



OFFICE OF GENERAL COUNSEL

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TO: Alicia R. Castaneda, Chairman
Allan I. Mendelowitz, Director
Franz S. Leichter, Director
John C. Weicher, Director

FROM: Mark J. Tenhundfeld, General Counsel /s/
Neil R. Crowley, Deputy General Counsel /s/

SUBJECT: 2004-GC-01: Federal Home Loan Bank Securities Registration and Disclosure

ISSUE:

Does the Federal Home Loan Bank Act (Bank Act) authorize the Federal Housing Finance Board (Finance Board) to require the Federal Home Loan Banks (Banks) to register a class of their equity securities under Section 12(g) of the Securities Exchange Act of 1934 (1934 Act)?

CONCLUSION:

The Bank Act authorizes the Finance Board to adopt a regulation requiring the Banks to register a class of securities with the Securities and Exchange Commission (SEC).

Section 2B(a)(1) of the Bank Act broadly authorizes the Finance Board to promulgate and enforce such regulations and orders as are necessary to carry out the provisions of the Bank Act. Section 2A(a)(3) of the Bank Act, which imposes several statutory duties on the Finance Board, specifically mandates that the primary duty of the Finance Board shall be “to ensure” that the Banks operate in a financially safe and sound manner. To the extent consistent with that primary duty, the Bank Act further requires the Finance Board “to ensure” that the Banks remain adequately capitalized and able to raise funds in the capital markets.

It is our opinion that these provisions of the Bank Act generally authorize the Finance Board to promulgate any regulation the purpose or effect of which is to advance any of the statutory duties imposed by Section 2A(a)(3), or to implement any of the other provisions of the Bank Act. It is also our opinion that the Finance Board has a reasonable basis for determining that a rule

requiring the Banks to register a class of securities under the 1934 Act¹ would advance the safe and sound operation of the Banks or their ability to raise funds in the capital markets. Accordingly, if the rule were to be challenged, we believe that a court would give the Finance Board's actions deference under the judicial review provisions of the Administrative Procedure Act (APA).

I. INTRODUCTION

The Office of General Counsel has been asked to address the authority of the Finance Board to implement a public disclosure regime for the Banks by requiring them to register a class of securities under Section 12(g) of the 1934 Act.² Among other things, Section 12(g) provides that an issuer not otherwise required to register its equity securities may do so by filing a registration statement with regard to any class of equity securities, as otherwise required by that Act.³ Registration by the Banks of a class of stock pursuant to Section 12(g) would subject the Banks to the periodic disclosure regime established under the 1934 Act, as interpreted and enforced by the SEC.⁴ While the Banks, as non-registrants, currently are not subject to the disclosure regime of the 1934 Act, as issuers of securities they currently are subject to the anti-fraud provisions of Section 10(b) of the 1934 Act.⁵

¹ 15 U.S.C. § 78a *et seq.* (2000).

² The Finance Board previously had issued a notice of proposed rulemaking (Proposed Rule) that proposed to require the Banks to register a class of their securities under the 1934 Act. 68 Fed. Reg. 54396 (Sept. 17, 2003).

³ 15 U.S.C. § 78l(g). Section 12(g) states that “[a]ny issuer may register any class of equity security not required to be registered by filing a registration statement pursuant to the provision of this paragraph.” *Id.*

⁴ *See* 15 U.S.C. § 78m. The Proposed Rule was drafted somewhat more broadly than Section 12(g), which expressly contemplates that issuers only would be able to register a class of equity securities. The broader language of the Proposed Rule, however, recognized that the SEC has the discretion (notwithstanding the specific language of Section 12(g)) to accept for registration a class of debt securities issued by the Banks in lieu of a class of equity securities. In fact, Alan L. Beller, the Director of the SEC's Division of Corporation Finance, specifically addressed this issue in testimony before the Senate Committee on Banking, Housing and Urban Affairs on February 10, 2004 (the Beller Testimony) (available at <http://www.sec.gov/news/testimony/ts021004alb.htm>). He stated that SEC staff initially had discussed the possibility of the Bank's registering a class of debt securities under the 1934 Act in part because registration of debt securities would not implicate certain requirements of the 1934 Act, such as proxy rules, that would apply to the registration of equity securities. Director Beller noted, however, that in their discussion with the SEC, the Banks had expressed a preference for registering a class of stock. Because the content of the corporate disclosure would be the same for debt or equity securities, Director Beller indicated that the registration of Bank stock would be acceptable. The final rule requires the Banks to register a class of their equity securities.

⁵ *See* 12 U.S.C. § 78j(b). Section 10(b) of the 1934 Act applies to “any security registered on a national securities exchange or any security not so registered or any securities-based swap agreement”. In relevant part, this section prohibits “any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails ... [t]o use or employ, in connection with the purchase or sale of any security ... any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.” *Id.* The Banks also are subject to various anti-fraud provisions in other federal securities laws.

A. Federal Home Loan Bank Equity Securities.

The 12 Banks are organized under the Bank Act as privately-owned, cooperative entities. Each Bank issues equity securities to its members, and no persons other than members of a Bank may purchase its stock. 12 U.S.C. § 1426(a)(4)(B). Each member is required to purchase and hold a specified amount of Bank stock as a condition both of membership and of doing business with the Bank. Until the passage of the Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (Nov. 12, 1999) (GLB Act), the Bank Act authorized the Banks to issue one class of stock. *See* 12 U.S.C. § 1426 (1994). The GLB Act altered the capital structure of the Banks by authorizing them to issue one or both of two classes of stock. Class A stock is redeemable at par value six months after a member files a notice with the Bank to redeem the stock, and Class B stock is redeemable at par value five years after a member files a redemption notice. 12 U.S.C. § 1426(a)(4)(A). A Bank may repurchase at par value any stock held by a member in excess of the member's minimum stock purchase requirement set forth in the Bank's capital plan.⁶ 12 U.S.C. § 1426(e)(1); 12 C.F.R. § 931.7(b).

The GLB Act also requires each Bank to adopt a capital plan in which the Bank must set forth, among other things, the attributes associated with each class (or subclass) of stock that the Bank intends to issue, including its par value, dividend rights and preferences, and liquidation rights.⁷ *See* 12 U.S.C. § 1426(b), (c); 12 C.F.R. § 933.2. The Finance Board must approve a capital plan before a Bank may implement or amend it. 12 U.S.C. § 1426(b). Until a Bank implements its capital plan, its capital structure, including its authority with regard to issuance of stock, is governed by the Bank Act requirements that were in effect immediately prior to the passage of the GLB Act. 12 U.S.C. § 1426(a)(6). The Finance Board has approved the capital plan of each Bank, and eight Banks have implemented their capital plans as of the date of this opinion. All the Banks are expected to complete the implementation of their capital plans by June 2005.

Each Bank issues its own equity securities although, as explained immediately below, all Bank System debt securities are issued through the Office of Finance (OF) on behalf of all the Banks jointly.⁸

⁶ Under Finance Board rules, the repurchase of excess stock is at the Bank's discretion and may be undertaken without regard to the six-month or five-year redemption periods. *See* 12 C.F.R. § 931.7(b). By contrast, redemption occurs at the request of a member, and a Bank generally is required to redeem excess stock at the end of these statutory redemption periods, unless certain regulatory restrictions apply. *Id.* at § 931.7(a). These regulatory restrictions prevent a Bank from redeeming, or repurchasing, stock in certain situations. *See, e.g., id.* at §§ 931.7(c) and 931.8.

⁷ Currently, all the capital plans of the Banks set the par value for every class or sub-class of Bank stock at \$100 per share.

⁸ The Federal Home Loan Bank System consists of the 12 Banks and the OF, which is a joint office of the Banks that was created by the Federal Home Loan Bank Board, predecessor to the Finance Board. As a "joint office" of the Banks, the OF has no separate corporate existence.

B. Federal Home Loan Bank Debt Securities.

Section 11 of the Bank Act authorizes three methods by which the Banks can borrow funds in the capital markets.⁹ Section 11(a) authorizes each Bank to borrow and issue debt instruments, subject to rules and regulations, terms and conditions prescribed by the Finance Board. Section 11(b) authorizes the Finance Board to issue consolidated debentures, within stated limitations, and upon such terms and conditions as the Finance Board may prescribe, which shall be the joint and several obligation of the Banks. Section 11(c) authorizes the Finance Board to issue secured consolidated bonds, upon such terms and conditions as the Finance Board may prescribe, which also shall be the joint and several obligations of the Banks. 12 U.S.C. § 1431(a) - (c).

At present, the only debt securities that the Banks are permitted to issue are consolidated obligations (COs), which are issued under Section 11(a) of the Bank Act. *See* 12 C.F.R. § 966.2(b). As of December 31, 2003, there were approximately \$740 billion of COs outstanding. The regulations provide that the COs must be issued through the OF, as agent for the Banks, and that the Banks shall be jointly and severally liable on all such COs. *Id.*; *see also* 12 C.F.R. §§ 966.9, 985.3(a) and 985.6(a). Finance Board rules also prohibit a Bank from issuing debt instruments in its own name.

II. LEGAL ANALYSIS

The first issue to address is whether the Bank Act authorizes the Finance Board to adopt the final rule. Assuming that such authority exists, the second issue is whether the Finance Board has exercised that authority in a manner that is consistent with the APA. Each of these issues is addressed separately below.

