The Deal Pipeline

Fairholme wants Fannie, Freddie re-listed on NYSE

by Ronald Orol In Washington | Published March 4, 2014 at 9:00 AM

Activist fund Fairholme Capital Management LLC is urging the boards of government-controlled Fannie Mae and Freddie Mac to implement a package of governance changes, which includes convening annual shareholder meetings and relisting their securities on the New York Stock Exchange.

The move, explained in two letters released Monday, is the latest in what observers describe as a multipronged public relations effort to highlight the perceived poor treatment of equity holders in the two government-seized refinance giants. The effort was prompted, partly, by two multibillion-dollar dividend payments set to be made by Fannie and Freddie to the Treasury Department later this month.

Those payments would have marked the complete recoupment of roughly $188 billion in taxpayer-infused injections made to Fannie and Freddie following a government takeover of the two firms at the height of the 2008 financial crisis.

However, a 2012 "profit sweep" amendment by government regulators shifted substantially all of their earnings to the general revenue of the Treasury Department and away from the two firms, a move that has shareholders outraged.

By the end of March, Fannie and Freddie will have made cumulative dividend payments of $202.9 billion to the Treasury Department -- significantly more than the $188 billion in taxpayer infused injections made during the crisis.

In two letters, Fairholme, which owns over 20 million Fannie Mae common shares and over 66 million preferred shares in the mortgage giant, argued that the companies are under no obligation to pay cash dividends to the Treasury. Instead, the fund, which calls itself a constructivist activist, wants the boards of both Fannie and Freddie to retain earnings, improve disclosure and hire independent advisers.

Government regulators privately said they are not supportive of any plan to relist Fannie and Freddie, partly because policy makers at the Treasury Department believe it would detract from efforts on Capitol Hill to reform the two troubled mortgage giants. The two firms, which were key contributors to the crisis, were taken over by the government in 2008 as part of an effort to stem a growing panic.

Philip Laskawy, Fannie Mae's chairman, responded in a statement that he is confident that the board is doing the job it has been given. Freddie Mac has not responded yet.

Officials from the Federal Housing Finance Agency, the regulator that oversees Fannie and Freddie, declined to comment. A Treasury spokesman did not return requests for comment.

"Our board and management will continue to perform their duties, as provided by federal statute and delegated by FHFA, diligently and to the best of their abilities," Laskawy said.

Daniel Schmerin, Fairholme's director of Investment Research, refuted assertions that efforts to relist Fannie and Freddie would discourage reform efforts on Capitol Hill. "Those are weak excuses," he said. "We have encouraged legislators to find a solution to preserve affordability of mortgages and I believe that publicly traded firms do not discourage lawmakers from that effort."

Schmerin, who worked as deputy executive secretary for Treasury Secretary Henry Paulson during the 2008 crisis, pointed out that the two firms are the largest companies by stock market capitalization trading in the OTC markets. "We believe that the boards of directors should once again abide by the NYSE code of conduct guidelines and we don't like the fact that OTC trading increases transaction costs for investors."

However, Schmerin declined to comment on whether Fairholme would ever consider a proxy contest as part of an effort to bring more attention to the plight of Fannie and Freddie shareholders.

Regulatory observers said they don't believe the activist investors' latest effort will have much impact. "The biggest flaw in their letters is the assumption that the boards have much say," said Mark Calabria, director of financial regulation studies at the Cato Institute. "The FHFA is running the show, as the law so clearly states."

Fairholme manages mutual funds and typically engages companies collaboratively and behind-the-scenes. Regulatory observers familiar with the campaign said they don't expect Bruce Berkowitz, who manages Fairholme, to launch a proxy contest in the interim at either mortgage giant. However, Berkowitz has launched a successful proxy contest in the past, demonstrating that he is not beyond employing such a tactic. In addition, insurgent billionaire investor Bill Ackman of Pershing Square Capital Management LP in November launched an activist campaign at Fannie and Freddie. Ackman has a history of launching proxy contests and could also do so here.

Because the Treasury Department owns 79.9% of both companies, a proxy contest wouldn't succeed at ousting incumbent directors. However, the backing of a substantial percentage of outside shareholders could put public pressure on the companies to improve their governance.

The letters follow Fairholme's November acquisition offer for assets of the two firms in a recapitalization valued at $52 billion. People familiar with the government's position noted at the time that the Treasury Department and the FHFA never seriously considered the offer.

It also comes as another activist investor has a campaign under way at the two mortgage giants. Activist fund Perry Capital Management Inc. has a lawsuit in the works that argues that the August 2012 "third amendment" profit sweep to the conservatorship agreement between Treasury and the FHFA tramples on private shareholder rights. Disputing that assertion, the Treasury asked the court to dismiss the action, arguing that Perry's suit is without merit and their "property" -- junior preferred shares and common shares the fund has owned since 2010 -- wasn't seized in the restructuring.

Bank of America Corp. analyst Ralph Axel said the Fairholme letters are an important development, demonstrating that shareholders are attacking the issue of investor rights from multiple directions. "Finding a way for [government-sponsored enterprises] to retain earnings would be a big deal," he said. "I'm not sure they can do it unless the third amendment is repealed."