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Federal Housing Finance Board

February 16, 1995

MEMORANDUM

TO: Gary B. Townsend
Director, Office of Examination
and Regulatory Oversight

FROM: Beth L. Climo
General Counsel

SUBJECT: Meaning of the Term "Securities" as Used in Subsection 16(a) of the Bank Act

ISSUES:

I. May term federal funds be considered to be "securities" for purposes of subsection 16(a) of the Bank Act, thereby making them eligible investments for FHLBank reserves to the extent that they are legal investments for fiduciary and trust funds under the laws of the state in which the particular FHLBank is located?

II. If so, would term federal funds be assets eligible for satisfaction of the Finance Board's negative pledge requirement?

CONCLUSIONS:

I. Yes. The term "securities" is used in subsection 16(a) in a generic sense to represent a broad class of financial investments and, as such, includes term federal funds to the extent that they are appropriate as investments for fiduciary and trust funds in the state in which the FHLBank is located.

II. Yes. Pursuant to section 910.1(c)(5) of the Finance Board's regulations, term federal funds which qualify under subsection 16(a) may be used to satisfy the negative pledge requirement.

DISCUSSION:

I. Background

Section 910.1(c) of the Federal Housing Finance Board's (Finance Board) regulations requires that the Federal Home Loan Banks (FHLBanks) maintain certain types of unpledged assets in a total amount equal to the amount of senior FHLBank bonds outstanding (hereinafter the "negative pledge requirement").[1] Among the types of assets that the FHLBanks may use to satisfy this "negative pledge" requirement are those investments described in subsection 16(a) of the Federal Home Loan Bank Act (Bank Act), 12 U.S.C. § 1436(a) (Supp. V 1993), which provision specifies the assets in which FHLBanks may invest their reserves. See 12 C.F.R. § 910.1(c)(5). Included among the eligible investments listed in subsection 16(a) are "such securities as fiduciary and trust funds may be invested in under the laws of the state in which the [FHLBank] is located."[2] We have been asked to interpret this section of the Bank Act to determine whether term federal funds may qualify as securities in which fiduciary and trust funds may be invested.

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1. See 12 C.F.R. § 910.1(c) (1994), which provides:

> The [FHLBanks] shall at all times maintain assets of the following types, free from any lien or pledge, in a total amount at least equal to the amount of senior bonds outstanding:
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> (1) Cash;
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> (2) Obligations of or fully guaranteed by the United States;
>
> (3) Secured Advances;
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> (4) Mortgages as to which one or more [FHLBanks] have any guaranty or insurance, or commitment therefor, by the United States or any agency thereof;
>
> (5) Investments described in section 16(a) of the Federal Home Loan Bank Act [(Bank Act)], as amended (12 U.S.C. 1436(a)); and
>
> (6) Other securities which have been assigned a rating or assessment by a major nationally recognized securities rating agency that is equivalent to or higher than the rating or assessment assigned by such agency on senior bonds outstanding.

Id.

2. 12 U.S.C. § 1436(a). Subsection 16(a) of the Bank Act provides in pertinent part that FHLBank reserves shall be invested:

> . . . subject to such regulations, restrictions, and

Generally speaking, to say that a FHLBank has invested in "term federal funds" means that the FHLBank has extended an unsecured loan of immediately available funds in its Federal Reserve account to another institution at a market rate of interest for a period of greater than one business day.[3] Commercial banks and certain other entities are required at all times to keep a prescribed amount of immediately available funds in their reserve accounts at the appropriate Federal Reserve Bank. Lucas, supra, note 3 at 34. A "federal funds transaction" occurs when an entity with excess reserves (including the FHLBanks, which are permitted, but are not required, to deposit funds with Federal Reserve Banks, see 12 U.S.C. §§ 1431(e)(2), 1435), lends immediately available funds to a bank with insufficient reserves.[4] The borrowing bank thereby satisfies its reserve requirement, while the lender earns interest on otherwise idle funds.

(Footnote 2 continued from previous page)

> limitations as may be prescribed by the [Finance] Board, in direct obligations of the United States, in obligations, participations, or other instruments of or issued by the Federal National Mortgage Association or the Government National Mortgage Association, in mortgages, obligations, or other securities which are or have ever been sold by the Federal Home Loan Mortgage Corporation . . ., and in such securities as fiduciary and trust funds may be invested in under the laws of the State in which the [FHLBank] is located.

Id. (emphasis added).