A. Authority Conferred by the Bank Act.

As a general proposition, any action taken by a federal regulatory agency must be within the scope of the authority conferred on it by Congress.¹⁰ With respect to the Federal Home Loan

⁹ Under Section 15 of the Bank Act, obligations of the Banks issued with the approval of the Finance Board must state that they are not the obligations of, and are not guaranteed by, the United States. 12 U.S.C. § 1435. The Congress has provided further that none of the obligations or securities issued by housing government-sponsored enterprises (GSEs) are backed by the full faith and credit of the United States. *See* Federal Housing Enterprises Financial Safety and Soundness Act of 1992, Pub. L. 102-550, Title XIII, § 1304, 106 Stat. 3941, 3944 (Oct. 28, 1992) (*codified at* 12 U.S.C. § 4503). Notwithstanding these statements, the capital markets often view debt issued by or on behalf of the Banks as having an implied government guarantee based on the GSE status of the Banks, the joint and several liability of the Banks, and the authority given to the Secretary of the Treasury to purchase debt obligations of the Banks issued under Section 11 of the Bank Act. The Secretary's purchase or sale of such obligations would be treated as "public-debt transactions of the United States." *See* 12 U.S.C. § 1431(i).

¹⁰ An agency has the power to issue binding legislative rules only to the extent that Congress has delegated such authority to the agency. *See* R. Pierce, *Administrative Law Treatise*, 4th Ed., § 6.2 (2000) (Pierce), *citing United States v. Storer Broadcasting Co.*, 351 U.S. 192 (1956); *National Broadcasting Co. v. United States*, 319 U.S. 190 (1943); *National Petroleum Refiners Ass'n v. FTC*, 482 F.2d 672, *cert. denied*, 415 U.S. 951 (1974). So long as the Finance Board exercises its power to promulgate its rule in a form authorized by Congress, and the rule is reasonable and consistent with the statute, the rule will be valid and enforceable, and will have the "force and effect

Bank System, the Congress has vested supervisory authority with the Finance Board, which is charged with ensuring both the safety and soundness of the Banks and the achievement of their housing finance mission.¹¹ The Finance Board has plenary authority over the Banks, which is derived from numerous provisions of the Bank Act, although those most relevant for purposes of this opinion relate to its rulemaking authority and its statutory duties.¹²

Congress has given the Finance Board broad rulemaking authority to carry out its oversight responsibilities. Specifically, Section 2B(a)(1) of the Bank Act authorizes the Finance Board “[t]o supervise the Federal Home Loan Banks and to promulgate and enforce such regulations and orders as are necessary from time to time to carry out the provisions of [the Bank Act].” 12 U.S.C. § 1422b(a)(1). The language of that provision includes no limitations on the authority of the Finance Board to regulate the Banks, or on its authority to adopt regulations that carry out the specific provisions or general purposes of the Bank Act. Moreover, the statute leaves to the Finance Board the discretion to determine what regulations or orders are “necessary” to carry out the provisions of the Bank Act.¹³

of law.” See *Pierce*, § 6.4 citing *Maryland Casualty Co. v. United States*, 251 U.S. 342, 349 (1920). Generally, Congress has authorized federal agencies to issue binding rules through the use of the notice and comment procedure set forth in Section 553 of the APA, 5 U.S.C. §§ 551 *et seq.* See generally *Pierce*, § 6.3, at 236.

¹¹ 12 U.S.C. § 1422a(a)(3). In 1989, Congress established the Finance Board as an independent agency in the executive branch. See Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, Title VII, § 702(a), 103 Stat. 183, 413 (Aug. 9, 1989) (FIRREA) (codified at 12 U.S.C. §§ 1422a and 1422b.).

¹² See 12 U.S.C. §§ 1422b(a)(2) (rulemaking) and 1422a(a)(3) (statutory duties). Other provisions of the Bank Act that confer supervisory authority on the Finance Board include: Section 2B(a)(2), which authorizes the Finance Board to suspend or remove any officer, director, employee or agent of any Bank or joint office for cause, 12 U.S.C. § 1422b(a)(2); Section 2B(a)(5), which confers administrative enforcement powers that are substantially the same as those possessed by other federal financial institution regulators, 12 U.S.C. § 1422b(a)(5); and Section 20, which authorizes the Finance Board to examine the Banks and to require reports from them, and which confers on the Finance Board examiners the same powers, duties, privileges and obligations as federal bank examiners have under the Federal Reserve Act and the National Bank Act, 12 U.S.C. § 1440.

¹³ The statutory grant of authority to issue regulations that are “necessary” to implement the Bank Act does not limit the Finance Board to doing only those things that, without which, the Bank System could not function. The term “necessary” is susceptible to many meanings, including “something reasonably useful and proper, and of greater or lesser benefit or convenience, and its force and meaning must be determined with relation to the particular object sought.” *Black’s Law Dictionary* 928 (5th ed. 1979).

As courts have recognized, an agency need not show that a particular action is, by itself, crucial to the ability of the agency to fulfill its duties. See, e.g., *Shinn v. Encore Mortgage Services, Inc.*, 96 F. Supp. 2d 419, 424 (D.N.J. 2000) (upholding Office of Thrift Supervision (OTS) rule regulating alternative mortgage transactions as an appropriate exercise of its authority to “prescribe such regulations and issue such orders as the Director may determine to be necessary for carrying out this chapter and all other laws within the Director’s jurisdiction”); *Home Mortgage Bank v. Ryan*, 986 F.2d 372, 377 (10th Cir. 1993) (upholding OTS merger regulation as a “permissible exercise of OTS’s regulatory responsibility over state-chartered savings associations”); *Federal Labor Relations Authority v. United States Department of the Navy*, 96 F.2d 747, 752 (3rd Cir. 1992) (upholding the Fair Labor Relations Authority determination that disclosure of home addresses was “necessary” for collective bargaining, and stating that “Congress delegated this sort of specific determination to the FLRA in the Labor Statute”). As stated by the United States Supreme Court, “An agency ... ‘must be given ample latitude to “adapt [its] rules and polices to the demands of changing circumstances.’”” *Rust v. Sullivan*, 500 U.S. 173, 187 (1991) (quoting *Motor Vehicle Mfrs. Assn. of United States v. State Farm Mutual Automobile Ins. Co.*, 463 U.S. 29, 42 (1983) (quoting *Permian Basin Area Rate Cases*, 390 U.S. 747, 784 (1968))). If the action is “reasonably useful” or “proper” within the context of

The Bank Act confers numerous specific powers and responsibilities on the Finance Board, and also imposes several overriding statutory duties. The primary duty is to ensure the safe and sound operation of the Banks. To the extent consistent with that primary duty, the Bank Act separately mandates that the Finance Board is to ensure that the Banks remain adequately capitalized and able to raise funds in the capital markets.¹⁴

In carrying out its supervisory responsibilities, the Finance Board has the authority to promulgate regulations or issue orders that implement any of the specific provisions of the Bank Act. The Finance Board also has the authority to adopt regulations or orders that carry out any of the purposes or duties imposed by the Bank Act. As a general proposition, given the breadth of the rulemaking authority conferred by Congress, it is our opinion that any regulation duly promulgated by the Finance Board that has the purpose or effect of advancing the safety or soundness of the Banks or any other of the statutory duties of the Finance Board (as well as implementing any specific provision of the Bank Act) would be within the scope of the legal authority conferred by Congress.¹⁵ More specifically, because the intent of the Finance Board in adopting a final rule requiring the Banks to register a class of securities with the SEC is to advance or promote both the safe and sound operation of the Banks and their continued access to the capital markets, it is our opinion that in adopting the final rule the Finance Board would be within the scope of authority conferred by the Bank Act.

B. Administrative Procedure Act Requirements.

Any rule adopted by the Finance Board is subject to judicial review under the provisions of the APA. The scope of such judicial review is governed by Section 706 of the APA, which requires a reviewing court to set aside any agency action that it finds to be, among other things: (1) in excess of statutory jurisdiction or authority or (2) arbitrary, capricious, an abuse of discretion, or not otherwise in accordance with law.¹⁶ An analysis of the final rule in light of each of those standards is set out below.

the agency's overall responsibilities, then it may be adopted pursuant to the authority to issue regulations that are "necessary" to implement other statutory provisions.

¹⁴ 12 U.S.C. § 1422a(a)(3). This provision of the Bank Act also directs the Finance Board to ensure that the Banks carry out their housing finance mission. Congress added these duties to the Bank Act in 1989, but without any order of priority. In 1992, Congress further amended this provision to prioritize these duties, stating expressly that the primary duty of the Finance Board shall be to ensure that the Banks operate in a financially safe and sound manner, and that in carrying out each of the other duties the Finance Board must act consistently with the primary duty of ensuring safety and soundness. *See* Federal Housing Enterprises Financial Safety and Soundness Act of 1992, Pub. L. No. 102-550, Title XIII, § 1391, 106 Stat. 3941, 4009 (Oct. 28, 1992) (*codified at* 12 U.S.C. § 1422a(a)(3)).

