922(d)(1)(G), 124 Stat. 1376, 1849 (2010). For comparison to the language of the qui tam provision of the False Claims Act, see 31 U.S.C. Section 3730(b)-(c) (2010).
collusion between plaintiffs and defendants, and delays in bringing a suit for the purpose of increasing the bounty award amount.

Some studies we reviewed concluded the best way to ensure that private enforcers’ interests are aligned with taxpayers’ is to permit a public regulator to oversee the proposed lawsuits. A public enforcer can allow legitimate claims to go through, but deny harmful, profit-seeking ones from reaching the judicial system. This gatekeeping mechanism would reduce the risk of the system being abused. Therefore, if Congress grants a private right of action to individuals who want to sue for securities fraud on behalf of the government and themselves, the studies suggest it is important to include the condition that a public enforcer has the authority to oversee such litigation and to exercise veto power over opportunistic lawsuits.

Views of the OWB Chief

OWB’s Chief informed OIG it is premature to consider the benefits of significantly restructuring the SEC’s approach to a whistleblower award program and sufficient time has not passed to assess the effectiveness of the current program which has only been in-place since August 12, 2011. The OWB Chief is particularly concerned that the system currently in place would be disrupted if a private right of action were added to the enforcement mechanisms. Additionally, he anticipated adjustments to the OWB program that may address some of the same issues a private right of action could remedy. He suggested data should be gathered on the program’s effectiveness before considering a dramatic enforcement measure such as adding a private right of action to the existing laws.

Views of Other Whistleblower Programs

OIG solicited the views of other federal government agencies with whistleblower programs on the use of a private right of action in their programs. In general the respondents' views were against a private right of action. Two respondents suggested private rights of action tend to weaken the government’s ability to shape and develop the law and may lead to wasteful, detrimental developments, such as pursuing a position that is inconsistent with executive and judicial interpretations. Another respondent suggested a private right of action for whistleblowers in the securities industry could lead to moral hazard. For example, an uninjured plaintiff, who would not have a standing without the whistleblower statute, could short a company’s stock and then sue the company for an alleged violation of the securities laws in the hopes the suit would harm the stock price. On the positive side, one respondent said that a private right of action may be helpful when a government agency’s resources are constrained. However, this may mean that private individuals pursue a case that the government does not think should be pursued and would not have spent resources on anyway.
Conclusion

Our research determined that a private right of action to bring a suit based on the facts of a whistleblower complaint that previously was considered by the SEC, may be useful in furthering the interest of protecting investors and preventing fraud in some cases. However, the unintended consequences of such a legislative move is generally undesirable. It is premature to consider the benefits of significantly restructuring the SEC’s approach to the whistleblower award program. Sufficient time has is needed to assess the effectiveness of the current program. Fundamental changes in the current approach would disrupt the system that is currently in place. Upon collecting additional data and assessing the effectiveness of the program in another two or three years, OIG will be in a better position to opine on the usefulness of adding a private right of action to the SEC’s whistleblower program.

Question 8: Determine Whether the FOIA Exemption Added by Dodd-Frank Aids Whistleblowers in Disclosing Information to SEC; What Impact it has had on the Ability of the Public to Access Commission Information; Should be Retained

Pursuant to the Dodd-Frank Act, Section 922(d)(1)(H), OIG further assessed:

(a) Whether the Freedom of Information Act (FOIA) exemption established in Section 21 F(h)(2)(A) of the Securities and Exchange Act of 1934, as added by the Dodd-Frank Act, aids whistleblowers in disclosing information to the Commission;

(b) What impact the FOIA exemption described above has had on the ability of the public to access information about the regulation and enforcement by the Commission of securities; and

(c) Any recommendations on whether the exemption described above should remain in effect.

OIG determined that the FOIA exemption added by Dodd-Frank aids whistleblowers in disclosing information to the Commission by serving as an additional safeguard for whistleblower confidentiality. Further, this exemption essentially had no impact on the public’s ability to access information about the Commission’s regulation and enforcement of securities. Therefore, we determined the exemption should be retained.
FOIA Exemption (b)(3) Added Into the Dodd-Frank Act

There are nine FOIA exemptions the Commission and other federal agencies can use to deny the release of certain information the public may request. Exemption 3, 5 U.S.C. Section 552(b)(3)(B) or (b)(3) pertains to information that is prohibited from disclosure by another federal law.