3. See Charles M. Lucas, Marcos T. Jones and Thom B. Thurston, Federal Funds and Repurchase Agreements, Fed. Res. Bank of N.Y. Q. Rev., Summer 1977, at 34. A December 27, 1974 memorandum by the Office of General Counsel of the former Federal Home Loan Bank Board concluded that overnight federal funds are the equivalent of cash for purposes of determining whether FHLBanks may invest in such funds under subsections 11(h) and 16(a) of the Bank Act. Thus, FHLBanks may use overnight federal funds to satisfy the negative pledge requirement pursuant to subsection (c)(1) of the regulation. See 12 C.F.R. § 910.1(c)(1). "Term federal funds" (as opposed to "overnight federal funds") are those funds loaned for more than one business day. See Lucas, supra, at 34.

4. Lucas, supra note 3, at 34. In order to remove restrictions on the amount that a nationally chartered bank could lend any one bank, a 1963 ruling by the Comptroller of the Currency declared federal funds transactions to be purchases and sales. Id. at 40. In practice, however, the

II. Analysis

A. Under Federal Law, Term Federal Funds Are "Securities" For Purposes Of Subsection 16(a)

1. The Finance Board's Interpretation of Subsection 16(a) Must Be Given Deference By Courts

Subsection 16(a) of the Bank Act provides that reserves shall be invested in enumerated obligations and securities "subject to such regulations, restrictions, and limitations as may be prescribed by the [Finance] Board." 12 U.S.C. § 1436(a). This subsection is one of the authorities upon which the Finance Board has based the promulgation of its Financial Management Policy (FMP), which, inter alia, sets forth the specific types of investments allowed to the FHLBanks. See Federal Housing Finance Board Financial Management Policy, Res. no. 93-133 ¶ II(B) (Dec. 15, 1993). The FMP authorizes FHLBank investment in term federal funds "having maturities not exceeding 271 days, placed with eligible financial institutions" to the extent that these investments are permitted under subsections 11(g), 11(h) or 16(a) of the Bank Act or to the extent that they are "securities in which fiduciary or trust funds may invest under the laws of the state in which the [FHL]Bank is located." Id. Because Congress did not define the word "securities" in the Bank Act or address that term in the Bank Act's legislative history,[5] the Finance Board must determine what "securities" means in the context of subsection 16(a).

(Footnote 4 continued from previous page)
transactions are in the nature of a borrowing and a lending. Id. at 34.

5. The House and Senate Bills which eventually evolved into the Bank Act were introduced in January 1932 and, regarding FHLBank reserves, provided only that the "reserves of each [FHL]Bank shall be invested subject to such regulations, restrictions, and limitations as may be prescribed by the board." S. 2959, 72d Cong., 1st Sess. § 14 (1932); H.R. 7620, 72d Cong., 1st Sess. § 14 (1932). Later versions, introduced in May and June 1932, added the clause "in direct obligations of the United States and in such securities as fiduciary and trust funds may be invested in under the laws of the State in which the [FHL]Bank is located" to the foregoing language. See S. 2959, 72d Cong., 2d Sess. § 15 (1932); H.R. 12280, 72d Cong., 2d Sess. § 15 (1932). The legislative history of the Bank Act contains no explanation of the "reserves" section.

As the agency charged with the administration of subsection 16(a) of the Bank Act, see 12 U.S.C. §§ 1422a(a)(3) & 1436(a), interpretations of this section by the Finance Board would be given great deference by courts if the question were to be litigated. See Nationsbank v. Variable Annuity Life Ins. Co., 63 U.S.L.W. 4076, 1995 U.S. LEXIS 691 at *10 (1995) [hereinafter VALIC] (quoting Clarke v. Securities Indus. Ass'n, 479 U.S. 388, 403-04 (1987)). Courts will uphold an agency's "permissible interpretation" of a statute that the agency administers if, using traditional rules of statutory construction, the court determines that "Congress has not directly addressed the precise question at issue." Chevron, U.S.A., Inc. v. Natural Resources Defense Council, 467 U.S. 837, 843 & n.9 (1984).

Under Chevron, a "permissible interpretation" is one which represents a "reasonable accommodation of conflicting policies that were committed to the agency's care by the statute." Id. 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 which 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.