¹⁵ *See, e.g., Fidelity Federal Savings and Loan Assn. v. De La Cuesta*, 458 U.S. 141, 159 - 162 (1982) (upholding rule addressing lending practices of savings associations as within scope of delegation from Congress and in furtherance of the purposes of the statute); *WFS Financial Inc. v. Dean*, 79 F. Supp. 1024, 1026 (W.D. Wis. 1999) (upholding rule addressing operating subsidiaries as within delegation of authority from Congress and consistent with advancing purposes of the statute); *Texas Savings & Community Bankers Assn., et al. v. Federal Housing Finance Board*, 201 F.3d 551 (5th Cir. 2000) (upholding Finance Board approval of a mortgage program).

¹⁶ 5 U.S.C. § 706. Section 706 also requires a court to set aside agency action that it finds to be contrary to constitutional right, power, privilege, or immunity, or without observance of procedure required by law. We do not

1. Agency Action In Excess of Statutory Jurisdiction or Authority.

a. The Chevron Standard.

In reviewing agency action under Section 706(2)(C) of the APA, a reviewing court must consider whether the agency has acted within the scope of authority conferred by Congress. The seminal case under this provision is *Chevron v. Natural Resources Defense Council*, 467 U.S. 837, 842-43 & n.9 (1984) (hereinafter *Chevron*), in which the Supreme Court articulated a two-part test for review of agency actions under Section 706(2)(C). The first step for a reviewing court under the *Chevron* analysis is to determine whether “Congress has directly spoken to the precise question at issue.” If Congress has done so, the court and the agency must “give effect to the unambiguously expressed intent.” *Chevron*, 467 U.S. at 842-43. Courts will apply traditional tools of statutory construction in determining whether Congress has addressed the question at issue.¹⁷ If a court determines that the statute is “silent or ambiguous on the precise issue,” *i.e.*, Congress has not spoken to the precise question, the court may then proceed to the second step of the analysis, under which it must determine whether the agency’s decision is based on a permissible construction of the statute. The court will “defer to the agency’s interpretation of the statute if it is reasonable and consistent with the statute’s purpose.”¹⁸

For the purposes of applying step two of the *Chevron* analysis, a “permissible interpretation” of the statute is one that represents a “reasonable accommodation of conflicting policies that were committed to the agency’s care by the statute.” *Chevron*, 467 U.S. at 845 (quoting *United States v. Shimer*, 367 U.S. 374, 382-83 (1961)). Even if the agency’s interpretation or corresponding policy choice is one that the court would not have chosen itself, the court may not overturn the interpretation unless “it appears from the statute or its legislative history that the accommodation is not one that Congress would have sanctioned.” *Id.* Moreover, in upholding the agency’s

believe, and no commenter has suggested, that the final rule would implicate any party’s constitutional rights. As the Finance Board has followed the APA requirements for informal rulemaking in this matter, we do not believe that any issue of a failure to follow required procedure is present here. Accordingly, this opinion does not address either of those grounds for setting aside agency action.

¹⁷ *Id.* At 843, n. 9. The court is “the final authority on issues of statutory construction and must reject administrative constructions which are contrary to congressional intent.” *Id.*

¹⁸ See, e.g., *Independent Insurance Agents of America, Inc. v. Hawke*, 211 F.3d 638, 643 (D.C. Cir 2000) (citations omitted). Further, deference can be granted to an agency’s interpretation only where it appears that, as is the case here, “Congress delegated authority to the agency generally to make rules carrying the force of law, and that the agency interpretation claiming deference was promulgated in the exercise of that authority.” *U.S. v. Mead Corp.*, 533 U.S. 218, 226-27 (2001). In this respect, the Court has made clear that “[i]f Congress has explicitly left a gap for the agency to fill, there is an express delegation of authority to the agency to elucidate a specific provision of the statute by regulation.” *Chevron*, 467 U.S. at 843-44. “Such legislative regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute.” *Id.* at 844. Moreover, the *Chevron* Court specifically noted that “[s]ometimes the legislative delegation to an agency on a particular question is implicit rather explicit” but even in cases of implicit delegation, “a court may not substitute its own construction of a statutory provision for a reasonable interpretation made by ... an agency.” *Id.* at 845. In this case, Congress has explicitly authorized the Finance Board to promulgate regulations that carry the force of law and, as discussed below, has not spoken on the issue of a disclosure regime for the Banks, which we believe constitutes an implicit delegation to the Finance Board the authority to address that issue through its rulemaking authority.

statutory construction, “[t]he court need not conclude that the agency construction was the only one it permissibly could have adopted to uphold the construction, or even the reading the court would have reached if the question initially had arisen in a judicial proceeding.” *Id.* at 843, n.11.

b. Chevron Step One Analysis.

Our first step in considering whether a reviewing court would likely uphold a regulation requiring each Bank to register a class of equity securities with the SEC is to identify the “precise question at issue.” In this instance, we believe that the “precise question” is whether Congress has established a particular disclosure regime for the Banks, *i.e.*, has Congress expressed its intent regarding the registration of Bank securities, including the form or content of the Banks’ public disclosures of their financial information or the manner in which those disclosures are to be made. Our analysis of that question is based primarily on the Bank Act, although we also have reviewed relevant provisions of the federal securities laws. For the reasons discussed below, we do not believe that Congress has spoken to this precise question.

The Bank Act is a comprehensive statute that addresses virtually all aspects of the Bank System. Among other things, the Bank Act provides for the incorporation of the Banks, their corporate structure, their capital structure, their powers and duties, their membership base, their lending and investment powers, their borrowing authority, tax status, and the circumstances under which they may be liquidated.¹⁹ In a similar fashion, the Bank Act provides for the creation of the Finance Board, confers on it both general and specific supervisory responsibilities and powers, and generally gives it “cradle to grave” supervisory authority over the Banks.²⁰ Nowhere, however, does the Bank Act speak expressly to the issue of Bank financial disclosures, either by establishing a unique disclosure regime for the Banks or by limiting the authority of the Finance Board to do so. Moreover, the Bank Act does not affirmatively exempt the Banks from the registration requirements of the 1934 Act, as do the chartering statutes for the other two housing government sponsored enterprises (GSEs), Fannie Mae and Freddie Mac.²¹ In short, the Bank Act is silent as to whether the Banks are to be subject to any particular disclosure regime.

In considering whether Congress has addressed the question of the appropriate disclosure regime for the Banks, we also have reviewed provisions of the Securities Act of 1933 (1933 Act) and the 1934 Act. Bank securities are not currently registered under either the 1933 Act or the 1934 Act. The reasons why Bank securities have not been registered under those Acts vary. For example, under the 1933 Act, Bank debt and equity securities are exempted from the registration

¹⁹ See 12 U.S.C. §§ 1432 (incorporation/corporate powers), 1426 (capital structure), 1427 (corporate structure), 1430 (advances), 1431 (powers/duties/borrowing authority), 1433 (tax status), 1436 (investment of reserves), and 1446 (liquidation/reorganization).

²⁰ See 12 U.S.C. §§ 1422a (creation), 1422b (general powers), 1426 (capital standards), 1427 (designation of directorships/appointment of directors), 1431 (approval/oversight of borrowing), 1440 (examinations), and 1446 (authority to liquidate/reorganize).

²¹ Congress expressly has provided that all securities issued by the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) shall be treated as exempt securities under federal securities laws to the same extent as securities that are the direct obligations of the United States. See 12 U.S.C. §§ 1723(c) (Fannie Mae’s securities) and 1455(g) (Freddie Mac’s securities).

provisions as securities issued by a “government instrumentality.” Under the 1934 Act Bank debt and equity securities are not generally exempted (although they may qualify under a more limited exemption). The Secretary of the Treasury has designated Bank debt securities as exempt from registration, but has not addressed whether Bank equity securities also are exempt.²²

This lack of uniformity in how Bank securities are treated suggests that Congress had no intention to establish a particular disclosure regime for the Banks under the federal securities laws. Although there are certain exemptions from registration available to the Banks under various provisions of both the 1933 Act and the 1934 Act, none of those exemptions is targeted specifically toward the Banks. Rather, they are generally available to any issuer or type of security that meets the particular requirements for each exemption. Moreover, Congress has not enacted an express exemption for Bank securities, as it has done for Fannie Mae and Freddie Mac,²³ nor has it conferred 1934 Act jurisdiction over the Banks on the Finance Board, as it has done with respect to the regulators of federally insured depository institutions.²⁴ Based on the absence of any Bank-specific provisions in these laws, and the inconsistent treatment generally afforded to Bank securities, we believe that there is no evidence that Congress intended to establish a particular disclosure regime for the Banks pursuant to the provisions of the federal securities laws or the Bank Act.

c. Chevron Step Two Analysis.

Because the Congress has not spoken to the precise question of the appropriate disclosure regime for the Banks in either the Bank Act or the federal securities laws, a reviewing court applying the *Chevron* analysis would next consider whether the Finance Board’s decision to require the Banks to register with the SEC is based on a permissible interpretation of the Bank Act. For purposes of this second step of the *Chevron* analysis, a permissible interpretation is one that represents a “reasonable accommodation of conflicting policies that were committed to the agency’s care by the statute.” *Chevron*, 467 U.S. at 845 (quoting *United States v. Shimer*, 367 U.S. 374, 382-83 (1961)).

²² See Sec. Ex. Act Rel. 1168 (April 28, 1937) (1937 WL 31498) (announcing decision by the Secretary of the Treasury to exempt debt securities issued by the Federal Home Loan Bank Board (the predecessor agency to the Finance Board) or by the Banks under the authority of Section 11 of the Bank Act).

