May 22,2000

OPINION OF THE OFFICE OF GENERAL COUNSEL

ISSUES:

1. Is there a legal basis for the Federal Housing Finance Board (Finance Board) to require, as a condition of authorizing the Federal Home Loan Banks (Banks) to issue debt under section 11(a) of the Federal Home Loan Bank Act (Act), that the Banks must be jointly and severally liable on that debt?

2. Would joint debt issued by the Banks under section 11(a) of the Act be subject to treatment under the federal securities laws or the tax laws that is different from the treatment afforded COs issued by the Finance Board under section 11(c) of the Act?

CONCLUSIONS:

1. Yes. The Finance Board has express and plenary authority to prescribe rules and regulations and to approve the terms and conditions under which the Banks may exercise their power to issue bonds, debentures or other obligations under section 11(a).

2. No. There would be no difference, either in tax treatment or in the treatment under the federal securities laws, between COs issued by the Finance Board under section 11(c) of the Act, and joint debt issued under section 11 (a) of the Act.

I. Introduction

Section 11 of the Act provides three options for raising funds in the capital markets for the Banks. Section 11(a) authorizes the Banks to issue debt, subject to rules and regulations, terms and conditions prescribed by the Finance Board. 12 U.S.C § 1431 (a). 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. *Id.* § 1431(b). Section 11(c) authorizes the Finance Board to issue secured consolidated bonds, upon such terms and conditions as the Finance Board may prescribe, which shall be the joint and several obligation of the Banks. The Finance Board may issue consolidated bonds only if no consolidated debentures are outstanding, or if the proceeds are used to retire all outstanding consolidated debentures. *Id.* § 1431 (c).[1]

Currently, the operational funding needs of the Banks and member demand for advances are financed primarily with proceeds from the sale of consolidated bonds, called consolidated obligations (COs), issued pursuant to section 11(c) of the Act, on which the Banks, individually and collectively, are the sole obligors. The issuance of COs by the Finance Board under section 11(c) of the Act is governed by Finance Board regulations set forth in 12 CFR parts 966 and 985,[2] the Financial Management Policy (FMP)[3] and an annual debt authorization.[4]

The Finance Board recently proposed a rule authorizing the Banks to issue debt under section 11(a) of the Act. 65 Fed. Reg. 324 (Jan. 4, 2000). The rule would impose a number of conditions on the authority of the Banks to issue debt under section 11 (a), including that the debt must be joint debt, that the debt must be the joint and several obligation of the Banks, and that the debt must be issued through the OF in the same manner as the COs that the Finance Board currently issues through the OF pursuant to section 11(c). The same rules governing the apportionment of joint-and-several liability with respect to COs issued by the Finance Board would apply to COs issued by the Banks pursuant to section 11(a) of the Act. [5]

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[1] It is by virtue of the joint-and-several nature of the consolidated obligations issued by the Finance Board, and the status of the Banks as government sponsored enterprises (GSEs), that the COs are afforded the highest credit ratings by nationally recognized statistical rating organizations. 12 U.S.C. § 143l(b)-(d). Under section 15 of the 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. Id. § 1435. The Federal Housing Enterprises Financial Safety and Soundness Act of 1992, provides that none of the housing government-sponsored enterprises' obligations or securities are backed by the full faith and credit of the United States. See Pub. L. 102-550, tit. XIII, sec. 1304, 106 Stat. 3944 (Oct. 28, 1992) (codified at 12 U.S.C. *§ 4503).*

Notwithstanding these statements, the capital markets rely on an implied government guarantee based on the GSE status of the Banks, the joint and several obligation of the Banks on the COs, and the existence of section 1 l(i) of the Act, 12 U.S.C. § 143 l(i). Section 11(i) of the Act provides that the Secretary of the Treasury is authorized to any purchase obligations of the Banks issued under section 11. The Secretary's purchase or sale of such obligations are treated as "public-debt transactions of the United States." *Id.*

[2] The Finance Board recently reorganized and redesignated all of its regulations. See 65 Fed. Reg. 8253 (Feb. 18, 2000). Part 910 was redesignated as part 966, and part 941 was redesignated as part 985. *Id.* at *8265,8267-68.*

[3] See Fin. Bd. Res. No. 96-45 (July 3, 1996), as amended by Fin. Bd. Res. No. 96-90 (Dec. 6, 1996), Fin. Bd. Res. No. 97-05 (Jan. 14, 1997), and Fin. Bd. Res. No. 97-86 (Dec. 17, 1997).

See Fin. Bd. Res. No. 98-08 (Mar. 13, 1998).

In conjunction with the consideration by the Finance Board of the adoption of a final rule, the Office of General Counsel (OGC) has been asked to address the authority of the Finance Board to require that debt issued under section 1 l(a) be issued solely on a joint basis, to require that the Banks be jointly and severally liable on all such joint debt, the tax treatment of such debt, and the applicability of the federal securities laws.

Accordingly, OGC has reviewed the relevant statutory authority and legislative history of the Act, prior legal opinions, applicable law under the Administrative Procedure Act; the Securities Act of 1933, the Securities Exchange Act of 1934, and the Finance Board's current regulations, to determine the Banks' borrowing authority and the grounds for adoption of the rule. For the reasons stated in the following analysis, it is our opinion that the Finance Board has express authority under the Act to prescribe rules and regulations and to determine the terms and conditions for the issuance of debt by the Banks under section 1 l(a) of the Act, and that such debt should be treated under law in the same manner as debt issued by the Finance Board pursuant to section 11 (c) of the Act.