2. The Term "Securities" Is Used In A Broad, Generic Sense In Subsection 16(a)

Traditional rules of statutory interpretation require that the meaning of a particular statutory provision be discerned, if possible, by examining the language of the statute and the legislature's intent in passing the statute. See Norman J. Singer, Sutherland Statutory Construction §§ 45.05-.08 (5th ed. 1992). Interpretation of the phrase "such securities as fiduciary and trust funds may be invested in under the laws of the state in which the [FHLBank] is located" is a matter to be resolved by reference to the context in which the phrase is employed and to Congress's intent in enacting subsection 16(a).

a. The Securities Laws Are Inapposite To Interpretation Of Subsection 16(a)

In developing an interpretation of the word "securities," it would seem natural to look first to the body of federal securities law developed under the Securities Act of 1933 (Securities Act), 15 U.S.C. § 77a, et seq. (1988), and the Securities Exchange Act of 1934 (Exchange Act), 15 U.S.C. § 78a, et seq. (1988). Both acts contain detailed definitions of the word "securities," see 15 U.S.C. §§ 77b(1), 78c(10), which definitions have been further refined through more than sixty years of case law. However, because the federal securities laws did not exist at the time subsection 16(a) was

enacted, reference to the definitions contained in the federal securities laws is of questionable validity in interpreting the term "securities" under subsection 16(a).[6] In addition, a series of recent cases addressing federal banking agency interpretations of the word "securities" under federal banking statutes such as the Glass-Steagall Act (Glass-Steagall), Banking Act of 1933, ch. 89, 48 Stat. 162 (1933), indicate that reference to the federal securities laws may not be appropriate when interpreting the term "securities" in other contexts.

In Securities Indus. Ass'n v. Board of Governors of the Federal Reserve System, 468 U.S. 137 (1984) [hereinafter Becker], the United States Supreme Court was called upon to determine the meaning of the term "securities" as used in sections 16 and 21 of Glass-Steagall, 12 U.S.C. §§ 24 (Seventh) & 378(a)(1), which, like the Bank Act, does not define the term. The dispute in Becker arose from the Federal Reserve Board's (FRB) refusal to initiate an enforcement action against a commercial bank that was underwriting commercial paper. There, the Court's principal inquiries were to determine the purposes for which Glass-Steagall was enacted[7] and the ordinary meaning of the term "securities" as understood by the 73d Congress, which passed the Act. See Becker, 468 U.S. at 144-160.

Because Glass-Steagall, the Securities Act and the Exchange Act were each passed by the 73d Congress, the Becker Court referred to the definition of "securities" contained in the federal securities laws for the limited purpose of determining the 73d Congress's understanding of the term. Because commercial paper is explicitly excluded from the definitions of "securities" contained in the Securities Act and

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6. The Bank Act was enacted by the 72d Congress in 1932, while the Securities Act and the Exchange Act were enacted by the 73d Congress in 1933 and 1934, respectively. The breakdown of Democrats to Republicans in the 72d Congress was 47/48 in the Senate and 216/218 in the House of Representatives. The ratios in the 73d Congress were 59/36 in the Senate and 313/117 in the House. World Almanac and Book of Facts 81 (1985). Because the compositions of the two Congresses were so different, it would be of questionable validity to use the federal securities laws as a guide to what the drafters of the Bank Act intended in using the term "security."

7. Following Chevron, the Supreme Court gave great weight to the FRB's opinion that commercial paper was not a security for purposes of Glass-Steagall. However, the Court ultimately rejected the FRB's interpretation in light of Glass-Steagall's structure and legislative history, which "reflect[] the congressional perception that certain investment-banking activities are fundamentally incompatible with commercial banking." Becker, 468 U.S. at 147.

the Exchange Act, the Supreme Court concluded that the 73d Congress believed that commercial paper would otherwise be considered a security. See Becker, 468 U.S. at 150-51 & n.7. Partially on this basis, the Court found that Congress intended commercial paper to be considered a security under Glass-Steagall and thus declined to apply to Glass-Steagall the technical definition of "securities" found in the federal securities laws. See id. at 150-51.

In a subsequent case, a federal appellate court explicitly declined to apply the federal securities laws in interpreting the term "securities" under Glass-Steagall. The court reasoned that "the definition of the term for securities law purposes should be different from that used in the [Glass-Steagall] analysis" because, inter alia, "the purposes of the banking and securities laws are quite different." Investment Co. Inst. v. Conover, 790 F.2d 925, 933 n.7 (D.C. Cir.), cert. denied, 479 U.S. 939 (1986). See also Securities Indus. Ass'n v. Clarke, 885 F.2d 1034, 1052 (2d Cir.), cert. denied, 493 U.S. 1070 (1989) (criticizing district court's analysis of Glass-Steagall reference to "securities" under federal securities laws).