²³ In the case of those GSEs, Congress included the express exemption in their chartering statutes, rather than in the securities laws. 12 U.S.C. §§ 1455(g) (Freddie Mac) and 1723(c) (Fannie Mae). Notwithstanding those exemptions, both GSEs have agreed to register their equity securities under the 1934 Act, which Fannie Mae already has done.

²⁴ Section 12(i) of the 1934 Act, codified at 15 U.S.C. § 78I(i). Under Section 12(i), any federally insured depository institution that is not controlled by a holding company but that is subject to the 1934 Act must make its 1934 Act disclosure filings with the federal banking regulator that supervises its operations. Section 12(i) requires the banking agency to adopt substantially similar disclosure regulations as those adopted by the SEC, unless it finds that implementation of a regulation is not necessary or appropriate in the public interest or for the protection of investors. The agency must publish a detailed explanation of the reasons for its departure from the 1934 Act rules in the *Federal Register*. The number of depository institutions making 1934 Act filings with their banking regulators is rather small. For example, 17 state member banks (out of 949 such banks) made such filings with the Federal Reserve (as of December 31, 2002), and 15 savings associations (out of 928 such associations) make such filings with the Office of Thrift Supervision.

In considering this issue, we have looked first to the statute itself as a guide to the type of matters that Congress has committed to the care of the Finance Board. In this case, the Finance Board would be relying principally on Section 2B(a), which imposes on the Finance Board the duties “to ensure” the safety and soundness of the Banks, their capital adequacy, and their continued access to the capital markets. The language of that provision is rather broad, *i.e.*, although Section 2B(a) mandates particular results, it uses terms – such as “safe and sound” and “able to raise funds in the capital markets” – that do not readily lend themselves to being precisely quantified. Indeed, each of those terms necessarily entails an exercise of judgment when considering what regulatory choices regarding the business, condition, and operations of the Banks are apt to further the statutory goals. Moreover, Section 2B(a) says nothing about what type of actions the Finance Board may, or should, take to ensure that those statutory objectives are met. In our view, the use of this type of language and this type of statutory structure reflects an intent on the part of Congress to grant the Finance Board considerable latitude when making decisions about how best to ensure that the statutory objectives are met.²⁵ That view is also consistent with language used by Congress in granting rulemaking authority to the Finance Board, which includes the discretion to determine what particular regulatory actions are “necessary” to carry out the provisions of the Bank Act.

Historically, the financial disclosures of the Banks have been somewhat less comprehensive than those provided by companies that have registered with the SEC under the federal securities laws. Because of that, and in light of the significant amounts of debt securities that the Banks (and the other housing GSEs) issue, there has been much debate in recent months about whether the housing GSEs should enhance the quality of their financial disclosures.²⁶ The administration, and others, have advocated that all of the housing GSEs register a class of securities with the SEC under Section 12(g) of the 1934 Act. Other parties, including many of the Banks, while generally agreeing that the quality of financial disclosures should be enhanced to meet 1934 Act standards, have proposed that the Banks file such disclosure documents with the Finance Board, rather than register with the SEC.

In the context of that ongoing debate, the Finance Board proposed to require the Banks to register with the SEC, and is now faced with making a policy determination as to what type of financial disclosure regime, if any, should be applied to the Banks. As presented by the final rule, this issue involves two related questions: (1) whether enhancing the current Bank disclosures to a level that complies with the 1934 Act is likely to enhance the safe and sound operations of the Banks and/or their access to the capital markets, and (2) if so, whether requiring the Banks to register with the SEC, rather than filing disclosure documents with the Finance

²⁵ See *Texas Savings & Community Bankers Assn., et al. v. Federal Housing Finance Board*, 201 F.3d 551 (5th Cir. 2000) (finding that Congress’ deliberate use of imprecise language in the Bank Act reflects an intent to leave the resolution of the ambiguity to the agency); see, e.g., *Texas Savings & Community Bankers Assn., et al. v. Federal Housing Finance Board*, No. A 97 CA 421 SS, 1998 WL 842181 (W.D. Texas, June 25, 1998), *aff’d*, 201 F.3d 551 (5th Cir. 2000) (noting that where Bank Act requires Finance Board “to ensure” that Banks carry out their mission, reviewing court must look at statute as a whole and not be restricted by literal wording of provisions read in isolation).

²⁶ Fannie Mae has already registered with the SEC under the 1934 Act, and Freddie Mac has agreed to do so.

Board, is a reasonable means of accomplishing that result.²⁷ For the reasons stated below, it is our opinion that there is sufficient evidence in the record to provide a reasonable basis for answering each of those policy questions in the affirmative, which would satisfy step two of the *Chevron* analysis.

d. Safety and Soundness Rationale.

The record includes a study by staff of the Board of Governors of the Federal Reserve (FRB Study) that documents how enhanced disclosure of a commercial bank's business risks and financial information can supplement the existing oversight regime for such banks.²⁸ The FRB Study notes that banking regulators have increasingly accepted the fact that market discipline can serve as one element of an effective program of bank supervision, and discusses in some detail how the concepts of financial disclosure, market discipline and bank supervision are interrelated. Briefly stated, the stakeholders of a banking institution, by deciding what return they are willing to accept on their investments in a bank's securities, can effectively determine the availability and cost of the bank's funding and thereby influence the bank's business decisions. This ability to "discipline" a bank's risk-taking through market forces is accepted by banking regulators as contributing to the stability of the banking system. The ability of the stakeholders to exert such influence on a bank, however, depends in large part on whether they can accurately assess its financial condition, risks and earnings prospects, which in turn depends on the quality and extent of the institution's financial disclosures. The FRB Study further notes that this recognition of the value of market discipline as a supplement to the regulatory regime has prompted banking regulators to focus on methods of improving the transparency of commercial banks' financial condition through enhanced disclosure.

The record also includes a document issued by the Basel Committee on Banking Supervision (Committee) that describes the New Basel Capital Accord (Basel II).²⁹ The Basel II accord will establish new international standards on bank capital adequacy, and is intended to improve the existing regulatory capital framework for commercial banking organizations. The Basel II accord is based on three separate "pillars" of supervision: minimum regulatory capital requirements for each banking organization; adequate supervisory review of banking institutions by their regulators; and market discipline. The Committee has explained that "the rationale for the third pillar is sufficiently strong to warrant the introduction of disclosure requirements for banks using the New Accord" and that it intends "to encourage market discipline by developing

²⁷ We note also that the Finance Board could consider, as a third alternative, retaining the current disclosure regime for the Banks, under which the form and content of the disclosure would be less comprehensive than what is required under the federal securities laws. Because no party has advocated maintaining the status quo, we do not address that issue in this opinion.

²⁸ *Improving Public Disclosure in Banking*, Federal Reserve Study Group on Disclosure (March 2000) (included at Tab 2 of the compilation of background materials prepared by the Office of General Counsel and Office of Supervision entitled, *Briefing for Board of Directors, Federal Housing Finance Board – Background Material, Various Disclosure Initiatives and Their Role in Supervision (March 10, 2004, as supplemented)* (hereinafter, *Board Briefing Materials*).

²⁹ Basel Committee on Banking Supervision, *Consultative Document: The New Basel Capital Accord*, p. 154, ¶ 760 (April 2003) (included at Tab 2 of the *Board Briefing Materials*).

a set of disclosure requirement which will allow market participants to assess key pieces of information on the scope of application, capital, risk exposures, risk assessment processes, and hence the capital adequacy of the institution.”³⁰

Both the FRB Study and the Basel II capital accord demonstrate that market discipline has become an accepted element of effective bank supervision, particularly with regard to the adequacy of a banking institution’s capital. The Office of Supervision (OS) also has endorsed the conclusion that enhanced disclosure can promote market discipline and hence, safety and soundness of the Banks.³¹ Full and consistent disclosure is an important element in achieving market discipline because it is only through such disclosure that market participants can obtain, and assess, information on the risks faced by individual financial institutions. Moreover, a common and consistent framework for such disclosure should be expected to enhance the ability of market participants to compare information across similar institutions and over time.³² The Office of Federal Housing Enterprise Oversight (OFHEO) made such observations about the importance of public disclosure to safety and soundness oversight when it recently adopted disclosure requirements for Fannie Mae and Freddie Mac.³³

At present, the annual or quarterly financial statements prepared by a Bank are required to be consistent, in both form and content, with the combined financial statements prepared by the OF for the entire Bank System.³⁴ The practices among the Banks, however, vary somewhat from Bank to Bank as to the level of detail that is provided by the annual and quarterly financial reports of each Bank. In conjunction with this rulemaking process, Finance Board staff has selectively reviewed the quarterly and annual Bank disclosure documents of several Banks, the results of which also are in the record. As a result of that comparison, staff has concluded that

³⁰ *Id.* at p. 154, ¶¶ 757 and 758.

³¹ Memorandum from Stephen M. Cross, Director, Office of Supervision to the Chairman and Directors of the Finance Board, dated June 4, 2004, at pages 4-5. That memorandum also notes the possibility that full disclosure could have negative effects on financial institutions, particularly during periods of financial crisis. The memorandum concludes, however, that an on-and-off disclosure policy that varied with market conditions would ultimately prove to be counterproductive and that disclosures need to be regular and consistent in order to be effective.

³² As previously noted, subjecting the Bank disclosures to SEC oversight will help ensure consistency of disclosure among the Banks and with other financial institutions, most importantly, with the other housing-related GSEs with which the Banks compete in the debt markets.