II. Analvsis

A. There is a Legal Basis for the Finance Board to Require Bank Joint and Several Liability as a Condition of Authorizing the Banks to Issue Debt Under Section 1 l(a) of the Act.

1. Pursuant to Subsection 1l(a) of the Act. the Banks have the power to issue debentures, bonds, or other obligations subject to rules and regulations prescribed by the Finance Board, and only upon such terms and conditions as the Finance Board may approve.

In order for a Bank to engage in any activity, such activity must be either expressly authorized by the Act, or incidental to authorities expressly set. forth in the Act. See Generally Association of Data Processing Service Orgs. v. Federal Home Loan Bank Board, 568 F.2d 478 (6th Cir. 1977). Section 11 provides that the Banks shall have the power to issue debentures, bonds, or other obligations subject to rules and regulations prescribed by the Finance Board, and upon such terms and conditions as the Finance Board may approve. 12 U.S.C. § 1431(a). There is no provision in section 11(a) expressly authorizing the issuance of consolidated debt by the Banks nor prescribing that the Banks shall be jointly and severally liable on debt issued under section 11(a).6 There also is

[5] On October 12, 1999, the Finance Board published a final rule clarifying how the joint-and-several liability of the Banks on COs would operate, and elucidating for bondholders how they benefit from the Banks' joint-and-several liability. See 64 Fed. Reg. 55125 (Oct. 12, 1999). The Bank System has been and remains financially strong. As of March 31, 2000, there were over $535.5 billion in COs outstanding. In the history of the Bank System, no Bank has ever been delinquent or defaulted on a principal or interest payment on any CO issued by the Finance Board or its predecessor agencies. The joint-and-several liability of the Banks on the COs is an integral part of investor confidence in Bank System debt

nothing in section 11(a) or in the Act that would expressly prohibit the Finance Board from authorizing the issuance of consolidated debt by the Banks under section 11(a) or from prescribing that the Banks must be jointly and severally liable on debt issued under section 11 (a) as a condition of such issuance.

2. Under Chevron, the Finance Board Has Wide Latitude To Adopt Reasonable Interpretations of the Act.

As the agency charged with the administration of subsection 11(a) of the Act, see 12 U.S.C. § 1422b(a)(l), interpretations of this subsection by the Finance Board would be given great deference by courts if the question were to be litigated. See Nations Bank v. Variable Annuitv Life Ins. Co., 130 L.Ed.2d. 740,747 (1995) (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 v. Natural Resources Defense Council 467 U.S. 837, 843 & n.9 (1984) (Chevron).

Under Chevron, a "permissible interpretation" is one that 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 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.

3. Section 11 (a) Expressly Confers on the Finance Board the Authoritv to Prescribe Rules, Regulations, Terms and Conditions Governing the Banks' Authority to Issue Debt Under that Section

Congress has explicitly required the Banks to be jointly and severally liable for consolidated debt issued by the Finance Board under sections 11 (b) or (c). The question raised is whether there is anything that would preclude the Finance Board from establishing by regulation the same requirement as a condition of issuance under section 11 (a), given its statutory duties to ensure that the Banks are operated in a financially safe and sound manner and able to maintain access to the capital markets, and its discretion to prescribe rules and regulations for and to approve terms and conditions upon which the Banks shall have the power to issue debentures, bonds or other obligations under section 11 (a). We believe

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[6] Section 11 of the Act, as enacted in 1932, provided that the Banks would be jointly and severally liable for the payment of all bonds, notes, debentures, and other obligations issued by any Bank. See H.R. 12280, 72nd Cong., 2nd Sess. (Pub. No. 304) (1932) (enacted). The Act did not provide for issuance of COs by the predecessor agency to the Finance Board until 1934. The 1934 amendments to the Act removed the provision requiring the Banks to be jointly and severally liable for debt issued by individual Banks, but added the provisions giving the agency plenary authority to prescribe rules, regulations, terms and conditions of issuance of debt by the Banks, and making the Banks joint and several obligors on COs issued by the agency. See H.R. 9620,73rd Cong., 2nd Sess. (Pub. No. 479) (1934)(enacted); see also discussion infra. 7-8.

there is no negative implication to be drawn from the fact that the Finance Board has been granted discretion under section 1 l(a) (but not under sections 1 l(b) or (c)) to decide whether or not to impose joint-and-several liability on the Banks as a condition of issuance. That the Finance Board has exercised its discretion to impose by regulation a joint-and-several liability scheme under section 1 l(a) that is identical to the scheme authorized by Congress under sections 11 (b) and 11 (c) only renders the Finance Board's decision that much stronger.

An agency has the power to issue binding legislative rules to the extent that Congress has delegated such authority to the agency. See Davis, K. & Pierce, R., Administrative Law Treatise, 3rd Ed., § 6.3 (Supp. 1999) (Davis & Pierce), citing *United States v. Storer Broadcasting Co., 35* 1 U.S. 192 (1956); *National Broadcasting Co. v United States, 3* 19 U.S. *190* (1943); *National Petroleum Refiners Assn v. FTC, 482* F. 2d *672, cert. denied,* 415 U.S. 95 1 (1974). There can be no question that section 11 (a) of the Act clearly, expressly and unambiguously grants the Finance Board plenary authority to prescribe rules and regulations for, and to approve terms and conditions upon which the Banks shall have the power to issue debentures, bonds or other obligations under that section. 12 U.S.C. § 143l(a) (1994).[7] There are no conditions or restrictions attached to the Finance Board's authority to prescribe rules and regulations or to approve the terms and conditions of issuance under section 11(a)[8]. So long as the Finance Board exercises its power to

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[7] Not only is that true under the plain language of the current statute, it also is true that at all times during the evolution of this provision of the Act authorizing the Banks to issue debt, this authority has been expressly contingent on the power of the regulatory agency to define the conditions under which the Banks may do so.