In a recently decided case, the United States Supreme Court took a similar approach in addressing an interpretation by the Comptroller of the Currency of the term "insurance" as used in the National Bank Act, ch. 106, 13 Stat. 99 (1864). See VALIC, 63 U.S.L.W. 4076, 1995 U.S. LEXIS 691. The Comptroller, in approving the sale of annuities by the brokerage subsidiary of a national bank, opined that annuities are not "insurance" for purposes of section 92 of the National Bank Act, 12 U.S.C. § 92. 1995 U.S. LEXIS 691 at *6. Finding that Congress had not addressed the meaning of the term "insurance" under that section and that the Comptroller's construction of the term was reasonable, the Court concluded that the Comptroller's interpretation "warrant[ed] judicial deference" under Chevron. Id. at *6, *10-*11. The Court upheld the Comptroller's characterization of annuities as investments, rather than as insurance, pointing out that "a characterization fitting in certain contexts may be unsuitable in others." Id. at *23. The Court summarized its holding by stating that:

> [t]he Comptroller has concluded that the federal regime is best served by classifying annuities according to their functional characteristics. Congress has not ruled out that course; courts, therefore, have no cause to dictate to the Comptroller the state law constraint [respondent] espouses.

Id. at *20 (citations omitted).

Considering the approach taken by the courts in the foregoing cases, we believe that it is inappropriate to look to the definition of the the term "securities" contained in the federal securities laws for purposes of interpreting the term under the Bank Act. Congress enacted the federal securities laws "to eliminate serious abuses in a largely unregulated securities market" and to address "the need for regulation to prevent fraud and to protect the interests of investors." United Housing Found. v. Forman, 421 U.S. 837, 849 (1975). Accordingly, the word "securities" is used in the federal securities laws as a term of art, so defined as to encompass those transactions in which the above-described abuses were most likely to occur. Id.

In contrast, subsection 16(a) of the Bank Act was designed to specify the manner in which the FHLBanks' reserves should be invested to preserve the safety and soundness of the FHLBank System and to safeguard the holders of FHLBank System debt. See infra § II(A)(2)(b)(i). It is unlikely that, for that purpose, Congress intended to include as investments for FHLBank reserves only those instruments which were most in need of regulation under the federal securities laws. Subsection 16(a) was designed to specify how the FHLBanks' reserves should be invested to preserve the safety and soundness of the FHLBank System and to safeguard the holders of FHLBank System debt.

We therefore believe that it is most appropriate to look to the purposes behind the Bank Act as a whole and subsection 16(a) in particular in interpreting the term "securities" in subsection 16(a), rather than to rely on interpretations of the term under the federal securities laws.

b. Congress Most Likely Intended A Generic Use Of The Term "Securities" As Used In Trust Law

i. The Legislative History Supports The Proposition That The Purpose of Subsection 16(a) Is The Protection of Holders of FHLBank Debt

Although the legislative history of the Bank Act lacks any specific mention of the "fiduciary and trust" provision of subsection 16(a),[8] it does comment on the reasoning behind an identical provision in subsection 11(h).[9] In the floor debates on the Senate bill, Senator James Watson, a member of the

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8. See supra note 5.

9. Section 11(h), which governs permissible investments for FHLBank surplus funds, provides, in pertinent part, that:

> [s]uch part of the assets of each [FHL]Bank

Committee on Banking and Currency, referred to the inclusion of the "fiduciary and trust" provision in section 11(h) as one of the "safeguards to the holders of obligations of the home-loan banks." 75 Cong. Rec. 14,562 (1932). Congress's inclusion of the same provision in subsection 16(a) would seem to have been prompted by identical concerns. Assuming, as indicated by the legislative history, that the inclusion of the relevant portion of subsection 16(a) arose from a concern for the protection of holders of FHLBank System debt, we conclude that Congress intended to stress the "fiduciary and trust" aspect of the provision and did not intend to separate the term "securities" from the "fiduciary and trust" language or to use the word "securities" in a technical or restrictive sense.

ii. The Term "Securities" Is Employed In Broad Sense Common In Trust Law

If the drafters of the Bank Act had any definition of "securities" in mind, it most likely would have been that existing under the state law of trusts. This conclusion is supported both by the direct reference to state trust law in subsection 16(a) and by the fact that the federal securities laws did not exist at the time that Congress passed the Bank Act.

In state cases interpreting wills and trust indentures decided during the 1920s and 1930s, courts often held that the word "securities" had been used in a generic sense when the context did not indicate otherwise. As stated in one contemporaneous case, "in the general usage of speech employed by men of business affairs, the word 'securities' is used in its widest sense to describe the broad class of financial investments."[10]

(Footnote 9 continued from previous page)
(except reserves and amounts provided for in subsection [11(g)]) as are not required for advances to members, may be invested . . . in such securities as fiduciary and trust funds may be invested in under the laws of the State in which the [FHL]Bank is located.