³³ Fannie Mae and Freddie Mac each agreed to register their securities under Section 12(g) of the 1934 Act. Subsequently, OFHEO adopted its public disclosure regulation for Fannie Mae and Freddie Mac. *See* 68 Fed. Reg. 16715 (April 7, 2003) (adopting 12 C.F.R. part 1730). Fannie Mae and Freddie Mac will have satisfied their disclosure obligations under this regulation by registering with the SEC under the 1934 Act.

³⁴ 12 C.F.R. § 989.4. The OF prepares the combined annual and quarterly financial statements for the Bank System, which are based on the financial statements of all twelve of the Banks. The scope, form and content of the combined financial statements must be consistent with the requirements of SEC regulations S-K and S-X. The Finance Board has ultimate authority for determining whether the combined financial statements meet those requirements. 12 C.F.R. § 985.6(b)(1), (5).

the current individual Bank disclosures fall somewhat short, in certain respects, of the requirements for 1934 Act compliant financial disclosures.³⁵

Accordingly, if the Finance Board were to require the individual Banks to comply with the disclosure requirements of the 1934 Act, that change would result in an increase in both the quality and quantity of the financial information about the individual Banks being disclosed. By disclosing such additional financial information, the Banks should help to maintain the confidence of their members, which buy and hold the stock necessary to capitalize Bank activities, and of the investing public, which buys the Bank System debt that serves as the major source of funding for each Bank's lending, investment and mission activity.³⁶

The regulations, practices and studies of the other banking regulators that have been cited above, as well as the cited Finance Board staff memoranda, all are factors that the Board of Directors may properly take into consideration when determining whether to revise the current disclosure regime for the Banks and whether improvements in the quality and quantity of such disclosures might contribute to the safe and sound operation of the Banks. In light of those factors, it is our opinion that the Finance Board would have a reasonable basis for concluding: that the Banks' current financial disclosures do not meet 1934 Act standards; that improving the quality of those disclosures to meet 1934 Act standards would make the financial statements of the Banks more transparent; that such increased transparency would be likely to promote a greater degree of market discipline; and that such discipline in turn would contribute to the capital adequacy and/or the safety and soundness of the Banks.

e. Capital Markets Rationale.

The Finance Board has a separate duty to ensure that the Banks remain able to raise funds in the capital markets. Because it has no involvement or control over those markets, the Finance Board cannot directly ensure access to them. Rather, the Finance Board can do so only indirectly, such as through regulatory policies that it believes will be conducive to preserving the Banks' ability to borrow in the capital markets. Developing such policies necessarily requires an exercise of

³⁵ See Memorandum from John P. Foley to John Harry Jorgenson, dated March 23, 2004 (comparing content of the annual reports of certain Banks to disclosure requirements under SEC Form 10-K) (included at Tab 3 of the *Board Briefing Materials*); Memorandum from Stephen M. Cross, Director, Office of Supervision to the Chairman and Directors of the Finance Board, dated June 4, 2004 (describing results of an OS review of recent disclosures prepared by each of the Banks, and results of informal review by SEC staff of the 2002 annual report of one Bank).

³⁶ Both before and after its amendment by the GLB Act, Section 6 of the Bank Act required members to buy and hold stock to capitalize the Bank. Compare 12 U.S.C. § 1426 (1994) to 12 U.S.C. § 1426 (2000). Prior to the GLB Act amendments, Section 6 set uniform stock purchase requirements applicable to members of each Bank. The GLB Act changed the Bank Act by requiring each Bank to adopt stock purchase requirements for its members in its capital plan. In addition, the GLB Act made membership in the Bank System voluntary for all members when it removed provisions from Section 5(f) of the Home Owners' Loan Act that required all federal savings associations to be mandatory members of their local Bank. See Interim Final Rule: Amendment of the Membership Regulation and the Advances Regulation, 65 Fed. Reg. 13866 (March 15, 2000). Arguably, the change to all voluntary membership increases the importance of disclosure in maintaining member confidence and thereby in maintaining adequate Bank capitalization. In addition, because the corporate disclosure regime is the same whether an entity has registered stock or debt instruments under the 1934 Act, Bank registration of a class of stock will provide investors in Bank System debt with information that will be equally relevant to their purchases. See Beller Testimony at p.6.

judgment as to what factors are likely to affect (in either a positive or negative fashion) the Banks' current or future access to the capital markets. Although there may be some uncertainties involved with making such predictive judgments, it is our view that the Finance Board has the authority to act to ensure access to the capital markets based on such judgments if those judgments have a basis in fact and there is some nexus between the facts and the statutory objective to be achieved.

There are two principal facts in the record that frame the issue of access to the capital markets: the parties with which the Banks compete in the global debt markets and the relative quality of the disclosures provided by each of those competitors. When issuing COs in those debt markets, the Banks compete primarily against the other two housing GSEs, Fannie Mae and Freddie Mac. As noted previously, both Fannie Mae and Freddie Mac have agreed to register their stock with the SEC under the 1934 Act. Fannie Mae already has done so, and Freddie Mac will do so after it has resolved certain accounting matters. Thus, unless the Finance Board requires the Banks to enhance their disclosures, once Freddie Mac has registered with the SEC the Banks will be the only housing GSE that is competing for funds in the capital markets with financial disclosures that are less comprehensive than those required under the 1934 Act.

Whether the prospective disparity between the quality of the disclosures provided by Fannie Mae and Freddie Mac and the Banks, respectively, is apt to have any significant effects on the ability of the Banks to raise funds in the capital markets is difficult to quantify, especially before the fact. Interviews with Office of Finance staff suggest that Bank registration with the SEC is unlikely to give them a cost of funds advantage relative to Fannie Mae and Freddie Mac, and that a delay in registration is unlikely to place them at a cost disadvantage. Nonetheless, the possibility that the disparity in disclosure quality may have adverse effects is a factor that the Finance Board should assess as part of its duty to ensure that the Banks have continued access to the capital markets.

Even if there is little or no quantifiable evidence of a cost of funds advantage or disadvantage likely to result from SEC registration (or from otherwise enhancing the quality of the disclosures), the fact remains that the disclosures provided by the Banks, for which the global debt markets are their principal source of funding, will soon provide the markets with a lesser degree of information than will be provided by their principal competitors. Although staff cannot state with certainty that the market will be less receptive to Bank debt offerings because of this information disparity, we also cannot say that there is no possibility that the Banks may find themselves at a competitive disadvantage as a result of that disparity. Unfortunately, the best evidence of whether such a disparity will have any limiting effects on the Banks' access to the capital markets is apt to become apparent only if the Finance Board were to allow the Banks to compete against Fannie Mae and Freddie Mac in the capital markets for some period of time with lesser quality financial disclosures. That is not a practical alternative, however, because allowing the possibility to exist that the Banks could be placed at a disadvantage in the capital markets likely would run contrary to the Finance Board's duty to ensure continued access to the capital markets, and could affect capital adequacy or safety and soundness if the Banks were in fact to be placed at a disadvantage to their principal competitors.

By requiring the Banks to publish financial disclosures that are equivalent to those provided by their principal competitors, the Finance Board would eliminate the possibility that Fannie Mae and Freddie Mac would gain a competitive advantage over the Banks based solely on the quality of their financial disclosures.³⁷ Although that conclusion is based more on a common sense assessment of the facts -- disparity in disclosure quality may disadvantage the entity with the lesser quality disclosure – than on empirical study, we believe that such an assessment is permissible in these circumstances. As noted previously, assessing the likely effects of current and future developments in the financial markets and political arena on the Banks’ access to the capital markets is not a matter that readily lends itself to being measured and necessarily requires the Finance Board to make certain policy judgments. One such judgment is whether enhancing the quality of the financial disclosures would promote the Banks’ future access to the capital markets by eliminating a competitive disadvantage that is certain to appear once Freddie Mac registers with the SEC. In our opinion, the facts before the Board – that the Banks compete primarily with Fannie Mae and Freddie Mac and that the quality of their respective disclosures are diverging – provide a reasonable basis on which the Board may determine that enhancing the quality of the Bank disclosures to the level of their competitors would further the Board’s duty to ensure that the Banks remain able to access the capital markets for the issuance of their COs.

f. Manner of Requiring Enhanced Financial Disclosures.

As noted previously, there are two distinct options available to the Finance Board by which it can require the Banks to increase the quality of their financial disclosures to the standards of the 1934 Act. First, as has been proposed, the Finance Board could require the Banks to register a class of equity securities with the SEC, which would result in the quality of their disclosures being enhanced to 1934 Act standards. Alternatively, the Finance Board could adopt the so-called “Section 12(i) approach” that has been proposed by a number of commenters, under which the Finance Board would require the Banks to prepare 1934 Act-compliant financial disclosures but file them with the Finance Board, rather than with the SEC.³⁸

To a certain degree, choosing between these two alternatives involves an assessment of how the relative expertise of each agency, *i.e.*, the knowledge and expertise of the Finance Board with respect to the Banks and the similar knowledge and expertise of the SEC with regard to financial disclosures and accounting issues, bears on the underlying issue. Fundamentally, the issue at the heart of the final rule is one of public disclosure. The OS, while recognizing that the record

³⁷ The final rule would require each Bank to register with the SEC, and thus would affect only the financial disclosures provided by the individual Banks. Although participants in the capital markets may look principally to the combined financial statements prepared by the OF, rather than to the financial disclosures provided by the individual Banks, we expect that the enhanced quality of the individual Bank financial disclosures will flow through to the combined financial disclosures prepared by the OF, and thus benefit the capital markets participants who look to the combined financial statements to assess the condition of the Bank System. In preparing the combined financial statements, the OF should have considerably more information from each of the Banks than it has had in prior years, particularly with regard to the narrative discussions that each Bank will provide regarding its operations and condition.

³⁸ Under each option, we have assumed for purposes of this opinion that both the SEC and the Finance Board would provide substantially identical “no-action” relief to the Banks relating to a number of issues raised by the Banks. Accordingly, this opinion does not further address the matter of issues subject to “no-action” relief.

includes materials that support each alternative, nonetheless has concluded that the more compelling choice is that the SEC is best suited to administer and enforce an enhanced disclosure regime for the Banks.

The OS has provided the Board of Directors with a memorandum (OS Memo) that sets out its reasons for recommending that the Banks become subject to an SEC-administered disclosure regime.³⁹ The OS Memo cites four principal reasons for its recommendation. First, Congress has established the SEC to administer and enforce the nation's securities laws, to promote stability in the financial markets and to protect investors. As a result, the SEC has a depth and breadth of disclosure expertise that is unmatched. Indeed, even the federal banking agencies that administer the 1934 Act under Section 12(i) generally must follow SEC rules and look to the SEC for guidance on interpretive matters relating to the 1934 Act and its implementing regulations. Since its creation, the SEC has been in the forefront of investor protection and generally is recognized as significantly contributing to the integrity of the United States securities markets. For those reasons, subjecting the Banks' disclosures to SEC oversight should strengthen investor confidence in the quality and consistency of the information that the Banks disclose to the markets.

Second, the SEC staff has a degree of expertise in dealing with complex accounting disclosure issues that the Finance Board does not currently possess. Although the Finance Board reviews Bank financial statements and call reports for safety and soundness purposes, it has not developed a breadth of experience in dealing with the interpretative complexities of certain issues, such as those relating to accounting for derivative instruments and hedging activities. Instilling confidence in the quality of the Banks' accounting disclosures is especially important in light of the changes in Bank activities and the resulting increase in the complexity and sophistication of the Banks' accounting and financial statements in recent years.⁴⁰

Third, the SEC reviews the financial reports from a diverse range of financial institutions, including the other housing GSEs and large banking organizations. That experience gives the SEC a broad frame of reference within which to review reporting and accounting issues that may arise from any issuer, and allows it to apply disclosure standards consistently to all such financial institutions.⁴¹

³⁹ Memorandum from Stephen M. Cross, Director, Office of Supervision, to the Chairman and Directors, dated June 4, 2004.

⁴⁰ Furthermore, new Financial Accounting Standards Board (FASB) statements also have given rise to interpretative complexities with regard to accounting and financial reporting. These requirements will give rise to more comprehensive and detailed disclosures by individual Banks. The SEC staff has the extensive accounting expertise required to review this type of disclosure.

⁴¹ The SEC currently reviews the disclosure documents of Fannie Mae and will soon review those of Freddie Mac. In addition, the SEC reviews the public disclosure documents of all bank holding companies and savings and loan holding companies, which represent the majority of large financial institutions in the United States. In light of this experience, over time the SEC staff should be best able to ensure that Bank disclosures are appropriately consistent with the financial disclosures of the other GSEs and financial institutions. This should allow market participants to better compare Bank disclosures with those of their competitors.

Fourth, over both the near term and thereafter, the advantages that the SEC has in terms of experience and expertise make it unlikely that the Finance Board could ever replicate the resources that the SEC can bring to bear when reviewing Bank disclosure documents or that it could keep pace with evolving standards for financial and accounting disclosures.

The OS Memo further notes that greater transparency and market discipline will supplement the Finance Board's supervision of the Banks, thereby enhancing their safety and soundness. Although the OS Memo concedes that such enhancements to safety and soundness may well result regardless of which agency administers the enhanced disclosure regime, it also has concluded that the only certain way to ensure that the disclosures are truly 1934 Act compliant would be for the Banks to register with the SEC. That approach also would ensure that the Banks' disclosures would achieve parity with those of Fannie Mae and Freddie Mac. Any other approach may be perceived as entailing a lesser quality of disclosure, which may prompt markets to draw distinctions based on those disclosures, whether such distinctions are warranted in fact or not. The OS Memo further notes that the SEC has a history of coordinating its actions with those of the other federal banking regulators and that it would be able to implement such a disclosure regime more quickly, and at less cost to the Banks, than could the Finance Board.

A number of commenters, citing a study commissioned by the Banks from First Manhattan Consulting Group (FMCG), have contended that the Finance Board would be better suited to administer an enhanced disclosure regime than would the SEC because registration with the SEC would cause the Banks to incur significant additional costs. The FMCG study contends that registration with the SEC would cause the Banks to incur significant compliance costs (both for the preparation of the initial disclosure documents and annually thereafter), liquidity costs and funding costs. The OS has conducted a separate analysis of the FMCG study, which concludes that FMCG has substantially overstated the costs that are likely to result from SEC registration. The reasons underlying the conclusions of the OS are set out in some detail in its analysis which, along with the FMCG study, is included in the record.⁴² We believe that the Board of Directors may reasonably rely on the analyses provided by the OS regarding the validity of the cost estimates projected by the FMCG study.

Certain commenters also have advocated a Finance Board-administered disclosure regime because the Finance Board has a far more detailed understanding about the business, operations and conditions of each Bank than the SEC likely could develop through its periodic review of Bank disclosure documents. Although that assessment is in all likelihood correct, it must be

⁴² The FMCG Study and Finance Board staff's analysis thereof, are located at Tab 4A of the *Board Briefing Materials*. With regard to the likely costs of compliance, we note that each of the two options would require the individual Banks to enhance the quality of their current financial disclosures to meet the standards of the 1934 Act. Thus, the costs to the Banks of preparing disclosure documents that comply with the 1934 Act, both as an initial matter and on an ongoing basis thereafter, and the costs resulting from investors' responses to the content of those disclosures, should not be materially different under either approach. In conjunction with a review of the issues raised by the FMCG study, the Office of Supervision has analyzed separately the current amount of liquid assets held by the Banks, which would be available to them if their access to the debt markets were to be curtailed for some period of time. That analysis concludes that the liquidity within the System is significantly greater than that assumed by the FMCG study and should be sufficient for hypothetical periods of interrupted market access of up to, and perhaps longer than, 30 days. That analysis is located at Tab 4C of the *Board Briefing Materials*.

weighed against other factors noted previously, most notably the SEC's unquestioned expertise on matters relating to disclosure and accounting. Moreover, the Board of Directors should consider the respective expertise of each agency in light of the objective to be achieved by the final rule, which is to enhance the quality of the financial disclosures provided by the individual Banks to the standards required by the 1934 Act.

After considering the substance of the OS Memo, as well as the OS analysis of the FMCG study and the OS analysis of Bank liquidity, it is our opinion that the record includes sufficient information on which the Board of Directors might reasonably conclude that requiring the Banks to register with the SEC would have benefits – in terms of disclosure expertise and overall costs to the Bank System – that would outweigh the benefits of having the Finance Board administer its own disclosure regime.

2. Agency Action that is Arbitrary or Capricious.

Agency action, such as the final rule, also is subject to judicial review under Section 706(2)(A) of the APA, which allows a reviewing court to set aside agency action that is “arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law.”⁴³ The APA does not elaborate on what factors may cause a given agency action to be arbitrary or capricious, but the Supreme Court has described such situations as follows:

Normally, an agency rule would be arbitrary and capricious if the agency has relied on factors which Congress has not intended it to consider, entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise.⁴⁴

As a practical matter, courts are apt to focus on three areas in reviewing agency action under this provision of the APA: (1) whether the record supports the agency's factual conclusions; (2) the rationality or reasonableness of the agency's policy conclusions; and (3) the extent to which the agency has articulated the basis for its conclusions.⁴⁵ A court normally will not substitute its judgment for that of the agency when making factual determinations, so long as the agency's conclusions are based on facts in the record, and generally will defer to an agency's policy choices so long as they are reasonable and the rationale for such choices is adequately explained.⁴⁶

⁴³ 5 U.S.C. § 706(2)(A).

⁴⁴ *Motor Vehicle Mfrs. Assn. v. State Farm Mutual Auto. Ins. Co.*, 463 U.S. 29, 43 (1983).

⁴⁵ J. Lubbers, *A Guide to Federal Agency Rulemaking* (3d Ed.) 318 (1998).

⁴⁶ *Id.* at 328. See also *Baltimore Gas & Electric Co. v. Natural Resources Defense Council, Inc.*, 462 U.S. 87, 105-106 (1983).

a. Factual Conclusions.

The final rule incorporates a number of factual conclusions, which relate principally to the state of the Banks' current financial disclosures and the likely consequences of enhancing the quality of those disclosures. In our view, the record includes sufficient information for each of those factual conclusions and demonstrates that the Board of Directors has considered the important factual aspects of this matter. With regard to the quality of the current Bank disclosure documents, both Finance Board staff and SEC staff have reviewed selected disclosure documents and have determined that they fall short of the requirements of the 1934 Act in numerous respects. The extent to which the current disclosures are deficient is documented in memoranda that are included in the record.⁴⁷

The likely consequences of requiring enhanced disclosures by the Banks also involve questions of fact for the Finance Board, which are necessarily predictive in nature and are interwoven to a degree with questions of policy. By requiring the Banks to prepare 1934 Act-compliant financial disclosures, the Board would be making a factual determination that such enhanced disclosures will promote market discipline which, by complementing the Finance Board's supervisory oversight of the Banks, would advance safety and soundness as well. The record includes Finance Board staff analysis, as well as information from other banking regulators, regarding the benefits of enhanced disclosure.

The record also includes information documenting that Fannie Mae and Freddie Mac are the principal competitors of the Banks in the global debt markets, and that they both have committed to enhancing the quality of their disclosures to comply with the 1934 Act. Implicit in the final rule is a related finding, based on that information, that the Banks' access to the capital markets is likely to be better preserved if they are not placed at a competitive disadvantage by publishing less robust disclosures than Fannie Mae and Freddie Mac. Although there is no empirical data that demonstrates the extent of any such disadvantage that is apt to result from a disparity in the quality of disclosure, the Board of Directors may make decisions that are predictive in nature, so long as they are within the area of expertise committed to the agency, which we believe to be the case here.⁴⁸

In adopting the final rule, the Board of Directors also would be making factual findings relating to the reasonableness of the anticipated costs to the Banks of registering with the SEC, as compared to the expected costs of a Finance Board administered disclosure regime. Specifically, the Board would be finding that the costs of the former approach are not so significantly different

⁴⁷ OS Memo at pages 2-3. *See also* Memorandum from John P. Foley to John Harry Jorgenson, dated March 23, 2004, and the document captioned "Anticipated SEC Comments on a FHLBank Annual Report" both of which are located at Tab 3 of the *Board Briefing Materials*.

⁴⁸ *See Baltimore Gas & Electric Co. v. Natural Resources Defense Council, Inc.*, 462 U.S. 87, 103 (1983). In that case, the Court upheld a decision of Nuclear Regulatory Commission that involved predictions that were within the agency's area of special expertise, and which the Court described as being "at the frontiers of science". The Court indicated that in reviewing such determinations, rather than simple findings of fact, a reviewing court must be at its most deferential. Although the issues under consideration by the Finance Board are not scientific in nature, they do relate to matters within the special expertise of the agency, *i.e.*, the safety and soundness of the Banks and their access to the capital markets, and should be given similar deference.

from those of the latter approach, as has been suggested by certain commenters. As noted previously, the record includes presentations expressing differing assessments of the costs associated with an SEC-administered disclosure regime. FMCG, a consultant retained by the Banks, has projected significant costs to the Banks of registering with the SEC. The OS, however, has analyzed the assumptions and conclusions expressed in the FMCG paper and has found them to be flawed in several respects. As a result of those flaws, the OS has determined that the FMCG analysis significantly overstates the costs of SEC registration. The OS also has described certain reasons suggesting that the overall costs of SEC registration may well entail lesser costs.⁴⁹

With regard to each of the matters referred to above, it is our opinion that there are sufficient items in the record to support the Finance Board's factual conclusions that: the current disclosures do not comply with the 1934 Act; enhancing the disclosures to 1934 Act levels would promote market discipline, and thereby advance safety and soundness; requiring registration would place the Bank disclosures on a parity with those of Fannie Mae and Freddie Mac, and thus eliminate one possible means by which the other GSEs could gain a competitive advantage over the Banks; and that there is no persuasive evidence that the costs to the Banks of registering with the SEC would be significantly greater than the costs of a Finance Board administered disclosure regime.

b. Policy Conclusions.

Under Section 706(2)(A) of the APA, a reviewing court will also consider whether an agency's asserted policy reasons for a particular action are reasonable or rational. Although this basis for a court's review of an agency's action is technically distinct from its review under step two of the *Chevron* analysis, there is as a practical matter significant overlap in what is reasonable under each approach.⁵⁰ This opinion has described in some detail the reasons underlying our conclusion that the adoption of the final rule would satisfy the "reasonableness" requirement of the *Chevron* step two analysis. We reiterate and incorporate that rationale for purposes of supporting our conclusion that the policy conclusions to be made by the Board of Directors also would be deemed to be reasonable for purposes of review under the arbitrary and capricious standard of the APA.

c. Articulation of Rationale.

In addition to the factual and policy matters noted above, an agency adopting a final rule must articulate the reasons for its actions. Section 553(c) of the APA generally requires an administrative agency, after considering comments received on a proposed rule, to include in its final rule a concise statement of the basis and purpose of the rule. Doing so demonstrates that the adoption of the rule is the product of reasoned decision making by the agency.⁵¹

⁴⁹ See Memorandum from Stephen M. Cross, Director, Office of Supervision, to the Chairman and Directors at page 8 (June 4, 2004).

⁵⁰ J. Lubbers, *A Guide to Federal Agency Rulemaking* (3d Ed.) 335 (1998).

⁵¹ *Id.* at 328.

We have reviewed the materials in the record, as well as the explanatory information in the draft *Federal Register* version of the final rule. It is our opinion that those documents adequately explain the basis and purpose of the final rule and demonstrate that the Finance Board has come to its conclusions through a reasoned decision making process. To briefly summarize, the *Federal Register* document explains in some detail the genesis and history of the Finance Board's concerns about the adequacy of Bank disclosures, describes the substance of the principal issues raised by the comment letters, and includes responses to those issues, notably the issues concerning the legal authority of the Finance Board, the possible costs to the Banks, and the reasons why the Finance Board has determined that the SEC is best suited to review the Banks' disclosures. The final rule also describes the factual bases on which the Finance Board has relied, and the principal conclusions that the Finance Board has drawn from those facts. For example, the factual bases include the quality of the current Bank disclosures, the disparity between those disclosures and those prepared (and to be prepared) by the other GSEs, and the practices of other banking regulators with regard to how enhanced disclosure and market discipline promote safety and soundness. The principal conclusions include the positive effects that enhanced disclosure are likely to have on both safety and soundness and capital markets access, as well as an assessment on the expected financial burdens to the Banks of registering with the SEC.

d. Legal Arguments.

The principal legal issues associated with the final rule, *i.e.*, whether it is authorized under the Bank Act and whether the Board has acted consistently with the APA, have been discussed at some length in this opinion. Because the arbitrary and capricious standard of review also requires the Board to consider all relevant legal issues relating to the rule, we note below two arguments raised by the comments that question the Board's legal authority and explain why we believe they are not well founded.

The first of those legal arguments is that the final rule "would purport to overturn, without specific statutory authorization, the statutory exemption from mandatory SEC registration of securities of the FHLBanks that Congress adopted in the 1933 Act and the 1934 Act."⁵² The short answer to this argument is that there is no such "statutory exemption" in the 1934 Act that expressly addresses the equity securities of the Banks. The commenter has implicitly acknowledged that fact by failing to cite to any such provision in the 1934 Act. As noted

⁵² Legal Memorandum from the law firm of Venable LLP, dated March 16, 2004 (the Venable Memorandum), at 8, submitted as part of the comment letter from America's Community Bankers, dated March 16, 2004. The Venable Memorandum contends that by adopting the final rule the Finance Board would "waive the FHLBanks' statutory exemption from SEC registration, granted in 1937 by the agency head (the Secretary of the Treasury) to whom congress had delegated" the power to grant exemptions under the 1934 Act. *Id.* at 14. The Memorandum further contends that the rule "would have the effect of revoking the statutory exemption from mandatory registration with the SEC under the 1934 Act that was granted by statute and an implementing decision of the Secretary of the Treasury." *Id.* at 15. As explained previously in this opinion, the action taken by the Secretary of the Treasury in 1937 related solely to Bank debt securities issued under the authority of Section 11 of the Bank Act, and not to Bank equity securities, which are issued under Section 6 of the Bank Act and which are the only Bank securities subject to the final rule.

previously, the final rule speaks only to the registration of Bank equity securities under the 1934 Act; it does not address either the registration of debt securities issued by the Banks or registration under the provisions of the 1933 Act. Accordingly, the commenter's reliance on exemptions under the 1933 Act and exemptions relating to Bank debt securities does not support its contention that the final rule would overturn a statutory exemption for Bank equity securities under the 1934 Act. Moreover, because the commenter has failed to identify a specific 1934 Act exemption for all Bank equity securities that would be "overturned" by the final rule, we do not believe that its argument is well founded.

Even if Bank equity securities were exempt under the 1934 Act, however, we do not believe that necessarily would preclude the Board of Directors from requiring the Banks to register with the SEC if the Board were to determine that doing so was necessary for reasons of safety and soundness. A statutory exemption for Bank equity securities would reflect a determination by the Congress that registration of those securities was not deemed necessary in order to carry out the purposes of the 1934 Act. The existence of such an exemption, however, would not necessarily mean that Congress has prohibited the registration of those securities for other reasons.

Indeed, the so-called "voluntary" registration provisions of Section 12(g) of the 1934 Act demonstrate that Congress clearly contemplated that circumstances might arise under which an issuer might register securities under the 1934 Act that are not otherwise required to be registered by the terms of that Act. We note that in this context the word "voluntary" is used to distinguish between a security that must be registered under the 1934 Act and a security that need not, but may be, registered under that Act. It may well be true that in most cases issuers who register equity securities under this provision do so for their own business reasons, and thus their actions are "voluntary" in the commonly understood sense of that word. That does not mean, however, that registration under Section 12(g) is available only to issuers that choose to register for their own business purposes.

In this regard, SEC senior staff has confirmed to us that the "voluntary" registration provisions of Section 12(g) would be the appropriate means by which the Banks could register under the 1934 Act, whether they chose to do so for their own reasons or were compelled to do so by the Finance Board. In this case, the Finance Board is requiring the Banks to register with the SEC in order to enhance their safety and soundness and their access to the capital markets, which is well within its authority under the Bank Act. We do not believe that an exemption under the 1934 Act could reasonably be said to limit the Finance Board's independent statutory authority over the Banks, which view we believe is consistent with the above described interpretation of Section 12(g) provided to us by SEC staff.

The second legal argument raised by the comments is that the final rule would unlawfully delegate the Finance Board's safety and soundness responsibilities to the SEC. The Venable Memorandum, citing a number of court cases, contends that an agency can sub-delegate its responsibilities to another agency only if it is expressly authorized to do so by Congress.⁵³

⁵³ The Venable Memorandum cites several cases in which a court overturned a delegation from one agency to another of decision-making authority that Congress had required the first agency to perform. *See, e.g., United States Telecom Assn. v. FCC*, 2004 WL 374262 (D.C. Cir. March 2, 2004) (rejecting FCC delegation to state utility

Although the Venable Memorandum may correctly describe the legal principles required for a valid delegation, we believe that it has erred in assuming that the final rule would constitute a delegation of the Finance Board's safety and soundness authority to the SEC.

In the context of the final rule, the exercise of the safety and soundness authority conferred by the Bank Act will occur when the Board of Directors determines that the Banks must enhance the quality of their financial disclosures to meet the standards of the 1934 Act and further determines that requiring the Banks to submit to the jurisdiction of the SEC is a key element in demonstrating to the markets that the financial disclosures are in fact 1934 Act compliant. Those are the critical safety and soundness decisions that are to be made with regard to financial disclosures, and they will be made solely by the Finance Board. Thus, it is the Finance Board that will determine the disclosure standards with which the Banks must comply (those of the 1934 Act) and the means by which their compliance with those standards will be monitored and enforced (through registration with the SEC).

In substance, the Finance Board has chosen SEC registration as the means through which its safety and soundness decisions are to be implemented, which is an entirely different matter than allowing the SEC to make its own judgments as to what is most appropriate to advance the safety and soundness of the Banks. The role of the SEC under the final rule, though a critical element in ensuring that the Banks adhere to the 1934 Act disclosure standards (and thus advance the statutory duties under the Bank Act), does not involve any determinations as to what is or is not a safe and sound practice for the Banks.⁵⁴ The Finance Board will have already made those determinations. Granted, the SEC does have ultimate authority for determining what is or is not required under the disclosure provisions of the 1934 Act and in enforcing compliance with those requirements by all who register, but that authority derives from the 1934 Act itself, not from any power delegated to it by the Finance Board.⁵⁵ In our view, by contending that the final rule would delegate safety and soundness authority to the SEC, the Venable Memorandum confuses the exercise of safety and soundness authority, which necessarily entails weighing options and

commissions of its responsibilities to make determinations related to telecommunications carriers opening their infrastructure to competition); *National Park Service v. Stanton*, 54 F. Supp. 2d 7 (D.D.C. 1999) (rejecting Park Service delegation to an outside entity of its responsibilities for managing a national scenic river).

⁵⁴ In this respect, the registration rule is similar to existing requirements that the Banks and the OF annually submit to audits by an independent external auditor. See 12 C.F.R. § 989.2. The rule is also similar to the Finance Board regulation conditioning the acceptability of certain investments on ratings received from a nationally recognized statistical rating organization. See 12 C.F.R. §§ 955.3(a), 956.1 and 956.3.

⁵⁵ In fact, the final rule appears to present a situation that one of the judicial opinions cited by the commenter has recognized as not being covered by the non-delegation doctrine. *United States Telecom Assn. v. FCC*, 2004 WL 374262 (D.C. Cir March 2, 2004). Although it set aside the delegation in the case before it, the *USTA* court distinguished that case from another case in which the court upheld Department of the Interior regulations that required an applicant for a permit to drive in a national seashore park to first obtain a permit from one of the neighboring municipalities. See *U.S. v. Matherson*, 367 F. Supp. 779 (E.D.N.Y. 1973). The *Matherson* Court found that the regulation “is in no way an abdication of the Superintendent’s power to administer the National Seashore. Rather, the instant section merely exemplifies an effort by the Superintendent to facilitate an orderly prevention of erosion on the land.” In a similar fashion, the Finance Board would be relying on the SEC to facilitate an outcome – enhanced disclosures – that the Finance Board has determined would supplement or facilitate the Finance Board’s duty to ensure the safety and soundness of the Banks and their access to the capital markets.

making decisions about what actions are likely to affect the safety and soundness of the Banks, with the means chosen to implement those safety and soundness decisions.

The Venable Memorandum also contends that 12 U.S.C. § 1422b(b)(1) bars the Finance Board from delegating its authority to other agencies. As noted above, we do not believe that the final rule delegates any of the Finance Board's responsibilities to the SEC, and thus does not implicate that provision of the Bank Act. Moreover, we believe that the historical context in which that provision was adopted demonstrates that it was concerned solely with delegations from the Finance Board to the Banks. In relevant part, that provision reads as follows:

... except that in no event shall the [Finance] Board delegate any function to any employee, administrative unit of any Bank, or joint office of the Federal Home Loan Bank System.

If read to reach beyond the Bank System, that language would bar the Board of Directors from delegating any function to any party, including to individual members of the Board, officers of the agency, or employees of the agency. That provision was added to the Bank Act in 1989, as part of FIRREA, which created the Finance Board and abolished its predecessor agency, the Federal Home Loan Bank Board (FHLBB).⁵⁶ Prior to FIRREA, the FHLBB was the principal federal regulator of the Banks and the savings and loan industry, and also functioned as the operating head of the Federal Savings and Loan Insurance Corporation, which insured deposits at savings associations.

In carrying out its regulatory responsibilities relating to the savings and loan industry, the FHLBB relied extensively on certain officers and employees of the Banks, effectively delegating to them certain of the FHLBB's supervisory authorities over the savings and loan associations. Certain Bank officers performed dual functions, *i.e.*, corporate functions relating to the Bank and regulatory functions relating to oversight of the savings and loan industry, while others performed only regulatory functions on behalf of the FHLBB. For example, the president of each Bank served as its chief executive officer, but also acted as the "Principal Supervisory Agent" of the FHLBB.⁵⁷ In that capacity the Bank president performed a variety of regulatory oversight functions relating to the savings and loan industry. Other Bank officers were designated as "Supervisory Agents" and in that capacity performed regulatory oversight functions relating to the savings and loan associations. In the years prior to FIRREA, the FHLBB also had transferred its examinations personnel to the Banks, where, as Bank employees, they examined the savings and loan associations on behalf of the FHLBB. In a similar manner, the FHLBB had created several "joint offices" of the Bank System to perform certain functions on its behalf. The most significant of these joint offices was the Office of Finance, which performed the debt issuance functions on behalf of the FHLBB and the servicing functions on behalf of the Banks.

⁵⁶ FIRREA, *supra* note 11, at § 702.

⁵⁷ See 12 CFR §§ 501.11(a) (1989) (designation of "Principal Supervisory Agents" and "Supervisory Agents" to perform functions for FHLBB); 545.92(e) (delegation from FHLBB to Principal Supervisory Agents of authority to approve certain branch office applications); and 574.8 (delegation from FHLBB to Principal Supervisory Agent of authority to approve certain holding company applications and change in control notices).

As part of its reform efforts, Congress intended to separate the chartering, deposit insurance, and credit allocation functions (all of which previously had been under the auspices of the FHLBB) and to assign them to the Federal Deposit Insurance Corporation (and/or the Resolution Trust Corporation), Office of Thrift Supervision (OTS), and Finance Board, respectively. In doing so, Congress also abolished all joint offices of the Bank System, other than the OF, and mandated the transfer to the Finance Board or OTS, respectively, of Bank employees who previously had been performing regulatory functions on behalf of the FHLBB.⁵⁸

In order to ensure that the Finance Board did not reinstitute the dual function arrangements previously employed by the FHLBB, Congress included in the Bank Act the above-cited limitation on delegations. When viewed in light of this history, that provision is more appropriately read as barring the Finance Board from delegating any of its functions to any employee of a Bank, administrative unit of a Bank, or joint office of the Banks (other than the OF). Although the punctuation and syntax of that provision may not be models of clarity, the Finance Board has never read this provision as reaching more broadly. Indeed, the Board of Directors has previously delegated certain authority to the Chairman, who in turn has delegated certain authorities to other officers of the Finance Board.

III. CONCLUSION

For all of the reasons set forth above, it is our opinion that the Board of Directors has the legal authority under the Bank Act to adopt the final regulation requiring the Banks to register a class of equity securities with the SEC.

⁵⁸ See FIRREA, *supra* note 11, at § 722 (addressing rights of employees of the Banks or their joint offices who had performed regulatory functions for FHLBB).