[8] A 1974 memorandum prepared by staff of OGC of the FHLBB opined that "section 11(a) cannot be regarded as authorizing, in general, the issuance of obligations which are the joint and several obligations of all the FHLBanks. The effect. . . in such a situation would be to make each [Bank] a surety or guarantor. [T]he scheme would thus fall within the general rule that, with limited exceptions, a corporation does not have implied authority to be a surety or guarantor. . .." See Memorandum from R.V. Pollard to C.E. Allen, FHLBB General Counsel, at 3 (Mar. 14, 1974) (Pollard Opinion). The Pollard Opinion was based on old state corporate case law holding that the power to guarantee may not be implied. See, e.g., Louisville Ky. Co. v. Louisville Trust Co., 174 U.S. 552 (1899); Ward v. Joslin, 186 ,U.S. 142 (1902). OGC expressly rejects the Pollard Opinion because: (1) the power to act as joint and several obligator in a corporate capacity is one that Congress expressly conferred on the Banks under sections 11(b) and (c) of the Act; (2) the power to act as surety or guarantor falls within the general "customary and usual" powers of a corporation under section 12(a) of the Act; (3) the states provide for the power, either by having adopted section 302(7) of the Model Business Corporation Act or by adoption of similar statutory provisions; and (4) the Finance Board is imposing joint and several liability expressly as a condition of issuance in its regulation and not by implication.

The FHLBB General Counsel subsequently issued a memorandum specifically declining to reach the question of whether the Banks could be made to be jointly and severally liable by the FHLBB on debt issued by the Banks under section 11(a), because in his view the issue was "not clear." See Memorandum fromC.E. Allen, FHLBB General Counsel, to M. Burkes, OF Director, at 2 (May 16, 1974) (1974 Memorandum). The 1974 Memorandum nevertheless gratuitously and without discussion, support or analysis goes on to conclude that: "In any event, the approval of all other FHLBanks would be needed." OGC, therefore, expressly rejects the 1974 Memorandum both as to the statement that the issue is unclear and as to the conclusory statement 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 of law." See Davis & Pierce, citing *Fawcus Machine Co. v. United States, 282* U.S. *375,378* (1931); *Maryland Casualty Co. v. United States,* 251 U.S. 342,349 (1920).

4. The Finance Board's Rule is Reasonable and Consistent with the Act

a. Requiring the Banks to be Jointly and Severally Liable as a Condition of Authorizing the Banks to Issue Debt Under Section 1 l(a) is Reasonable

By requiring joint and several liability as a condition of authorizing the Banks to issue debt under section 11 (a), the Finance Board is implementing by regulation an issuance scheme that is identical to the issuance scheme established by Congress elsewhere in section 11 of the Act. Importantly, the Banks will be subject to the same payment provisions (i.e., the joint and several liability provisions) currently established in the Finance Board's regulations. Nothing in the Finance Board's regulatory action requiring the Banks to be jointly and several liable on debt issued under section 11 (a) is inconsistent with any existing statutory or regulatory requirement.

With the enactment of FIRREA in 1989, Congress charged the Finance Board with ensuring that the Banks are "operate[d] in a financially safe and sound manner." 12 U.S.C. § 1422a(a)(3)(A). Consistent with that primary duty, the Finance Board must "ensure" that the Banks "remain adequately capitalized and able to raise funds in the capital markets," and that the Banks "carry out their housing finance mission." *Id.* at § 1422a(a)(3)(iii), (ii). Since 1946, the operations of the Banks and member demand for advances have been financed principally with the proceeds from COs issued pursuant to section 11 (c) of the Act by the Finance Board, or its predecessor agencies. [10]

The Banks' ability to carry out their housing finance mission depends on their having access to the capital markets to finance their advances and other programs for the benefit of their members. Congress understood the importance of this connection when it amended section 11 in 1934, as indicated by comments from the then-Chairman of the House Committee on Banking and Currency, who stated that "Section 11 of the [Act] is also amended so as to authorize the issuance of consolidated [Bank] bonds or debentures in an effort to secure a form of security which will be more marketable." See 78 Cong. Rec., Part 10, at 11191 (House Debate on H.R. 9620, Remarks of Mr. Steagall (D.Ala.) (1934)). As with the original authorization permitting the Banks to enter the capital markets to sell debt,

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that the approval of all of the Banks would be a necessary prerequisite for the agency to prescribe that the Banks be jointly and severally liable as a condition of issuing debt under section 11(a).

[9] 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 Administrative Procedure Act, 5 U.S.C. §§ 55 1 et seq. See *generally,* Davis & Pierce, § 6.3, at 236.