12 U.S.C. § 1431(h).

10. In re Estate of Vanderbilt, 229 N.Y.S. 631, 635 (Surr. Ct. N.Y. 1928). See also Huckabee v. Hanson, 422 S.W.2d 606, 608 (Ct. App. Tx. 1967) (trust case holding term "securities" to signify "any and all evidences of debt"); Trustees of the Protestant Episcopal Church v. Equitable Trust Co., 24 A.2d 327 (Del. 1942) (trust case stating that term "securities" is "widely used as a synonym for investments"); In re McGraw's Estate, 337 Pa. 93, 94, 10 A.2d 377, 378 (1940) (trust case

Given the foregoing, we believe that as a matter of federal law the term "securities" is used in subsection 16(a) not in a technical or restrictive sense, but in a generic fashion to signify "the broad class of financial investments" in which fiduciaries may invest. We believe that Congress, by employing the "fiduciary and trust" language, intended to protect holders of FHLBank debt by emphasizing the need for preservation of capital and a regular return, regardless of the type of instrument in which the FHLBanks invested their reserves.[11] Once it is determined that a particular instrument is one in which trusts and fiduciaries of the relevant state may invest, this concern has been addressed.

By its terms, subsection 16(a) permits reference to state law only to determine whether trusts and fiduciaries of the relevant state may invest in a given security. See 12 U.S.C. § 1436(a). To engage in further inquiry into whether the investment is, by some other technical definition, a "security" would not further any purpose of the Bank Act in general or subsection 16(a) in particular and is therefore irrelevant and inappropriate.

3. Term Federal Funds May Qualify As "Such Securities As Fiduciary And Trust Funds May Be Invested In" Under Subsection 16(a) of The Bank Act

To determine whether term federal funds are a permissible investment under subsection 16(a), each FHLBank need only determine whether term federal funds are an appropriate investment for fiduciary and trust funds under the laws of the

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stating that term "securities" represents "all classes of investments"); Irving Trust Co. v. Natica, 284 N.Y.S. 343, 349 (N.Y. Sup. Ct. 1935) (trust case concurring with definition of "securities" rendered in Vanderbilt).

Black's Law Dictionary also takes a broad view, defining "securities" to mean, inter alia, "[e]vidences of debt or property" and "[e]vidences of obligations to pay money or of rights to participate in earnings and distribution of corporate, trust, or other property." Black's Law Dictionary 1215 (5th ed. 1979).

11. In general, the primary duty of any trustee is "to make . . . only such investments [with a trust's corpus] as a prudent man would make of his own property having in view the preservation of the estate and the amount and regularity of the income to be derived." Restatement (Second) of Trusts § 227(a) (1959) (emphasis added).

state in which the FHLBank is located. If so, then term federal funds are appropriate investments under subsection 16(a) for that particular FHLBank.

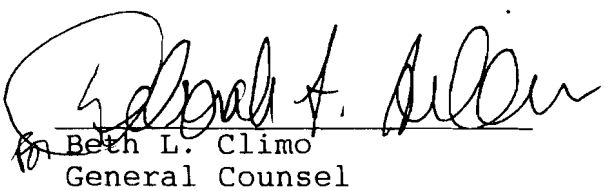
B. Term Federal Funds May Satisfy The Negative Pledge Requirement

If, using the above-described analysis, a FHLBank obtains an opinion from counsel licensed in the appropriate state that term federal funds are permissible investments for "fiduciary and trust funds . . . in the state in which the [FHLBank] is located," the FHLBank may use term federal funds to fulfill the negative pledge requirement under section 910.1(c)(5) of the Finance Board regulations. See 12 C.F.R. § 910.1(c)(5).

CONCLUSION:

In its capacity as the agency responsible for administering subsection 16(a) of the Bank Act, the Finance Board may interpret the term "securities" as used therein. Such interpretation is purely a matter of federal law, except and only to such extent as subsection 16(a) references state law. Because, under the federal securities laws, the word "securities" is defined specifically to further the purposes of those laws, reference thereto is inappropriate in interpreting the word "securities" as used in the Bank Act.

Instead, we believe that, given Congress's failure to define "securities" in the Bank Act and the term's relation to matters of trust law in subsection 16(a), the word "securities" is used in subsection 16(a) in the generic sense common under the law of trusts -- that is, to signify a "broad class of financial investments." As such, term federal funds may be considered to be "securities" for purposes of subsection 16(a) and may therefore qualify as appropriate investments for FHLBank reserves to the extent that fiduciary and trust funds of the state where the FHLBank is located may legally invest therein. If found to be appropriate investments under subsection 16(a), term federal funds also may be used to satisfy a FHLBank's negative pledge requirement pursuant to section 910.1(c)(5) of the Finance Board regulations.



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