The Dodd-Frank Act which became effective in July 2010, included FOIA exemption (b)(3), which provides an additional safeguard to whistleblower’s confidentiality and aids whistleblowers in disclosing information to the Commission. FOIA exemption (b)(3) states the following:

Except as provided in subparagraphs (B) and (C), the Commission and any officer or employee of the Commission shall not disclose any information, including information provided by a whistleblower to the Commission, which could reasonably be expected to reveal the identity of a whistleblower, except in accordance with the provisions of section 552a of title 5, unless and until required to be disclosed to a defendant or respondent in connection with a public proceeding instituted by the Commission or any entity described in subparagraph (C). For purposes of section 552 of title 5, this paragraph shall be considered a statute described in subsection (b)(3)(B) of such section.

Information that is withheld on the basis of the new FOIA exemption has always been withheld by the SEC’s FOIA office, based on other similar exemptions, in addition to exemption (b)(3), which indicates that whistleblower confidentiality was addressed under FOIA’s pre-existing exemptions.31 We discussed the use of FOIA exemption (b)(3) with the SEC’s FOIA Officer and determined the following:

- Whistleblower records are housed in the TCR system, and whistleblower records can be identified in TCR. The FOIA office will determine whether a FOIA request is related to a whistleblower based on whether or not the records requested are flagged as such.
- Under this exemption the FOIA office has no discretion regarding the release of “information provided by a whistleblower to the Commission, which could reasonably be expected to reveal the identity of a whistleblower.” Under other exemptions the FOIA office has discretion in weighing the privacy interest of the individual against the public’s right to know the information. Therefore, the new exemption allows the FOIA office to withhold

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31 Examples of the other FOIA exemptions that have caused SEC to withhold a whistleblower’s identity include: (i) Exemption 6 – information involving matters of personal privacy; and (ii) Exemption 7 – records or information compiled for law enforcement purposes . . . among others.
more information than would be withheld based on other similar exemptions. However, in practice this has never been the case.

The SEC’s FOIA Officer informed us the FOIA office has always withheld information based on FOIA exemption (b)(3), as well as other similar exemptions.

**Frequency that FOIA Exemption (b)(3) is Used at SEC**

OIG reviewed the FOIA office’s statistics for fiscal years 2010 to 2012, regarding the frequency and use of FOIA exemption (b)(3). Our review found the exemption was not the sole reason for denying information request. Further, we determined the Dodd-Frank exemption has not impacted the public’s ability to access information about the SEC’s regulation and enforcement of securities, since information requested would have been withheld anyway under another FOIA exemption. We determined the exemption provides additional assurance to the whistleblower that their identity will be protected. The OWB Deputy Chief told OIG the exemption was a vital feature of the whistleblower program because it gives whistleblowers an additional level of comfort. OIG’s overall results of our review of the SEC’s FOIA exemption (b)(3) denials for fiscal years 2010 to 2012 are found below in Table 6.

<table>
<thead>
<tr>
<th>Fiscal Years 2010 to 2012 Denials</th>
<th>Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of FOIA requests processed</td>
<td>33,315</td>
</tr>
<tr>
<td>Number of times exemption (b)(3) used</td>
<td>26</td>
</tr>
<tr>
<td>Number of times exemption (b)(3) added by Dodd-Frank used</td>
<td>7</td>
</tr>
<tr>
<td>Number of times request denied on the basis of exemption (b)(3) added by Dodd-Frank in conjunction with other exemptions</td>
<td>7</td>
</tr>
<tr>
<td>Number of times request denied solely on the basis of exemption (b)(3) added by the Dodd-Frank Act</td>
<td>0</td>
</tr>
</tbody>
</table>


**Conclusion**

Although FOIA Exemption (b)(3) established in Dodd-Frank allows the FOIA office to withhold more information than would have been withheld under other exemptions, in practice this has not been the case. Therefore, the public’s ability to access information about the SEC’s regulation and enforcement of securities remains essentially unchanged by this new exemption. OIG determined that whistleblowers gained additional confidentiality safeguards and the Dodd-Frank FOIA exemption should remain in effect.
## Abbreviations