[10] See, 57 Fed. Reg. 20061 (May 11, 1992) (Federal Home Loan Bank Administration had retired all outstanding debentures issued under section 11(b) of the Act by the close of 1946).

the Act required the Banks to be jointly and severally liable on FHLBB-issued consolidated bonds and debentures precisely because Congress understood that the Banks' access to the capital markets would be enhanced by the joint and several liability of the Banks on the debt.[11]

The purpose of requiring joint and several liability as a condition of authorizing the Banks to issue debt under section 1 l(a) is to effect the technical change in the issuer of the debt in a way that will be the least disruptive in the capital markets, by having that debt be identical in all material respects and, most importantly, be so perceived in the markets, to the COs heretofore issued by the Finance Board on behalf of the Banks under section 11 (c). To do otherwise would not achieve the stated goals or duties of the Finance Board to ensure that the Banks have and maintain access to the capital markets in the least disruptive manner possible, or might even jeopardize the Banks' position in the capital markets. The regulatory logic and reasonableness of the Finance Board's determination would seem to be indisputable.

Moreover, the Finance Board's authority to impose this condition, *i.e.*, that debt issued under section 1 l(a) by the Banks be the joint and several obligation of the Banks, by regulation, so as to minimize disruption in the capital markets, cannot be eliminated by implication where, as here, "Congress has not ruled out that course," *Variable Annuity Life Insurance Co. v. Clarke, 998* F.2d 1295 *(5th* Cir. 1993), *rev'd on other grounds,* 513 U.S. 251,262 (1995), or "purposely withheld" the authority, *Marshall v,. Gibson 's Products, Inc.,* 584 F.2d 668,677 (5th Cir. 1978). The fact remains that Congress has not prohibited the Finance Board from imposing this necessary and reasonable condition on the Banks' debt.

b. Amendments to the Act in 1934 Do Not Render the Finance Board's Rule Inconsistent with the Act.

As originally enacted, subsection 11(f) of the Act provided that the Federal Banks shall be jointly and severally liable for all bonds and debentures, notes and other obligations issued by any Bank, provided that the joint and several liability provisions would not prevent any particular Bank, when specifically so authorized by the Federal Home Loan Bank Board (FHLBB), from incurring sole liability on an individual issuance. That subsection also authorized the Banks, in accordance with rules, regulations, and orders of the FHLBB, to make adequate agreements and arrangements among themselves for meeting the payment of the bonds, debentures, notes, or other obligations on which they were jointly and severally liable, but such agreements and arrangements were not to restrict in any

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[11] Sixth Annual Report of the Federal Home Loan Bank Board (Bank Board), for the period July 1, 1937 through June 30, 1938 (January 5, 1939), 76th Cong. 1st Sess., House Dot. No. 90 at 38 (1938 Annual Report). Consolidated debentures were first issued by the board in 1937 to raise needed additional funds to meet the advances demands of Bank System members. As reported to Congress, "[t]he advantage of a consolidated issue appeared compelling from the various view-points of convenience, expense, and rate obtainable in the market." *Id.* at 33.

respect the joint and several liability established. by the Act. H.R. 12280, 72nd Cong., 2d Sess. (Pub. No. 304) (1932) (enacted).

No individual Bank debt was issued under section 1 l(f), and a mere two years later, Congress was considering amendments to the Act. In testimony before Congress, Mr. Horace Russell, the General Counsel of the Federal Home Loan Bank Board (FHLBB), made the case for granting authority to the FHLBB to issue consolidated debt.[12] Mr. Russell testified that the issuance of consolidated debt would avoid the expenses involved in the issuance of individual Bank debt, "would be more salable; that supported by the capital of all the banks and the reserves of all the banks, it would be a more flexible and marketable security, and that type of security would be very much cheaper to operate." *Report.* at 73

When Congress amended section 11 of the Act in 1934, it authorized the FHLBB to issue consolidated bonds and debentures on which the Banks would be jointly and severally liable. *Id.* at 7 1. Congress deleted the provision authorizing any Bank to issue debt on which all of the Banks would be jointly and severally liable, and substituted for that a provision granting broader borrowing authority for the Banks, subject to the express plenary authority of the FHLBB to prescribe rules and regulations and approve the terms and conditions upon which the Banks could exercise that broader authority. See H.R. 9620, 73rd Cong., 2d Sess. (Pub. No. 479) (1934) (enacted).

The fact that the 1934 amendments to the Act eliminated the requirement in section 11 (f) that all Banks "shall be jointly and severally liable" for any Bank-issued obligation has no effect on the Finance Board's authority now to impose joint and several liability on the Banks as condition of issuing debt under section 1 l(a). There is no contemporaneous evidence that Congress removed the statutory requirement for joint and several liability on Bank-issued debt to preclude or restrict the agency's otherwise broad authority to prescribe the rules and regulations and determine the terms and conditions of such debt. To the contrary, as discussed above, Congress merely substituted the FHLBB's plenary regulatory authority to prescribe rules and regulations and determine terms and conditions governing the issuance of debt by the Banks, for a statutory joint and several requirement. Also to be considered is a congressional preference for the joint and several liability of the Banks on Bank debt. This preference is evident from the original Act, which expressly required the Banks to be jointly and severally liable for any Bank-issued debt, from the testimony offered by Mr. Russell, and from the 1934 amendments, which required all consolidated debt issued under revised sections 1 l(b) and (c) to be the joint and several obligation of the Banks. [13]

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[12] See *generally* H.R. Rep. No. 1922, 73rd Cong., 2d Sess., at 68-72 (1934) *(Report).* Mr. Russell's testimony before the Senate Committee on Banking and Currency in support of the Senate bill (S. 3606) is relevant because the pertinent provisions of the Senate bill are substantially the same as the enacted version.