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Definition</th>
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<tbody>
<tr>
<td>CFTC</td>
<td>U.S. Commodity Futures Trading Commission</td>
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<tr>
<td>COSO</td>
<td>Committee of Sponsoring Organizations of the Treadway Commission</td>
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<tr>
<td>DOJ</td>
<td>Department of Justice</td>
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<tr>
<td>Enforcement</td>
<td>Division of Enforcement</td>
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<tr>
<td>Dodd-Frank</td>
<td>Dodd-Frank Wall Street Reform and Consumer Protection Act</td>
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<tr>
<td>FCA</td>
<td>False Claims Act</td>
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<td>FOIA</td>
<td>Freedom of Information Act</td>
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<td>IPF</td>
<td>Investor Protection Fund</td>
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<td>IRS</td>
<td>U.S. Internal Revenue Service</td>
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<tr>
<td>MUI</td>
<td>Matters under inquiry</td>
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<tr>
<td>NFA</td>
<td>No Further Action</td>
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<td>OFM</td>
<td>Office of Financial Management</td>
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<td>OGC</td>
<td>Office of General Counsel</td>
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<td>OMB</td>
<td>Office of Management and Budget</td>
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<td>OIG</td>
<td>Office of Inspector General</td>
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<td>OMI</td>
<td>Office of Market Intelligence</td>
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<td>OWB</td>
<td>Office of the Whistleblower</td>
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<td>POC</td>
<td>Point of Contact</td>
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<tr>
<td>TCR</td>
<td>Tips, Complaints, and Referrals</td>
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<tr>
<td>SEC or Commission</td>
<td>U.S. Securities and Exchange Commission</td>
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Scope and Methodology

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Scope. Our audit focused on the SEC's policy and procedures for processing whistleblower complaints. As required by Dodd-Frank Section 922, we also reviewed the operations of OFM and the FOIA office related to the whistleblower program. Additionally, we tested whistleblower TCRs submitted to the SEC from August 12, 2011 to September 30, 2012.

Methodology. To meet the objective of determining whether the whistleblower final rules made the whistleblower program clearly defined and user-friendly, we defined and examined “clearly defined” and “user-friendly” attributes and reviewed the final rules to determine how these attributes were presented in the text of the final rules. Further, we reviewed and tested the SEC’s website pertaining to the whistleblowers program to determine if it was user-friendly.

To meet the objective of determining whether the whistleblower program is promoted on the SEC’s website and has been widely publicized, we tested the accessibility of OWB’s website from the SEC’s public homepage, reviewed webpage statistics, and assessed the public's accessibility on major internet search engines to the SEC’s whistleblower program and whistleblower information. Finally, we reviewed OWB’s use of social media sources and its internal and external outreach efforts to promote the whistleblower program.

To meet the objective of determining the SEC’s promptness in responding to whistleblower information, award applications, and general requests for information, we walked through the whistleblower process with OWB and reviewed Enforcement, OWB, and OMI policies and procedures on the whistleblower program and TCR. We also tested a statistical sample of whistleblower TCRs using different attributes related to processing timeliness. Finally, we tested OWB’s promptness in responding to award applications and OWB’s hotline telephone calls.

To meet the objectives of determining whether the whistleblower minimum and maximum award levels were adequate and whether the SEC’s whistleblower program should include a private right of action, we reviewed academic literature on both topics and solicited opinions from OWB and other federal government
agencies with whistleblower programs. We also compared key features of SEC’s whistleblower program with these agency’s whistleblower programs.

To determine whether the appeals process was unduly burdensome for the Commission we reviewed potential appeals submitted to the SEC and reviewed the appeal processes and procedures.

To determine whether the funding mechanism for the IPF is adequate, we reviewed OFM’s IPF policies and procedures, the IPF financial statements, and budget documents. Additionally, we reviewed the history of the IPF to include its establishment, expenditures, and investing activities. Finally, we reviewed the procedures established for replenishing the fund.

Finally, to determine whether the FOIA exemption added by Dodd-Frank aids whistleblowers in disclosing information to the Commission, its impact on the ability of the public to access SEC information, and whether the exemption should be retained, we reviewed the SEC’s annual FOIA report for fiscal years 2010 to 2012, interviewed SEC’s FOIA Officer, and reviewed the history of SEC’s use of the new exemption.