[13] Congress had few options available to it in 1934 when it was seeking to construct a vehicle within which to consolidate the Banks' debt. No Bank had established a trustee under the registrar provisions of the original Act. *Report* at 68. Nor was there available at the time any centralized issuance facility, such as OF, for the

B. There would be no difference, either in tax treatment or in the treatment under the federal securities laws, between COs issued by the Finance Board under section 1 l(c) of the Act, and joint debt issued under section 1 l(a) of the Act.

1. Joint Debt Issued Pursuant to Section 11 (a) of the Act Will be Exempt from the Registration Requirements of the Securities Act of 1933 and from the Registration and Reporting; Requirements of the Securities Exchange Act of 1934 As Are COs Issued by the Finance Board Under Section 1 l(c) of the Act

a. The Securities Act of 1933

COs issued by the Finance Board under section 1 l(c) of the Act are exempt from the registration requirements of section 5 of the Securities Act of 1933 (15 U.S.C. §§ 77a, *et* seq.) (Securities Act), because they are among a class of securities "'issued or guaranteed by . . . any person controlled by or supervised by and acting as an instrumentality of the Government of the United States pursuant to authority granted by the Congress of the United States," which are exempt from registration pursuant to section 3(a) of the Securities Act. *Id.,* § 77c(a)(2). Joint debt issued by the Banks under section 1 l(a) would be exempt under the same exemption.

Congress enacted the Securities Act of 1933, primarily to regulate the distribution - rather than the trading - of securities.[14] Section 5 of the Securities Act (15 U.S.C. § 77e) prohibits the sale or offer for sale by any person of any security that has not been registered with the Securities and Exchange Commission (SEC), which is not accompanied by a prospectus meeting the requirements of section 10 of the Securities Act *(id. § 77j),* and is not otherwise exempt from the provisions of section 5 of the Securities Act.

Section 3(a) of the Securities Act exempts certain classes of securities from all provisions of the Securities Act, including section 5, unless otherwise specified. *Id.,* § 77c(a)(2). The exempted classes include securities "issued or guaranteed by . . . any person controlled by or supervised by and acting as an instrumentality of the Government of the United States pursuant to authority granted by the Congress of the United States." *Id.* It is this exemption that applies to COs issued by the Finance Board under § 1 l(c), and this exemption would also apply to joint debt issued by the Banks pursuant to section 1 l(a) of the Act.

Banks, which were at the time a part of the FHLBB. It was logical at the time for Congress to have concluded that the best, if not the only, way to provide for the issuance of consolidated debt was to do so through the FHLBB.

[14] See Loss, L. Fundamentals of Securities Regulation 87 (1988) ("Securities Regulation").

The Banks would be issuing debt "pursuant to authority granted by Congress" under section 1 l(a) of the Act." The Banks also would be acting as instrumentalities of the United States. The Banks are defined as "mixed-ownership Government corporation[s]" under the Government Corporation Control Act.,[16] and historically have been considered federal instrumentalities organized to carry out public policy. See Fahey v. 0'Melveney & Myers, 200 F.2d 440, 446 (9th Cir. 1952), *cert. den., 345* US. 952 (1953); see *also Maryland Dep't of Assessments and Taxation v. Maryland Nat'1 Bank, 531* A.2d 294, 297-98 (1987) (consolidated obligations on which the Banks are jointly and severally liable are "obligation[s] of the United States Government" under section 3124(a) of the Internal Revenue Code, even though the obligations are not obligations of the United States and are not guaranteed by the United States pursuant to 12 U.S.C. § 1435); (Merrill, Lynch, Pierce, Fenner & Smith, SEC No Action Letter, 1986 SEC No-Act. LEXIS 2877 (Nov. 5, 1986) (the Banks are "agencies of the United States" for purposes of Investment Company Act rule 2a-7(b)(l), which applies to instruments "guaranteed by the United States government, or any agency thereof.")). Therefore, pursuant to section 3(a)(2) of the Securities Act, joint debt issued by the Banks under section 11(a) of the Act would be exempt from the registration requirements of section 5 of the Securities Act.

The Banks may have no greater insulation from liability for debt issued under section 11(c) than for joint debt issued under section 1 l(a), under section 17(a) of the Securities Act. The Banks may bear a risk of liability in either case under section 17(a) of the Securities Act because the anti-fraud provisions of section 17(a) of the Securities Act expressly apply even with respect to securities that are exempted under section 3(a), see 15 U.S.C. § 77q(c)[17] In other words, the Banks would continue to be subject to SEC actions under section 17(a), or any of the civil enforcement remedies available to the SEC under the Securities Act, and would continue to be subject to cease-and-desist orders; injunctions to enjoin violations of section 17(a), see 15 U.S.C. § 77t(b); the issuance of a writ of

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[15] The Banks would issue debt under section 11 (a) to fund their operations and in furtherance of their statutory housing finance and community lending mission, which is a "public and governmental function."

[16] See 31 U.S.C. § 9101(2)(C).