**Internal Controls.** The Internal Control—Integrated Framework, published by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) provides a framework for organizations to design, implement, and evaluate controls that facilitate compliance with federal laws, regulations, and program compliance requirements. For our audit, we based our assessment of OWB’s internal controls significant to our objectives on the COSO framework as follows: control environment, risk assessment, control activities, information and communication, and monitoring. Among the internal controls we assessed were the Commission and Enforcement’s controls related to processing TCRs, the annual risk assessment for the Federal Manager’s Financial Integrity Act assurance statement, OWB’s policies, procedures, OWB’s internal controls plan, and OWB’s controls over external communications of the whistleblower program.

**Use of Computer-Processed Data.** We used the SEC’s TCR system to generate the universe of whistleblower TCRs that were submitted to the SEC from August 12, 2011 to September 30, 2012. We also used the TCR system to retrieved key documents for our whistleblower TCR testing.

**Statistical Sampling.** To review the SEC’s promptness in responding to whistleblower information OWB used the TCR system to generate whistleblower TCR’s that were submitted to the SEC from August 12, 2011 through September 30, 2012. Our audit universe consisted of 3,335 whistleblower TCRs.

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33 Federal Manager’s Financial Integrity Act of 1982.
We used the EZ Quant Statistical Analysis Audit Software to generate a statistical sample of 74 whistleblower TCRs.\textsuperscript{34} Our sample was designed to project rates of occurrence (e.g., percentage of whistleblower TCRs that were submitted by the public) with 90% confidence and the point estimation was within \pm 5\% of the universe of TCRs under consideration.

**Prior Coverage.** The OIG conducted an audit of SEC’s now defunct bounty program and issued *Assessment of the SEC’s Bounty Program*, Report No. 474 on March 29, 2010. The objectives of this audit were to:

1. Assess whether necessary management controls have been established and operate effectively to ensure bounty applications are routed to appropriate personnel and are properly processed and tracked; and

2. Determine whether other government agencies with similar programs have best practices that could be incorporated into the SEC bounty program.

The report found that although the SEC had a bounty program in-place for more than 20 years that rewarded whistleblowers for insider trading tips and complaints, there were very few payments made under the program. The report further found the Commission received few applications from individuals seeking bounties over this 20-year period and the program was not widely recognized inside or outside the Commission. Finally, the report determined the bounty program was not fundamentally designed to be successful.

\textsuperscript{34} EZ Quant is statistical analysis software provided by the Defense Contract Audit Agency at their public website. It is freeware and its use and copying is unrestricted. EZ Quant has the capability to perform both attribute and variable sample selection and evaluation.
Appendix III

Criteria

**Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Section 922.** Section 922 outlines the statutory requirements for SEC’s whistleblower program and required OIG to conduct an evaluation of the SEC’s whistleblower program.

**Securities and Exchange Act of 1934, Section 21F.** This is an amendment in Dodd-Frank that covers the SEC’s whistleblower program.

**17 CFR Parts 240 and 249, Implementation of the Whistleblower Provisions of Section 21F of the Securities and Exchange Act of 1934.** The final rules provide key definitions, determine who is eligible for a whistleblower award, and outline the procedures for submitting whistleblower complaints and applications for awards.

**Enforcement Manual.** This is Enforcement’s internal manual and it serves as a reference guide its staff uses to aid with investigating potential violations of federal securities laws. The manual also includes general guidance on the SEC’s whistleblower program.

**SEC, Enforcement and OWB Policy on Handling TCRs.** Internal SEC policy and procedures on handling tips, complaints, and referrals.

**OWB Policies and Procedures.** This includes OWB’s policy and procedures on the SEC whistleblower program’s operations, guidance on tracking and documenting whistleblower claims, procedures for notifying whistleblowers on the status on their complaints, OWB’s hotline telephone call protocol, etc.

**OMI Triage Manual and Allocation Principles.** OMI’s internal policy and procedures covering the review, disposition and allocation of TCRs the SEC receives.

**OFM Policies and Procedures on the Investor Protection Fund.** OFM’s internal policy and procedures covering IPF, to include financial reporting requirements, budget submissions, and replenishing the IPF.

**5 USC Section 552, Freedom of Information Act.** FOIA requires federal agencies to make certain agency materials available for public inspection and copying. FOIA also provides for exemptions to this requirement.