[17] The current state of the law is less than clear. We assume that the SEC would not take the position that the United States, or an independent agency thereof, would be exempt from the anti-fraud provisions of the Securities Act. Moreover, even though section 17(a) does not provide for a private right of action, it is not clear that the Finance Board could successfully claim sovereign immunity in a private securities fraud action. For example, in Countv of Orange, et al. v. Federal Home Loan Bank of Boston, et al.. Case No. SACV97-122GLT (C.D. Cal.) (Orange County), the court issued a preliminary ruling on the United States' Motion to Dismiss that preserved for further determination plaintiffs' claims against the United States for equitable relief consisting of rescission and restitution brought under the Administrative Procedure Act, 5 U.S.C. §§ 702,704, and 706, based on allegations that the issuance of certain COs violated the anti-fraud provisions of the Securities Act. Whether plaintiffs' claims were cognizable under the APA turned on whether the United States could be deemed to owe restitution where the United States did not receive the sale proceeds, the Banks received all of the proceeds from the sale of the COs. The issue was never decided. Orange County dropped all claims against the United States, the Office of Finance and the Banks following a global settlement with the broker-dealers. The Banks could not have had the benefit of sovereign immunity in the Orange County action, and would not otherwise be entitled to the defense.

mandamus to compel compliance with section 17(a), *Id.* § 77t(c); or the imposition of civil money penalties, see *id.* § 77t(d).

b. The Securities Exchange Act of 1934

COs issued by the Banks under section 11(a) of the Act would be entitled to the same exemptions from the registration and reporting requirements of the Exchange Act currently accorded COs issued under section 11(c) of the Act. COs issued by the Finance Board under section 11(c) of the Act are exempt from the registration and reporting requirements of sections 12, 13, 14 and 15(d) of the Securities Exchange Act of 1934, (15 U.S.C. §§ 78a *et seq),* (Exchange Act), because they are among a class of exempted securities, ("Government Securities"), "which are issued or guaranteed by corporations in which the United States has a direct or indirect interest and which are designated by the Secretary of the Treasury for exemption as necessary or appropriate in the public interest or for the protection of investors." Id. § 78c(a)(42)(B). Government securities are exempt from registration and reporting requirements of the Exchange Act pursuant to section 3(c) of the Exchange Act.

Joint debt issued by the Bank, under section 11(a) would be treated as an exempt security because both conditions of section 3(a)(42) are met. The United States has an indirect interest in the Banks to ensure the Banks remain adequately capitalized and able to raise funds in the capital markets to accomplish their housing finance mission. See 15 U.S.C. § 78c(c).

Additionally, the Secretary of the Treasury designated for exemption under the Exchange Act "securities issued by the Federal Home Loan Bank Board or the Federal Home Loan Banks under the authority of Section 11 of the Federal Home Loan Bank Act." See Sec. Ex. Act Rel. 1168 (Apr. 28, 1937) (1937 WL 3510). The designation fulfills the second requirement for exemption under section 3(a)(42)(B). The Department of Treasury has thus taken the position that any debt issued by the Banks under section 11 of the Bank Act would be issued by "a corporation in which the United States has a direct or indirect interest." A joint report issued by the Department of Treasury, the SEC, and the Board of Governors of the Federal Reserve suggests that these agencies would find that securities issued by a government-sponsored enterprise, including the Banks, "are generally exempt from registration and are treated as government securities for purposes of the federal securities laws." See DOT, SEC, FRB, Joint Report on the Gov't Sec. Mkt., ix, 24 (Jan. 1992).

The anti-fraud provisions of the Exchange Act, would continue to apply to the Banks for COs issued under section 1 l(a) just as the provision currently may apply to the Banks for COs issued under section 1 l(c) of the Act. Section 10(b) of the Exchange Act makes unlawful the use of any manipulative or deceptive device in connection with the purchase or sale of any security "in contravention of such rules and regulations as the [SEC] may prescribe." 15 U.S.C. § 78j(b).r[8] The SEC promulgated Rule 10b-5[19] to implement section 10(b), and the Supreme Court has recognized an implied private right of action under the rule. See *Herman & MacLean v. Huddleston,* 459 U.S. 375 (1983). To establish liability under rule 10b-5, a plaintiff must prove that "(1) the defendant made a false statement or omission of material fact (2) with scienter (3) upon which the plaintiff justifiably relied (4) that proximately caused the plaintiffs damages." *Myers v. Finkle, 950* F.2d 165, 167 (4th Cir. 1991). Section 3(c) of the Exchange Act exempts the United States and its agencies from claims under both section l0b of the Exchange Act and SEC rule l0b-5. See 15 U.S.C. § 78c(c). That immunity would not necessarily shield the Banks from liability, however, even when the Finance Board issues COs under section I l(c) of the Act, because both section l0b and Rule l0b-5 hold liable "any person" (not just the issuer) who engages in fraud <u>in connection with the purchase or sale of securities</u>. See 15 U.S.C. § 78j(b); 17 C.F.R. § 240.l0b-5. (Emphasis supplied).

Additionally, whether directors, officers, and employees of a Bank may be subject to liability as "control persons" under section 20(a) of the Exchange Act is not dependent upon whether the debt is issued under section 11(a) or 11(c) of the Act. Section 20(a) provides in pertinent part:

> Every person who, directly or indirectly, controls any person liable under any provision of this title or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted

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[18] Section 10(b) of the Exchange Act states:

> [I]t shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . (b) to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b).

[19] Rule 10b-5 reads as follows:

> [I]t shall be lawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange, (a) to employ any device, scheme or artifice to defraud, (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they wee made, not misleading, or (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

The SEC also promulgated rules that would be applicable in specific scenarios of fraud which are unlikely to pertain to debt issued under section 11 of the Act. <u>See, e.g.,</u> 17 CFR §§ 24O.10b-1 through 10b-4 and 10b-6 through 10b-18.

> in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

15 U.S.C. § 78t(a). The courts will look beyond a person's title or position in determining whether or not that person is a "controlling person" under section 20(a), see *Wool v. Tandem Computers Inc.,* 818 F. 2d 1433, 1441 (9th Cir. 1986) *("Wool"),* and base the determination upon that person's power or ability to control the subject transaction. *Donohoe v. Consol. Operating and Prod. Corp., 982* F.2d 1130, 1138 (7th Cir. 1992) *("Donohoe'); accord Wool,* 818 F.2d 1440. The Federal Courts of Appeals appear split as. to whether having the "ability to control" the transaction or activity is sufficient to establish that an individual is a "controlling person," or the individual must be shown to have been a "culpable participant" in the wrongdoing. *See Donohoe 982* F.2d 1138, n. 7, and cases cited therein. Therefore, directors , officers, and employees of the Banks and the Office of Finance could potentially be held liable under section 10b of the Exchange Act, depending on the extent of their personal involvement in any primary violation related to the issuance of consolidated obligations under section 11 (a) or 11 (c).

2. <u>Joint Debt Issued bv the Banks Pursuant to Section 11(a) of the Act Would be Entitled to the Same Tax Treatment Accorded COs Issued by the Finance Board Under Section 11(c) of the Act</u>

a. P<u>ursuant to the Public Debt Act of 1941 and Its Progeny. Gains from the Sale of and Interest Earned on Consolidated Obligations on which the Banks are Jointly and Severally Liable Are Not Exempt from Federal Taxation</u>

COs issued by the Finance Board pursuant to section 11(c) of the Act are not exempt from federal taxation. The language in section 13 of the Act, exempting "consolidated Federal Home Loan Bank bonds and debentures" (including principal and interest) "from all taxation," see 12 U.S.C. § 1433,[20] is nullified by the Public Debt Act of 1941 codified, as amended, at 31 U.S.C. § 3124(b), which reads in pertinent part:

> The tax status of interest on obligations and dividends, earnings, or other income from evidences of ownership issued by the Government or an agency and the tax treatment of gain and loss from the disposition of those obligations and

[20] Section 13 reads as follows:

> Any and all notes, debentures, bonds, and other such obligations issued by any bank, and consolidated Federal Home Loan Bank bonds and debentures, shall be exempt both as to principal and interest from all taxation (except surtaxes, estate, inheritance, and gift taxes) now or hereafter imposed by the United States, by any Territory, dependency, or possession thereof, or by any State, county, municipality, or local taxing authority. The bank, including its franchise, its capital, reserves, and surplus, its advances, and its income shall be exempt from all taxation now or hereafter imposed 'by the United States, by any Territory, dependency, or possession thereof, or by any State, county, municipality, or local taxing authority; except that . . . any real property of the bank shall be subject to State, Territorial, county, municipal, or local taxation to the same extent according to its value as other real property is taxed. . . .

12 U.S.C. § 1433.

> evidences of ownership is decided under the Internal Revenue Code of 1954 (26 U.S.C. §§ 1 *et seq.)*

The Internal Revenue Code provides that interest on obligations issued by the Federal Government or an agency is included in income for federal tax purposes. See 26 U.S.C. § 61,26 C.F.R. §§ 1.103-4(a)(l), (b)(l).

Similarly, COs issued by the Banks under section 11(a) of the Act also would not be exempt from federal taxation. The Public Debt Act was intended to "provide for the Federal taxation of future issues of obligations of the United States *and its instrumentalities."* (Emphasis supplied). [21] The legislative intent to end the Federal tax exemption for obligations of instrumentalities of the United States is clearly stated in the House Report accompanying the bill:

> The bill . . . will remove . . . all privileges of exemption from Federal taxation not only from direct obligations of the United States but also from all obligations issued by various Federal corporations, *instrumentalities*, and agencies. [T]he elimination of the Federal tax-exemption privilege will apply to all future issues of Federal obligations. . . .
>
> [Section 4] would, in effect, make interest upon, and gain from, the sale or other disposition of all obligations issued in the future by the United States, and its agencies and *instrumentalities* . . . subject to taxation by the Federal Government to the same extent as like obligations of private issuers. . . . The phrase "the United States or any agency or instrumentality thereof' is used in the broadest possible sense, so as to effectively eliminate for the future . . . whatever exemptions from Federal taxation may have been accorded to any obligations by any act of Congress.

H.R. REP. No. 20, 77th Cong., 1st Sess. 3, 5 (1941) (Emphasis supplied).** Section 4 eliminated any exemptions from Federal taxation that previously may have been afforded obligations of the United States, its agencies, or its instrumentalities, by any prior act of Congress, including the Federal Home Loan Bank Board, the predecessor agency to the Finance Board.[23] Thus, the interest and sale gains on consolidated obligations of the Banks would be subject to taxation as provided for in the Internal Revenue Code, whether issued under section 11(a) or 11(c) of the Act.

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[21] See H.R. 2959, ch. 7, § 4,55 Stat. 9 (1941) (quoting preamble).

[22] The Senate Report contained nearly identical language. See S. Rep. No. 41, 77th Cong., 1st Sess. 3,5 (1941).

[23] See e.g., 26 C.F.R. § 1.103.2 (IRS statement that the Public Debt Act amended the Act even thought it did not do so expressly); see *also* Prentice-Hall Federal Tax Service, *Income Tax,* vol. 1, ¶¶ 4565,8 100-8101, *8103* (1945); *Maryland Dept. of Asses. & Tax v. Nat'1 Bank, 531* A.2d *294,299* (Md. 1987), *app. dismissed 486* U.S. 1048 (1988).

b. Pursuant to Section 13 of the Act, Gains on the Sale of and Interest Earned on both COs and Joint Debt Are Exempt from State and Local Taxation

AS stated section 13 of the Act provides that all obligations issued under section 11 of the Act are exempt from local and state taxes (except for surtaxes, estate, inheritance, and gift taxes). 12 U.S.C. § 1433. The Public Debt Act does not eliminate the exemption provided in section 13 of the Act from state and local taxes.[24]

In fact, a broader exemption provided for separately in Title 3 1 may apply to COs issued under section 11 of the Act:

> Stocks and obligations of the United States Government are exempt from taxation by a state or political subdivision of a State. The exemption applies to each form of taxation that would require the obligation, the interest on the obligation, or both, to be considered in computing a tax, except -
>
> (1) a nondiscriminatory franchise tax or another non-property tax instead of a franchise tax, imposed on a corporation; and
> (2) an estate or inheritance tax.

31 U.S.C. § 3124(a).[25] Section 3124(a) was not part of the Public Debt Act, and it was not intended to amend section 13 of the Act.[26] The statutory immunity from state and local taxes granted in section 3124(a) is intended to promote the investment attractiveness of obligations issued by the United States.

No controlling precedent as yet exists to resolve the tension between the more limited immunity of section 13 of the Act and the broader immunity from state taxation provided in section 3124(a). The exemption established in section 3124(a) for "obligations of the United States" applies to consolidated obligations of the Banks at least with respect to direct state taxation. *See Maryland Dep 't of Assessments and Taxation v. Maryland Nat 'l*

[24] See H.R. Rep. No. 20, 77th Cong., 1st Sess. 3, 5 (1941); S. Rep. No. 41,77th Cong., 1stSess. 3,5-6 (1941).

[25] The origin of section 3124(a) dates from 1862. See Revised Statutes of 1878, title 42 § 3701, 18 Stat. 731, 3 1 USC. 742 (amended in 1959 for clarification; re-enacted in 3 1 U.S.C. § 3124(a).

[26] *See e.g., Rockford Life Ins. Co. v. Illinois Dept. Rev., 482* U.S. 182, 188 (1987); *Memphis Bank & Trust Co. V. Garner, 495 U.S. 392,396-97* (1983) *(Memphis Bank).* Specifically, section 3124(a) codified the Constitutional prohibition against state taxation of obligations of the Federal government first enunciated in *McCulloch V. Maryland, 17* U.S. *(4* Wheat) *316 (1819) (McCulloch).* In *McCulloch, the* Supreme Court established that "States may not impose taxes directly on the Federal Government, nor may they impose taxes the legal incidence of which fall on the Federal Government. "*Memphis Bank, 495* U.S. at 397 (citations omitted); *see also Weston v. City Council of Charleston,* 27 U.S. (2 Pet.) 449,467 (1829) (prohibiting state taxation of federal obligations in the possession of private persons). The rule, which was derived from the "Borrowing" and "Supremacy" clauses of the Constitution of the United States, is intended to protect the borrowing power of the United States from state encroachment. *Fahey v. O'Melveny & Myers, 200* F.2d 420, 446 (9th Cir. 1952).

Bank, 531 A.2d *294,297-98* (1987); *National Bank of Alaska v. Alaska Dep't of Revenue,* 769 P.2d 990, 996-97 (1989) (both courts found that the exemption in section 13 is not applicable where the State had imposed an indirect franchise tax that included principal and interest of Bank bonds when measuring net income to calculate the tax on the business value of the Banks).

The exemption in Section 13 of the Act is not contingent upon the Finance Board acting as the issuer of the debt; it exempts from taxation all obligations issued under section 11 of the Act. Under the plain language of the Act, transferring the issuance function to the Banks should not affect the tax status of bonds, notes or debentures issued under section 11(a) of the Act. This conclusion is supported by section 21(e)(7)(A) of the Act, which provides:

> Except as provided in subparagraph (B), obligations of the Financing Corporation shall be exempt from tax both as to principal and interest to the same extent as any obligation of a Federal Home Loan Bank is exempt from tax under section 1433 of this title.

12 U.S.C. § 1441(e)(7)(A).[27] Therefore, obligations issued by the Banks pursuant to section 11 (a) of the Act will be subject to federal taxation under section 3124(b) of title 31, but will not be subject to direct taxation under state or local law.

Charlotte A. Reid, Attorney-Advisor

I concur:

Deborah F. Silberman, General Counsel

[27] The exception provided in subparagraph (B) states that the "Financing Corporation, like the Federal Home Loan Banks, shall be treated as an agency of the United States for purposes of the first sentence of section 3124(b) of title 3l(relating to determination of tax status of interest on obligations)." 12 USC. § 1441(e)(7)(B). As stated, section 3124(b) provides that the interest on obligations issued by the Government or an agency, and the tax treatment of gain and loss from the disposition of those obligations is subject to federal taxation. Under section 21(e)(7)(B) of the Act, the Banks are treated as an agency of the United States for purposes of section 3124(b) of title 31.