**OMB Circular A-123, Management’s Responsibility for Internal Control.** Establishes that management has a fundamental responsibility to develop and maintain effective internal controls.
List of Recommendations

Recommendation 1:

The Division of Enforcement should ensure that the Office of Market Intelligence (OMI) assesses the manual triage process and establishes key performance metrics that can be used to measure process performance. These performance metrics should be documented in OMI’s written policies and procedures.

Recommendation 2:

The Division of Enforcement should ensure that the Office of the Whistleblower (OWB) assesses the key performance measures that are contained in their internal control plan and develop performance metrics where appropriate. These performance metrics should be added to OWB’s internal control plan.
Access to OWB’s Website from the SEC’s Website

There are four or more possible ways the public can access OWB’s website to learn about the whistleblower program or file a complaint with the SEC. The SEC’s public website consists of two hyperlinks: (1) Submit a Tip File a Complaint, and (2) Large “whistle” image, as shown in Figure 1, that takes the public to OWB’s website. The third way to reach OWB’s website from the SEC’s homepage is by using the search engine on the SEC’s public website. OIG’s use of the keyword “whistleblower” and the option “SEC Documents” in the search engine resulted in 397 options, the first of which led us to OWB’s website. Finally, from the SEC’s public website, the “Education” drop down menu has a “File a Tip or Complaint,” option that takes the public to OWB’s website. Overall, we found the quickest way to access OWB’s website is by clicking on the “Whistle” hyperlink.

Figure 1: SEC Website

When the hyperlink “Submit a Tip File a Complaint” is clicked from the SEC’s website, the public is taken to a “Questions and Complaints” webpage which consists of four options regarding various SEC programs that can be accessed, as illustrated below in Figure 2.
The third option “Learn about the whistleblower provisions,” feeds directly into OWB’s website. OWB’s website is shown in Figure 3.

Source: http://www.sec.gov/complaint/select.shtml
I. Introduction

The Division of Enforcement (Enforcement) submits this memorandum in response to the draft report of the Office of Inspector General (OIG) on OIG Audit No. 511 entitled "OIG's Evaluation of the SEC's Whistleblower Program" (Report). We appreciate the opportunity to respond to the Report.

The Report included two recommendations for the Division of Enforcement; one related to the work of Enforcement's Office of Market Intelligence (OMI) and one related to the work of the Office of the Whistleblower (OWB). You requested that our response indicate whether we "concur or do not concur" with the recommendations. As described more fully below, we "concur" with both of the recommendations of the Report.

II. Recommendation Related to OMI

Recommendation 1: The Office of Market Intelligence (OMI) should assess the manual triage process and establish key performance metrics that can be used to measure process performance. These performance metrics should be documented in OMI's written policies and procedures.

Enforcement concurs with this recommendation, and is in the process of assessing the manual triage process to determine if key performance metrics can be established to measure process performance beyond those measures currently employed by OMI management. Enforcement is committed to the timely, effective, and responsible
handling of tips, complaints, and referrals (TCRs). Each year, the agency receives a high volume of TCRs of varying quality that allege a broad spectrum of possible violations of the federal securities laws and other possible improper conduct. The broad spectrum of alleged conduct requires OMI management to employ a number of measures to ensure that each TCR timely receives appropriate review and consideration by professional staff before disposition or assignment. OMI management continues to assess the manual triage process to ensure that Enforcement appropriately pursues all credible allegations of conduct that could violate the federal securities laws or conduct that could pose a risk of harm to investors.

III. Recommendation Related to OWB

Recommendation 2: The Office of the Whistleblower (OWB) should assess the key performance measures that are contained in their internal control plan and develop performance metrics where appropriate. These performance metrics should be added to OWB's internal control plan.

Enforcement concurs with this recommendation and supports OWB's work to assess the key performance measures contained in its internal control plan, including the development of performance metrics, where appropriate. Enforcement agrees that performance metrics related to OWB's internal controls may be of value to the whistleblower process, including review and assignment of whistleblower complaints in conjunction with OMI's manual triage process; timely communications with whistleblowers, where appropriate; and the administration of whistleblower award claims.
Audit Requests and Ideas

The Office of Inspector General welcomes your input. If you would like to request an audit in the future or have an audit idea, please contact us at:

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Office of Inspector General
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Hotline

To report fraud, waste, abuse, and mismanagement at SEC, contact the Office of Inspector General at:

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Web-Based Hotline Complaint Form: