

FEDERAL HOUSING FINANCE BOARD

Proposed Rule Requiring Federal Home Loan Banks to Voluntarily Register a Class of their Securities Under the Securities Exchange Act of 1934

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I. Introduction

I respectfully submit the following comment concerning the Federal Housing Finance Board's recently proposed rule requiring the Federal Home Loan Banks to voluntarily register a class of their securities with the Securities Exchange Commission pursuant to the Securities Exchange Act of 1934. *See Registration by Each Federal Home Loan Bank of a Class of Its Securities Under the Securities Exchange Act of 1934*, 68 Fed. Reg. 54,396-54,400 (Sept. 17, 2003) (to be codified at 12 C.F.R. pts. 900 & 998). I am currently a third year law student at Villanova University, who is interested in becoming a transactional attorney when I graduate in May of 2004. Because I am interested in the transactional side of the law, it is my belief that successful transactional attorneys must have a thorough knowledge of how to negotiate the administrative process, as well as an understanding of how it affects their clients in the business world. Furthermore, my wife and I recently purchased a townhouse in the Easton, Pennsylvania area, so I have a newly acquired stake in the ability of lending institutions to allow average citizens, such as my family, to fulfill the fundamental American dream of home ownership. I appreciate the opportunity to submit the following comment on my own behalf,¹ and I thank the Federal Housing Finance Board for its time in reading it.

II. Summary of Contents

This comment will discuss the Federal Housing Finance Board's ("FHFB" or the "Board") proposed rule more fully in depth following this summary section. The Federal Home Loan Banks ("FHLBs" or the "Bank System") are a uniquely structured group of Government Sponsored Entities ("GSEs") that were initially formed for the purpose of making secured advances to their member institutions. Within the past decade, the FHLBs have diversified their business, and have since moved into the secondary mortgage market for member lending institutions similar to the Federal Home Loan Mortgage Corporation ("Freddie Mac") and the Federal National Mortgage Association ("Fannie Mae"). The FHFB's recently proposed rules requiring the FHLBs to voluntarily

¹ The following comment reflects only my personal views and reflections, and not those of either Villanova University or the Villanova University School of Law. Furthermore, nothing in this comment constitutes or should be construed as legal advice of any kind, as I do not yet have a Juris Doctor and I am not a member of any State Bar.

register a class of their securities under the Securities Exchange Act of 1934 (“SEA 1934”) are clearly a product of the current political and business environment resulting from the Enron scandal.² The combined effects of Enron along with the fruition of the Post-September 11th “Big Bath” Theory³ upon the United States’ capital markets has left investors and analysts alike demanding greater transparency and accountability with respect to financial reporting.⁴ This call for improved financial disclosures as well as strictly enforced ethical duties for management has ultimately moved into the realm of GSEs due to the recent (and probably confined) problems at Freddie Mac.⁵

Overall, the proposed rule requiring voluntary registration under the SEA 1934 is well-founded, and will ultimately benefit the FHLBs, as well as the home buying industry at large. Aside from the apparent differences in structure between the Bank System and publicly traded companies that are normally subject to Securities Exchange Commission (“SEC”) regulations, the FHLBs are a major player in the current debt securities market insofar as the Office of Finance issues over five trillion dollars (**\$5,000,000,000,000**) worth of bonds each year. As one of the largest, if not *the* largest, issuers of debt securities, the FHLBs should be subject to a sophisticated financial disclosure regime, such as only the SEC’s financial reporting requirements can provide. This is especially true insofar as the FHLBs use derivatives and other risk-hedging investments to a great extent, as well as the fact that the accounting standards governing such instruments has become increasingly complex in recent years.

Furthermore, as GSEs, the Bank System should serve as an example of compliance with the SEC’s financial disclosure regime under the SEA 1934 for two reasons. First, insofar as the FHLBs have traditionally maintained a AAA investment and credit rating,

² This comment recognizes that there have been numerous publicized instances of corporate securities and financial reporting fraud over the past two years that have implicated many public companies from Sunbeam to WorldCom. See, e.g., Christopher Rhoads, *U.S. Loses Sparkle as Icon of Marketplace—Funds Flow Back to Europe as Mistrust in Wall Street Mounts With Each Day*, WALL ST. J., June 28, 2002, at A10. The author uses general references to Enron to denote all such instances of corporate financial reporting fraud, because Enron has thus far proven to be the most visible case.

³ The Big Bath Theory denotes the accounting method of large companies taking large charges against income in hopes that it will decrease future profit expectations until the company can get back on its feet. See, e.g., Phillip J. Boeckman, *SEC’s Focus on “Earnings Management” and the New Audit Committee Standards*, in PRACTICING LAW INSTITUTE, CORPORATE LAW AND PRACTICE COURSE HANDBOOK: CURRENT SEC AND CROSS-BORDER M&A DEVELOPMENTS 523, 540-43(2000)

⁴ See, e.g., Andrew Countryman, *Fairness and Transparency; Sentiment is Clear: Ethics Must Improve*, CHI. TRIB., July 28, 2002, at Business 1.

⁵ During the unfortunate economic decline of the past two years, home buying has seemed to keep the American economy afloat and remains strong even as we are beginning to see a light at the end of the tunnel. See Michael Schroeder, *U.S. Home Starts Rise 1.5%, Hitting 17-Year High*, WALL ST. J., Aug. 20, 2003, at A2. The lending industry was a bit shaken, however, when amid allegations of understating profits, Freddie Mac fired high-ranking management members and announced that it would restate three years of financial reports. See generally Patrick B. & Greg I.P., *Out the Door: Freddie Mac Ousts Top Officials as Regulators Prepare Inquiries*, WALL ST. J., June 10, 2003, at A1.

registering a class of the FHLBs' securities under SEA 1934 could only benefit the FHLBs' ability to raise capital in the open market because the lending institutions and investors that typically purchase FHLB securities will have greater confidence in FHLB financial statements. Second, because FHLBs are such a large and accessible source of liquidity for lending institutions in supporting the home-buying market, they should ideally be the first to step forward and subject themselves to the SEC's periodic financial reporting regime in order to set an example for publicly traded companies in the United States.

Although the proposed rules requiring voluntary registration of a class of FHLB securities under SEA 1934 will be beneficial overall, there are certain logistical issues apparent from their surface. The foremost issue raised by the FHFB's proposed rule is that it does not even mention which agency will be responsible for enforcing the Bank System's new financial reporting requirements. Although the SEC normally retains the authority to compel compliance with the applicable financial disclosure regulations, the broad authoritative powers announced in the Federal Home Loan Bank Act of 1932 ("FHLBA") have the potential for overlapping areas of authority with respect to the FHLBs' future compliance under SEA 1934. Absent explicit clarity as to which agency should enforce the FHLBs' full compliance with SEA 1934, the FHFB's proposed rule could generate potential oversight conflicts. Furthermore, certain provisions within SEA 1934, such as the SEC's ability to suspend the trading of securities in certain circumstances, would either have to be amended or interpreted by SEC regulations in order to accommodate the unique structure and business of the Bank System. Otherwise, the FHFB, the FHLBs and the SEC could find themselves in a legal holding pattern concerning the proper course of action in the event that certain actions taken by a FHLB would implicate such provisions in SEA 1934.

Although it may not be immediately apparent on the face of the FHFB's current proposed rule, requiring voluntary registration of FHLB securities under SEA 1934 may implicate a larger question of administrative organization and oversight within the Executive Branch of the Federal Government. As the FHLBs continue to operate in the secondary mortgage market with greater frequency, it naturally begs the question of why the FHLBs and GSEs such as Freddie Mac and Fannie Mae are not supervised by the same administrative agency. Although it appears that many individuals in the lending business want a consolidated federal administrative agency within the Executive Branch to supervise the FHLBs along with Freddie Mac and Fannie Mae, it also appears that those GSEs want oversight from an agency that can remain independent of political pressure. The question thus becomes how to retain the goal of the FHFB's proposed rule requiring voluntary registration of FHLB securities under SEA 1934, while consolidating supervision of Freddie Mac, Fannie Mae and the FHLBs in an agency that can retain its independence from such political pressures as Congressional budgeting. Although this Comment recognizes the logistical mountains that would have to be overcome in order to accomplish the following proposed administrative feat, one potential solution to the above dilemma would perhaps be to collapse the FHFB and the Office of Federal Housing Enterprise Oversight ("OFHEO") into a new Division of Housing GSE Supervision within the SEC.

III. Background

In 1932, Congress passed the FHLBA, 12 U.S.C.A. § 1421 *et seq.* (West 2003), creating the Bank System to provide secured advances to certain lending institutions, such as savings and loans and insurance companies, in order to maintain the liquidity of such lenders for the broad purpose of stimulating home buying in America.⁶ Under the current version of FHLBA, the FHFb's primary duty is to supervise and ensure that the FHLBs operate in a financially safe and sound manner, and that the FHLBs remain adequately capitalized, in addition to being able to raise capital in America's capital markets. *See* 12 U.S.C.A. § 1422a(a)(3) (West 2003). Included within the FHFb's supervisory powers is the ability to require periodic examinations of the FHLBs. *See* 12 C.F.R. § 905.4(a)(2)(iii) (2003). In addition, FHLBA provides the FHFb with certain broad general powers in overseeing the Bank System,⁷ including the ability to promulgate and enforce such regulations that are necessary to carry out FHLBA and the ability to issue and serve a notice of charges or an order requiring a party within the Bank System to take affirmative action where the FHFb reasonably believes the party is operating in an unsafe manner. *See* 12 U.S.C.A. § 1422b(a)(1) & (4) (West 2003). To maintain flexibility, however, FHLBA also allows the FHFb to delegate its "ministerial functions," such as issuing consolidated obligations under FHLBA section 1431(b).⁸ *See* 12 U.S.C.A. § 1422b(b)(1) (West 2003).

The basic function of the FHLBs is to offer secured advances to their member lending institutions in order to maintain liquidity within the home-buying market,⁹ although the FHLBs have also begun operating in the secondary mortgage market within the past ten years. As GSEs, the FHLBs are already very heavily regulated entities due to their important function within the American economy. FHLBs raise the necessary capital to perform their liquidity functions in the market by issuing stock¹⁰ to their members and

⁶ Until the Financial Institution Reform, Recovery and Enforcement Act of 1989 ("FIRREA"), Pub. L. No. 101-73 (1989), commercial banks were not permitted to become members of FHLBs. *See* FIRREA, Pub. L. No. 101-73, § 704(a)(1) (1989).

⁷ The FHFb also has the general power to suspend FHLB or Office of Finance employee, to determine necessary Board expenditures, use the United States mail in a manner consistent with other Federal Agencies, to address any insufficiencies in capital levels in certain cases and to act in its own name and through its attorneys in enforcing FHLBA. *See* 12 U.S.C.A. § 1422b(a) (West 2003).

⁸ The FHFb has, in fact, delegated the function of offering consolidated bonds on which the FHLBs are jointly and severally liable. *See* 12 C.F.R. § 985.3(a) (2003).

⁹ *See* 12 C.F.R. § 940.2(a) & (b) (2003).

¹⁰ Under the Gramm-Leach-Bliley Act ("GLBA"), Pub. L. No. 106-102 (1999), FHLBA was amended to require the FHFb to adopt regulations requiring each FHLB to adopt new risk-based capital structures. *See* 12 U.S.C.A. § (a)(1)-(3) (West 2003) (requiring FHLBs to maintain permanent capital sufficient to meet FHLB credit risks, as well as market risks such as interest rate risk to which FHLBs are subject based upon a "stress test"); *see also* 12 C.F.R. §§ 932.2, 932.3 & 932.4 (2003). Currently, there are six FHLBs that

issuing consolidated bonds¹¹ through the Office of Finance, a joint office of the Bank System. *See* 12 U.S.C.A. §§ 1426(a)(4) & 1431(b) (West 2003); *see also* 12 C.F.R. § 985.3(a) (2003). The Securities Act of 1933 (“SA 1933”), 15 U.S.C.A. § 77a *et seq.* (West 2003), was enacted for the protection of the investing public from the fraudulent issuance of securities by requiring entities issuing such securities to register prior to offering such financial instruments to the general public. Both FHLB stock and consolidated bond issuances are exempt from the registration requirements of the SA 1933.¹² *See* 15 U.S.C.A. § 77c(a)(2) (West 2003).

SEA 1934, on the other hand, was enacted in order to create the SEC to regulate national securities exchanges and the securities dealers operating on those exchanges for the protection of the investing public. *See* 15 U.S.C.A. § 78a *et seq.* (West 2003). One of the key features of SEA 1934 is that it requires entities whose securities are traded in interstate commerce to comply with certain periodic financial disclosure requirements. Specifically, SEA 1934 requires the issuers of securities to file such information as is necessary to keep its initial registration information up to date, as well as any such annual and quarterly reports or information as the SEC prescribes by regulation. *See* 15 U.S.C.A. § 78m(a) (West 2003). Under current SEC regulations, an issuer must, at the very least, comply with Regulations S-X and S-K, the applicable rules under the Code of Federal Regulations, Title 17, Chapter II, Part 240, as well as the various applicable

have implemented their new capital plans and are operating under new capital structures. FHLBA currently permits the FHLBs to issue Class A stock redeemable at par value (\$100) in cash within six months following submission of written notice by the member holding such stock, as well as Class B stock redeemable at par value in cash within five years following submission of written notice by the member holding such stock. *See* 12 U.S.C.A. § 1426(a)(4)(A) (West 2003); *see also* 12 C.F.R. §§ 925.20, 931.1 & 931.9 (2003). Of course, FHLB stock can only be issued to and held by member financial institutions. *See* 12 U.S.C.A. § 1426(a)(4)(B) (West 2003).

¹¹ Although FHLBA permits the FHLBs to issue consolidated obligations (debentures), the FHFBA has since delegated this responsibility to the Office of Finance. *See* 12 U.S.C.A. § 1431 (West 2003); 12 C.F.R. § 985.6(a) (2003). Because of the FHLBs’ GSE status, the Office of Finance is able to issue such consolidated bonds at favorable rates in the market, upon which the FHLBs are jointly and severally liable. Each year, the Office of Finance issues over five trillion dollars worth of these consolidated obligations on behalf of the FHLBs, although the actual outstanding amount averages around a little over six-hundred billion dollars at any time. *See* FHFBA Chairman John T. Korsmo, Address to the Independent Community Bankers of America (Mar. 4, 2003). Although the FHLBs are restricted from pledging any assets to guarantee such obligations, FHLBA requires the FHLBs to have reserves equal to the amount of outstanding obligations invested in low-risk interest bearing investments. *See* 12 U.S.C.A. § 1431(b)&(g) & 1436(a) (West 2003).

¹² At this time, it does not appear that either the FHFBA or the SEC wishes to subject the FHLBs to the registration requirements of the SA of 1933 due to the enormous practical difficulties in doing so. *See* FHFBA Chairman John T. Korsmo, Address to the America’s Community Bankers Government Affairs Conference (Mar. 11, 2003). It should be noted, however, that the Office of Finance currently distributes various disclosure documents in connection with its bond issuances to the general investing public that are modeled after a Form S-3 shelf registration statement required under the disclosure regime of SA of 1933. *See* Registration by Each Federal Home Loan Bank of a Class of Its Securities Under the Securities Exchange Act of 1934, 68 Fed. Reg. 54,396, 54,398 (Sept. 17, 2003) (to be codified at 12 C.F.R. pts. 900 & 998)

interpretations issued under Parts 211 and 241. *See* 17 C.F.R. §§ 210.1-01(a)(2) & 229.10(a)(2) (2003).

Under SEA 1934, government securities, meaning securities issued or guaranteed by corporations in which the United States Government has a direct or indirect interest, are exempt from the Act's registration requirements when the Secretary of the Treasury designates such securities as exempt for the public interest. *See* 15 U.S.C. § 78c(a)(12)(A)(i) & (a)(42)(B) (West 2003). In Release 34-1168 of April 28, 1937, the SEC announced that the Secretary of the Treasury had designated the consolidated bonds issued by the FHLBs as exempt from the registration requirements of SEA 1934. *See* Registration by Each Federal Home Loan Bank of a Class of Its Securities Under the Securities Exchange Act of 1934, 68 Fed. Reg. 54,396, 54,397 (Sept. 17, 2003) (to be codified at 12 C.F.R. pts. 900 & 998). The Secretary of the Treasury, however, has never designated FHLB stock as being exempt from the registration requirements of SEA 1934. Nonetheless, the FHLBs' stock has been presumed to be exempt from SEA 1934's registration requirements in conjunction with the FHFB's supervisory authority under FHLBA. *See id.*

Currently, the FHLBs must submit annual financial statements to the Office of Finance, which prepares combined financial statements to be submitted to the FHFB. *See* 12 C.F.R. §§ 989.2(b) & 989.3 (2003).¹³ These combined financial statements are required to be generally consistent with SEC Regulations S-K and S-X. *See* 12 C.F.R. § 985.6(b)(1) (2003); *see also* Registration by Each Federal Home Loan Bank of a Class of Its Securities Under the Securities Exchange Act of 1934, 68 Fed. Reg. 54,396, 54,398 (Sept. 17, 2003) (to be codified at 12 C.F.R. pts. 900 & 998). Although annual and quarterly financial statements provided by individual FHLBs are required to be consistent in form and content with the combined financial statements prepared by the Office of Finance, there is currently no specific FHFB regulation that explicitly requires the individual FHLBs' financial statements to comply with either Regulation S-K or Regulation S-X. *See* 12 C.F.R. § 989.4 (2003); *see also* Registration by Each Federal Home Loan Bank of a Class of Its Securities Under the Securities Exchange Act of 1934, 68 Fed. Reg. 54,396, 54,398 (Sept. 17, 2003) (to be codified at 12 C.F.R. pts. 900 & 998).

In 2002, in response to overwhelming demand for increased financial reporting controls and oversight in wake of the Enron scandal,¹⁴ Congress enacted the Public Company Accounting Reform and Investor Protection Act, better known as the Sarbanes-

¹³ Both the FHLBs and the Office of Finance must obtain an independent, external audit of their financial statements on an annual basis. *See* 12 C.F.R. § 989.2(a) (2003). Furthermore, these independent auditors must meet at least twice a year with each FHLB's audit committee and the Office of Finance, while the FHFB's regulatory examiners have unrestricted access to all financial data prepared by these independent auditors. *See* 12 C.F.R. § 989.2(d)&(e) (2003).

¹⁴ For a broad discussion of the events leading up to the Enron scandal, see generally Douglas M. Branson, *Enron-When All Systems Fail: Creative Destruction or Roadmap to Corporate Governance Reform?*, 48 VILL. L. REV. 989 (2003).

Oxley Act of 2002 (the “Sarbanes-Oxley Act”). *See* Pub. L. No. 107-204, 116 Stat. 745 (2002). The Sarbanes-Oxley Act was enacted in order to both strengthen existing oversight and reporting requirements,¹⁵ as well as create new and sophisticated oversight measures designed to reign in such professionals as accountants and attorneys who were not previously subject to existing controls. *See, e.g.*, 15 U.S.C.A. § 7211 (establishing Public Company Accounting Oversight Board for the purpose of registering all public accounting firms and subjecting them to rules to be promulgated in the future concerning the ethical preparation of audit reports for publicly-traded companies). In addition to its registration requirements concerning public accounting firms,¹⁶ *see* 15 U.S.C.A. §§ 7211(c)(1) & 7212(a) (West 2003), the Sarbanes-Oxley Act authorizes the SEC to issue regulations requiring annual reports filed pursuant to SEA 1934 to contain an internal control report concerning risk-management activities engaged in by the provider of such financial statements. *See* 15 U.S.C.A. § 7262(a) (West 2003). Furthermore, the independent audit committee for companies submitting such financial statements must also provide a report concerning the risk-management activities engaged in by that company. *See* 15 U.S.C.A. § 7262(b) (West 2003). The Sarbanes-Oxley Act also authorizes the SEC to promulgate rules requiring the disclosure of whether or not an audit committee has a qualified financial expert.¹⁷ *See* 15 U.S.C.A. § 7265(a) (West 2003). Furthermore, all issuers of financial statements must now disclose whether or not the company has developed a code of ethics, and all changes to any existing code of ethics must now be disclosed to the SEC in a Form 8-K filing. *See* 15 U.S.C.A. § 7264(a)&(b) (West 2003). While the Sarbanes-Oxley Act is no doubt a well-intentioned step towards transparency, it will concurrently lead to increased costs for companies subject to SEA 1934. *See, e.g.*, Donald C. Langevoort, *Managing the “Expectations Gap” in Investor Protection: The SEC and the Post-Enron Reform Agenda*, 48 VILL. L. REV. 1139, 1140 (2003).

IV. Federal Home Loan Banks Should be Subject to the SEC’s Periodic Financial Reporting Regime

As stated above, FHLBs should be subject to the periodic financial reporting requirements under SEA 1934, as interpreted and administered by the SEC. Although

¹⁵ For example, one of the most publicized provisions of the Sarbanes-Oxley Act was its requirement that the SEC issue regulations governing the certification of publicly traded companies’ annual financial reports by their principal executive officers as well as their principal financial officers. *See* 15 U.S.C.A. § 7241(a) (West 2003).

¹⁶ The Sarbanes-Oxley Act defines the term “public accounting firm” as any “legal entity that is engaged in the practice of public accounting or preparing or issuing audit reports; and, to the extent so designated by the rules of the [Public Company Accounting Oversight] Board, any associated person of any entity described [above].” 15 U.S.C.A. § 7201(a)(11) (West 2003).

¹⁷ Although the Sarbanes-Oxley Act does not specifically define the term “financial expert,” the Act requires the SEC to consider certain things in defining whether an individual is a financial expert such as the individual’s experience and education in the accounting profession, including their experience with respect to preparing financial statements and serving on audit committees. *See* 15 U.S.C.A. § 7265(b) (West 2003).

FHLBs are for most practical purposes private entities, their status as GSEs along with the concurrent implication that debt securities issued by the Office of Finance are backed by the United States Department of the Treasury imparts a special responsibility within the marketplace to serve as an example of compliance. As a business matter, increased (or perhaps more official) disclosure requirements can only serve to restore what, if any, investor confidence has been shaken in the Bank System in recent months due to the recent financial irregularities at Freddie Mac.¹⁸

Prior to January of this year, Freddie Mac along with Fannie Mae were seen as companies in which management would never misstate material financial information due to the fact that both GSEs back nearly half of all mortgage debt in the United States. *See, e.g.,* Jerry Markon & Carrie Johnson, *U.S. Opens Criminal Probe of Freddie Mac; Possible Securities Law Violations Discussed*, WASHINGTON POST, June 11, 2003, at E01. The financial industry (especially those subscribing to the preceding lofty view) received a serious wake up call when Freddie Mac announced in January that it would have to restate its earnings for the past three years due to disagreement expressed by Freddie Mac's new auditors over the GSE's derivatives accounting methods. *See id.* Since this inauspicious announcement, it has come to light that Freddie Mac understated its net earnings by up to \$4.5 billion over the past three years, *see* Elliot Blair Smith, *Manipulation Kept Profit Steady*, USA TODAY, June 26, 2003, at Money 3B; *see also* *Freddie's Profit Revision Grows; The Mortgage Giant Says Its Earnings for 2000-2002 may Increase as Much as \$4.5 Billion*, L.A. TIMES, June 26, 2003, at Business 3. Furthermore, in addition to having to restate three years worth of financial statements, Freddie Mac has since gone through two chief executive officers,¹⁹ its subordinated debt and preferred equity securities have been downgraded²⁰ and it now faces back taxes worth millions of dollars.²¹ What remains to be seen is whether the financial reporting

¹⁸ This comment recognizes that there are a number of intelligent and much more experienced commentators that do not necessarily agree that GSEs, such as the FHLBs and Freddie Mac, should be subject to increased disclosure requirements under SEA 1934. *See, e.g.,* Susan Woodward, *Today's debate: Corporate Accountability: Opposing View: Calls for Greater Freddie Mac Disclosure are Premature*, USA TODAY, June 13, 2003, at News 15A.

¹⁹ Amid allegations of document tampering and an impending SEC investigation, Freddie Mac fired its Chief Executive Officer, Leland C. Brendsel, along with its President and Chief Operating Officer, David W. Glenn and Chief Financial Officer, Vaughn A. Clarke, in June of this year. *See* Jerry Markon & Carrie Johnson, *U.S. Opens Criminal Probe of Freddie Mac; Possible Securities Law Violations Discussed*, WASHINGTON POST, June 11, 2003, at E01. Soon after, due to pressures from the OFHEO, Freddie Mac's new Chief Executive Officer, Gregory J. Parseghian and its General Counsel Maud Mater were asked to step down. *See* Kathleen Day, *Freddie Mac CEO to Step Down; Board of Directors Yields to Pressure from Regulator*, WASHINGTON POST, Aug. 24, 2003, at A06.

²⁰ Only days after Freddie Mac reluctantly asked its new Chief Executive Officer, Gregory J. Parseghian, to resign, Fitch Ratings downgraded Freddie Mac's subordinated debt securities and preferred stock from a AA rating to a AA-. *See* Carrie Johnson, *Some Freddie Mac Securities Downgraded; Fitch Ratings Cites Management Uncertainty After Ouster of Chief Executive*, WASHINGTON POST, Aug. 26, 2003, at E03 (quoting a Fitch Ratings spokesperson as stating that Mr. Parseghian's departure was a significant reason for the downgrade).

irregularities at Freddie Mac will have any long-term effects on the financial community's perception of its financial stability.

Unfortunately, the well-publicized financial reporting problems at Freddie Mac have also raised issues about the accuracy of the FHLBs financial reporting, in addition to the economic soundness of the Bank System. This new attention centering upon the FHLBs is partly due to the fact that the Bank System is now in competition with Freddie Mac and Fannie Mae in the secondary mortgage market.²² See David S. Hilzenrath, *Challenging an Empire; Regional Home-Loan Banks Eye Fannie, Freddie's Market*, WASHINGTON POST, Oct. 8, 2003, at E01. In light of the fact that the secondary mortgage market is much more risky due to interest rate changes, perhaps some of the scrutiny is well deserved. *But see* 12 C.F.R. § 950.10 (2003) (governing collateral valuation methods). FHLBs do, after all, utilize derivative contracts to a great extent in order to hedge against interest rate risk. See *Oversight of the Federal Home Loan Bank System: Hearing Before the Subcomm. On Financial Institutions of the Senate Comm. On Banking, Housing and Urban Affairs*, available at <http://www.fhlb.com/Testimony.pdf>, (2003) (statement of Terry Smith, President and CEO, Federal Home Loan Bank of Dallas). On the other hand, what many people in the investing public do not know is that the FHFB has recently established two divisions, the Risk Modeling Division²³ and Risk Monitoring Division,²⁴ to enhance financial analysis and promote risk management within the Bank System. See *Oversight of the Federal Home Loan Bank System: Hearing Before the Subcomm. On Financial Institutions of the Senate Comm. On Banking, Housing and Urban Affairs*, available at http://www.fhfb.gov/pressroom/PR03_testimony2.pdf, (2003) (statement of John T. Korsmo, Chairman, Federal Housing Finance Board). Furthermore, the FHLBs have accounted for their derivative financial transactions under FAS 133 the same way that they would be required to account for such risk-hedging transactions under

²¹ The estimates concerning Freddie Mac's liability for back taxes have ranged from \$30 million to over \$750 million. See Dawn Kopecki, *IRS Probes Tax Issues at Freddie Mac*, WALL ST. J., Oct. 22, 2003, at A6; Dawn Kopecki, *Freddie Tax Bill May Be \$30 Million*, WALL ST. J., Nov. 3, 2003, at A2.

²² Until 1997, FHLBs were content to simply provide low-cost secured advances to their member institutions. Commentators frequently cite the fact that many of the FHLB's members are now much larger and able to raise capital within the markets than the FHLBs themselves as a reason for the Bank System moving into the secondary mortgage market. See David S. Hilzenrath, *Challenging an Empire; Regional Home-Loan Banks Eye Fannie, Freddie's Market*, WASHINGTON POST, Oct. 8, 2003, at E01. In fact, many commentators argue that the FHLBs are becoming obsolete due to the fact that many large banks can simply go to the capital markets in order to obtain secured advances and raise capital. See *id.* The FHLBs, themselves, insist that they remain a vital source of liquidity for smaller community banks that do not have the ability to go to the capital markets in order to obtain funds to provide more loans with. See *id.*; see also *Hearing on H.R. 2575, the Secondary Mortgage Market Enterprises Regulatory Improvement Act, and the Administration's Proposals on GSE Regulation: Hearing Before the House Committee on Financial Services*, <http://www.fhlbsf.com/about/news/releases/2003/pr61.asp>, (2003) (statement of Dean Schultz, President and CEO, Federal Home Loan Bank of San Francisco) (stating that Bank System provides lenders confidence in holding loans that cannot easily be sold in the secondary mortgage market and still meet the cyclical demands of borrowers).

²³ The FHFB Risk Modeling Division monitors the FHLB's internal interest rate risk controls.

²⁴ The FHFB Risk Monitoring Division compiles all FHFB data along with all FHLB financial reports into a risk management framework.

current SEC regulations. *See* 12 C.F.R. § 956.6 (2003) (governing FHLB use of hedging instruments); Letter from Lynn E. Turner, Chief Accountant, Securities Exchange Commission, to Arleen Thomas, Vice-President of Professional Standards and Services, American Institute of Certified Public Accountants (Oct. 13, 2000) (available at <http://www.sec.gov/info/accountants/staffletters/audrsk2k.htm>); *see also* ACCOUNTING FOR DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES, Statement of Financial Accounting Standards No. 133 (Financial Accounting Standards Bd. 1998). So why is it necessary for FHLBs to be subject to the financial reporting regime under SEA 1934?

Perception. It appears to be well settled within the Bank System and the investing community that (although they are by no means perfect) the SEC currently maintains the most comprehensive financial reporting requirements in the world. *See* FHFBC Chairman John T. Korsmo, Address to the American Land Title Association (Apr. 14, 2003) (“The SEC represents the ‘gold standard’ of financial disclosures.”); Letter from Andrew J. Jetter, President & CEO, Federal Home Loan Bank of Topeka to Member Banks (Oct. 2, 2003) (available at http://www.fhlbtopeka.com/pdf/SEC_letter.pdf) (“[T]he highest caliber regulatory regime for public disclosures is one administered by the SEC.”). In light of the recent and well-publicized investing losses at some of the FHLBs,²⁵ voluntary registration under SEA 1934 would serve, at least in the short-term, to quell the fears of some commentators that the Bank System is being run without proper oversight. *See, e.g.,* David S. Hilzenrath, *Challenging an Empire; Regional Home-Loan Banks Eye Fannie, Freddie’s Market*, WASHINGTON POST, Oct. 8, 2003, at E01 (hereinafter cited as Hilzenrath, *Challenging an Empire*). Furthermore, if the Bank System voluntarily submitted to the regulation of an agency such as the SEC with *comparatively* large government resources, it would demonstrate to investors that the FHLBs are attempting to strike a balance between their inherently conflicting goals of maximizing profit and encouraging home ownership. *See, e.g.,* Steven Pearlstein, *Fannie, Freddie, Flubs Can Stop Growing Now*, WASHINGTON POST, Oct. 10, 2003, at E01. Thus, voluntary disclosure will only improve investors’ perception of FHLB responsibility and risk management. This improved perception can only benefit the Bank System’s ability to raise capital in the market, as well as ultimately stimulate home ownership in America.

Perception can also work against the Bank System. The financial reporting problems at Freddie Mac have no doubt subjected *all* GSEs to greater scrutiny. *See, e.g.,* Hilzenrath, *Challenging an Empire, supra*, at E01. This growing firestorm of public scrutiny was also fanned by recently reported losses at some of the FHLBs themselves. *See* Pearlstein, *supra*, at E01. This increased scrutiny of the Bank System began with the FHLB of New York’s disclosure of around \$183 million in investment losses in late September followed by Standard & Poor’s reduction of its counterparty credit rating from AAA to AA+. *See* Jenny Wiggins, *S&P Lowers FHLB Rating Banking*, FINANCIAL TIMES, Sept. 27, 2003, at 9; Jenny Wiggins, *S&P Changes View of FHLB of NY News Digest*, FINANCIAL TIMES, Aug. 9, 2003, at 5. This was the first time that a FHLB had ever had a credit rating adjustment, and it did not take long for the investing public to

²⁵ The recent quarterly and investment losses at the FHLBs of Atlanta, Pittsburgh and New York will be discussed *infra*.

question the financial stability of the Bank System as a whole.²⁶ *See, e.g.,* Patrick Barta, *Home Loan Bank of New York Spurs Wave of Concern*, WALL ST. J., Sept. 26, 2003, at A1. The FHLB of New York's investing loss disclosures were soon followed by news from the FHLBs of Atlanta and Pittsburgh that they were forecasting a combined loss of around \$16 million.²⁷ *See Two Providers of Home Loans to Post Losses*, N.Y. TIMES, Oct. 9, 2003, at C4.

The negative effects of the recent losses posted by the FHLBs of Atlanta, New York and Pittsburgh on investors' perception of the Bank System's stability are further compounded by the views of some commentators that the FHLBs will become obsolete in the near future. *See Hilzenrath, Challenging an Empire, supra*, at E01. Thus, the Bank System is currently faced with a growing perception that FHLBs maintain risky investment portfolios, as well as the possibility that they could become irrelevant in the near future due to the ability of commercial banks to directly issue debt in the capital markets to maintain their liquidity. This view that the FHLBs will become obsolete because lending institutions can maintain their liquidity by directly issuing debt in the capital markets is likely attributable to the multiple mergers and trend towards large, consolidated lending institutions.²⁸ Nevertheless, this view that the Bank System will become obsolete could be ameliorated by the fact that FHLBs remain critical to the smaller community banks around the nation that do not have the ability to go directly to the capital markets and issue debt to maintain their liquidity. *See id.* Unfortunately, even though more than half of the nation's community banks rely heavily upon the Bank System to maintain their liquidity, this is not a well-publicized fact. *See id.* The FHLBs *can*, however, improve the growing negative investor perception that they maintain risky investment portfolios by voluntarily registering a class of their securities under SEA 1934.

Although the FHLBs will not experience an enormous change in their financial reporting methods by subjecting themselves to SEA 1934's financial disclosure regime, this will not matter to the investing public. The recent financial losses at the FHLBs of

²⁶ As a result of the investment loss, the FHLB of New York recorded a significant loss in its second quarter and did not declare dividends in an attempt to offset that loss. *See Jenny Wiggins, S&P Lowers FHLB Rating*, FINANCIAL TIMES, Sept. 27, 2003, at 9.

²⁷ The FHLB of Atlanta forecasted a \$9 million loss, while the FHLB of Pittsburgh forecasted a \$7 million loss. *See Federal Home Loan Banks Expect Loss*, L.A. TIMES, Oct. 9, 2003, at Business 3.

²⁸ In fact, some of the FHLBs members are now much larger than the FHLBs themselves. *See Hilzenrath, Challenging an Empire, supra*, at E01. During the first half of 2003, seventeen lending institutions with more than \$50 billion of assets accounted for 20.6% of the Bank System's loans outstanding. *See id.* These seventeen lending institutions represented, at the time the information was recorded, only .21% of the Bank System's 8,080 members. *See id.* For instance, the FHLB of Des Moines carries \$42.3 billion of assets on its balance sheet, while its largest customer, Wells Fargo, has \$349.3 billion of assets. *See id.* Also, 30.4% of the FHLB of Seattle's outstanding loans were to Bank of America Oregon, while 41.1% of the FHLB of San Francisco's outstanding loans were to Washington Mutual Bank FA, the subsidiary of an entity with twice as many assets as the FHLB of San Francisco. *See id.*

Atlanta, New York and Pittsburgh were attributable to securities backed by poor quality assets, as well as low derivative instrument market values due to low market interest rates. *See Federal Home Loan Banks Expect Loss*, FINANCIAL TIMES, Oct. 9, 2003, at Business 3. As stated above, there will not be a significant change in the way the FHLBs report their derivative instrument transactions under SEA 1934 and the applicable SEC regulations. *See* 12 C.F.R. § 956.6 (2003) (governing FHLB use of hedging instruments); Letter from Lynn E. Turner, Chief Accountant, Securities Exchange Commission, to Arleen Thomas, Vice-President of Professional Standards and Services, American Institute of Certified Public Accountants (Oct. 13, 2000) (available at <http://www.sec.gov/info/accountants/staffletters/audrsk2k.htm>); *see also* ACCOUNTING FOR DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES, Statement of Financial Accounting Standards No. 133 (Financial Accounting Standards Bd. 1998). Most investors, however, are not aware of the present and likely future financial reporting requirements for the Bank System, and they probably do not care to compare the two. What investors *are* concerned with, however, is whether the FHLBs are subject to the “gold standard” of financial reporting requirements under the SEC’s current financial disclosure regime under SEA 1934.²⁹ Thus, by voluntarily registering a class of their securities with the SEC pursuant to SEA 1934, the FHLBs will only improve investors’ perception of the Bank System’s financial reports and stability. Furthermore, an improved overall investor perception of the Bank System’s financial reporting and stability can only lead to an even better ability for the FHLBs to raise capital in the marketplace.

Moreover, because FHLBs are GSEs, they should have already voluntarily subjected themselves to the SEC’s financial reporting regime under SEA 1934. As stated above, FHLB stock has never actually been designated as exempt from SEA 1934’s registration requirements, although its exemption was presumed in light of the FHF’s oversight responsibilities. *See* Registration by Each Federal Home Loan Bank of a Class of Its Securities Under the Securities Exchange Act of 1934, 68 Fed. Reg. 54,396, 54,397 (Sept. 17, 2003) (to be codified at 12 C.F.R. pts. 900 & 998). Furthermore, as GSEs, the FHLBs are able to raise capital by issuing debt that is implicitly backed by the federal government at favorable rates in the market. *See* FHF Chairman John T. Korsmo, Remarks to the American Land Title Association (Apr. 14, 2003). Because the FHLBs occupy such a favorable position concerning their ability to raise capital within the marketplace due to their status as GSEs, they should be the first to voluntarily submit to the SEC’s financial reporting regime under SEA 1934. This is especially true in light of the recent and well-publicized financial reporting scandals that have plagued Wall Street. Currently, there are six FHLBs³⁰ that have publicly supported voluntary registration with

²⁹ This comment recognizes the fact that many investors still do not have a good overall impression concerning SEC oversight in the wake of the Enron scandal. Nonetheless, this comment merely strives to point out that the average investor would rather have GSEs such as the Bank System, Freddie Mac and Fannie Mae subject to the SEC’s financial reporting oversight, subject to whatever flaws the current system may have, as opposed to the concededly overextended oversight capabilities of the FHF and OFHEO.

³⁰ The banks that have *publicly* acknowledged their support for voluntarily registering a class of their securities with the SEC pursuant to SEA 1934 are the FHLBs of Boston, Cincinnati, Dallas, New York, San

the SEC, although all of these FHLBs acknowledge the fact that there are a number of issues that must be worked out before the Bank System can successfully subject itself to the SEC's financial reporting regime.³¹

V. The Federal Housing Finance Board's Proposed Rules Requiring Federal Home Loan Banks to Voluntarily Register a Class of their Securities Pursuant to the Securities Exchange Act of 1934 Do Not Provide for Oversight Allocation Between the Securities Exchange Commission and the Federal Housing Finance Board

Overall, the FHFB's proposed rules requiring FHLBs to voluntarily register a class of their securities pursuant to SEA 1934 will benefit the Bank System, the investing public and lending institutions as a whole. Nonetheless, there are certain logistical issues that are apparent on the face of the FHFB's proposed rules.³² The main issue apparent from the face of the proposed rules concerns enforcement.

The FHLBA created the FHFB with broad primary duties and general powers in overseeing the Bank System.³³ The primary duty of the FHFB under the FHLBA is to make sure that the FHLBs operate in a financially prudent manner. 12 U.S.C.A. §

Francisco and Topeka. *See Will the System See New Disclosure Rules?*, FHLB of Boston, at http://www.fhlbboston.com/aboutus/features/09_02_features_detail.jsp?id=1055 (last visited Nov. 14, 2003) (hereinafter cited as FHLB of Boston Position); *FHLBank of Cincinnati Statement Enhanced Disclosure/SEC Registration*, FHLB of Cincinnati, at http://www.fhlbcin.com/04_NEW.ASP?ID=428 (last visited Nov. 14, 2003) (hereinafter cited as FHLB of Cincinnati Position); *Enhanced Disclosure/SEC Registration*, FHLB of Dallas, at <http://www.fhlb.com/Legislative%20and%20Regulatory> (last visited Nov. 14, 2003); *President's Report/Board Votes For SEC Registration*, FHLB of New York, available at <http://www.fhlbnny.com/news/news.htm> (last visited Nov. 14, 2003) (hereinafter cited as FHLB of New York President's Report); Letter from the Board of Directors, FHLB of San Francisco, to *inter alia* John W. Snow, Secretary of the Treasury, United States Department of the Treasury (Aug. 21, 2003) (available at <http://www.sec.gov/info/accountants/staffletters/audrsk2k.htm>) (hereinafter cited as FHLB of San Francisco Letter); Letter from Andrew J. Jetter, President and CEO, FHLB of Topeka, to Member Financial Institutions (Oct. 2, 2003) (available at http://www.fhlbtopeka.com/pdf/SEC_letter.pdf);

³¹ The FHLB of San Francisco has stated that although the SEC has established positions on several relevant accounting issues, there remains to be performed some "significant analyses and quantification" with respect to some of those accounting issues. *See* FHLB of San Francisco Letter, *supra*, at 2. This concern over some initial accounting issues has been echoed by the FHLBs of Boston (concerning the cooperative nature of FHLB stock) and Cincinnati as well. *See* FHLB of Boston Position, *supra*; FHLB of Cincinnati Position, *supra*. After opposing a "dual regulatory structure," the FHLB of New York supports voluntary registration as long as the FHFB enacts regulations requiring such registration to alleviate concerns over ambiguities of fiduciary duties concerning voluntary registration pursuant to SEA 1934. *See* FHLB of New York President's Report, *supra*.

³² This comment recognizes that some of the logistical matters discussed *infra* are likely being settled upon in private meetings between the FHFB, SEC and the FHLBs.

³³ This comment recognizes the fact that legislation has recently been introduced in Congress to consolidate the Bank System along with Freddie Mac and Fannie Mae under a single regulator. *See, e.g.*, Housing Finance Regulatory Restructuring Act of 2003, H.R. 2803, 108th Cong. § 201 (2003). The pending legislation will be discussed as appropriate *infra*.

1422a(a)(3)(A) (West 2003). The FHFBS also has broad supervisory powers to ensure that the FHLBs carry out their housing finance mission, as well as remain adequately capitalized and able to raise capital in the financial markets. *See* 12 U.S.C.A. § 1422a(a)(3)(B) (West 2003); *see also* 12 C.F.R. § 905.4 (2003). Additionally, the FHFBS has the broad general power to supervise the Bank System, as well as promulgate and *enforce* such regulations and orders as are necessary to carry out the purposes of the FHLBA. 12 U.S.C.A. § 1422b(a)(1) (West 2003). Furthermore, the FHFBS may remove FHLB employees for cause, as well as issue and serve notice of charges upon FHLB employees when they have or are about to engage in unsound practices with respect to running the FHLB; the FHFBS may also serve notice of charges upon a FHLB employee when they violate the FHLBA or *any* law. *See* 12 U.S.C.A. § 1422b(a)(2) & (a)(5) (West 2003).

The SEC was similarly created with broad oversight powers.³⁴ Under SEA 1934, it is in the public interest and appropriate for the protection of investors in the United States to maintain the availability of information concerning quotations for and transactions in securities. 15 U.S.C.A. § 78k-1(a)(1)(C)(iii) (West 2003). The SEC is required, having due regard for the protection of investors and the maintenance of fair and orderly markets, to facilitate the capital markets in achieving the above objective.³⁵ *See* 15 U.S.C.A. § 78k-1(a)(2) (West 2003). SEA 1934 requires an issuer of a security conducting business in interstate commerce to register its security with the SEC within 120 days after the last day of its first fiscal year in which it has assets over \$1 million and more than five hundred shareholders.³⁶ *See* 15 U.S.C.A. § 78l(g)(1) (West 2003). Once an issuer has registered its security with the SEC under SEA 1934, the issuer must file periodic information to keep its registration statements up to date, in addition to periodic financial information as required by SEC regulations promulgated for the protection of investors and fair dealing in the security.³⁷ *See* 15 U.S.C.A. § 78m(a) (West 2003). SEA

³⁴ In fact, the purposes behind SEA 1934 recognized a connection between the manipulation of securities and the fluctuation of market rates which could prevent the fair valuation of collateral for bank loans and obstruct the national banking system. *See* 15 U.S.C.A. 78b(3) (West 2003).

³⁵ For instance, the SEC may prohibit securities registered pursuant to SEA 1934 from being traded other than on a national securities exchange in certain cases. *See* 15 U.S.C.A. § 78k-1(c)(3)(A) (West 2003).

³⁶ The registration filed with the SEC contains a large amount of financial and legal information about the issuer. *See generally* 15 U.S.C.A. § 78l(b) (West 2003). The amount of assets a company has before it is subject to SEA 1934 has been increased to \$10 million. *See* 17 C.F.R. § 240.12h-3 (2003).

³⁷ Given the current political and economic environment, another issue concerning FHLBs registering a class of their securities under SEA 1934 will be the impact of the Sarbanes-Oxley Act. While the Sarbanes-Oxley Act could potentially increase the Bank System's financial reporting costs, it is not exactly clear how much the Bank System's reporting costs will increase. The Sarbanes-Oxley Act requires companies to include an internal control report in their annual Form 10-K filings, as well as an independent auditor's report on such internal control reports. *See* 15 U.S.C.A. § 7262(a) & (b) (West 2003). The Office of Supervision within the FHFBS is already responsible for conducting periodic bank examinations that include monitoring Bank System market, credit and operational risks. *See* 12 U.S.C.A. § 1440 (West 2003); 12 C.F.R. § 905.13(b)(2) (2003). Furthermore, the FHLBs are required to have risk management policies in effect that address exposure to credit risk, market risk, liquidity risk, business risk and operations

1934 also permits the SEC to prescribe the form of such periodic financial statements and allows the SEC to promulgate regulations with respect to the form and content of financial statements that may be inconsistent with other applicable laws prescribing the form of such financial statements for certain entities where the public interest or protection of investors so requires such inconsistent reporting requirements. *See* 15 U.S.C.A. § 78m(b)(1) (West 2003). Moreover, the SEC has the broad power to suspend or revoke the registration of a security if it finds that the issuer has failed to comply either with SEA 1934 or the applicable regulations to which it is subject, in addition to having the power to bring civil actions to enjoin violations of SEA 1934 and its applicable SEC regulations. *See* 15 U.S.C.A. §§ 78l(j) & 78u (West 2003).

Thus, the FHFBS and the SEC both have broad sweeping oversight powers that implicate the public interest concerning the capital markets, as well as the ability to sanction the entities that they regulate. To be sure, at least one of the FHLBs has already expressed confusion regarding which agency to file its financial statements with under the FHFBS's proposed rules requiring voluntary registration under SEA 1934.³⁸ *See* FHLB of Boston Position, *supra*. This confusion illustrates the potential for a number of issues that could arise with respect to enforcement issues concerning matters under SEA 1934 that could implicate the FHFBS's authority under FHLBA. For instance, FHLBA prohibits the FHLBs from redeeming their capital stock in cases where they are incurring or likely to incur losses that would require charges against the FHLB's minimum capital. *See* 12 U.S.C.A. § 1426(f) (2003). The SEC, on the other hand, is permitted to promulgate financial reporting regulations that may be contrary to established reporting requirements for certain entities under other law when it is necessary, in the opinion of the SEC, for the public interest or the protection of investors. *See* 15 U.S.C.A. § 78m(b)(1) (West 2003). The juxtaposition of these two provisions naturally begs the question of what a FHLB could do if SEC reporting requirements allowed the FHLB to not record certain losses that would otherwise impair the FHLB's minimum statutory capital if the FHLB decided to redeem some of its capital stock. Furthermore, as some of the FHLBs themselves have pointed out, the proposed rules do not articulate any methods of preventing the financial reporting requirements under SEA 1934 from interfering with

risk. *See* 12 C.F.R. § 917.3(a)(1) (2003); *see also* 12 C.F.R. § 917.3(c) (2003) (requiring FHLB senior management to conduct annual risk assessments and submit such findings in writing to the FHLB's board of directors). FHLBs are also required to maintain an internal control system to be reviewed periodically by senior management as well as external auditors. *See generally* 12 C.F.R. § 917.6 (2003); *see also* *Oversight of the Federal Home Loan Bank System: Hearing Before the Subcomm. On Financial Institutions of the Senate Comm. On Banking, Housing and Urban Affairs*, available at <http://www.fhfb.com/Testimony.pdf>, (2003) (statement of Terry Smith, President and CEO, Federal Home Loan Bank of Dallas). The Bank System is also heavily regulated concerning FHLB audit committees. *See generally* 12 C.F.R. § 917.7 (2003).

³⁸ It should be noted that the proposed rules would require each FHLB to concurrently file a copy of all requisite financial disclosure documents under SEA 1934 with the FHFBS. *See* Registration by Each Federal Home Loan Bank of a Class of Its Securities Under the Securities Exchange Act of 1934, 68 Fed. Reg. 54,396, 54,399 (Sept. 17, 2003) (to be codified at 12 C.F.R. pts. 900 & 998). Although the FHFBS's proposed rules do seem to resolve this small quandary, the confusion expressed by the FHLB of Boston *does* create at the very least the potential for further issues concerning the proper allocation of enforcement power between the FHFBS and SEC.

the Bank System's housing finance mission or their ability to raise capital in the financial markets.³⁹ See FHLB of Boston Position, *supra*. Thus, at the very least, there will have to be further agreement between the Bank System and the SEC, as well as some legislative and administrative amendments to clearly allocate the enforcement responsibilities of the FHFb and the SEC with respect to FHLB compliance with SEA 1934 and SEC regulations.⁴⁰

VI. The Dilemma of Collapsing Government Sponsored Entity Oversight into a Politically Independent Agency Could be Solved by Combining the Federal Housing Finance Board and the Office of Federal Housing Enterprise Oversight into a New Division of Housing Government Sponsored Entity Oversight Within the Securities Exchange Commission

Ultimately, the FHFb's proposed rules requiring FHLBs to voluntarily register a class of their securities pursuant to SEA 1934 implicate the issue of GSE oversight within the federal government. Although the FHLBs, Freddie Mac and Fannie Mae (hereinafter collectively referred to as "Housing GSEs") were all created by federal statute,⁴¹ they exist separately from the federal government as for profit entities. See *Oversight of the Federal Home Loan Bank System: Hearing Before the Subcomm. On Financial Institutions of the Senate Comm. On Banking, Housing and Urban Affairs*, available at <http://www.fhfb.com/Testimony.pdf>, (2003) (statement of Terry Smith, President and CEO, Federal Home Loan Bank of Dallas). Additionally, Housing GSE employees are not considered federal government employees. Nonetheless, the FHFb and OFHEO both

³⁹ The FHLB of Boston's point implicates another potential conflict between the FHFb and the SEC. As discussed above, the FHFb is responsible for making sure that the FHLBs are able to raise capital in the financial markets to provide their member banks with liquidity to offer in turn to individuals seeking mortgage loans. See 12 U.S.C.A. § 1422a(a)(3)(B) (West 2003). However, if the SEC's reporting requirements (especially those that are open to interpretation) may potentially harm the FHLBs' ability to raise capital (i.e. requiring a charge against net income that would not be required under the Bank System's current financial reporting regime that could have a potential adverse effect upon a FHLB's counter party credit rating), this would create an inherent conflict in the primary duties of the Bank System's dual regulators under the FHFb's proposed rule. This inherent conflict would exist insofar as the FHFb would have a duty to make sure that the FHLBs are able to raise capital (something that can become more difficult under conditions of economic recession and stringent financial disclosure requirements), while the SEC would have a duty to protect the investing public. This comment does not purport to insinuate that the FHFb would be disingenuous to investors, but simply points out that the FHFb has a clear statutory duty that could potentially conflict with the equally clear statutory duties of the SEC.

⁴⁰ This section of the comment could probably have been much longer based upon the various areas of potentially conflicting statutory minutiae between SEA 1934, the FHLBA and FHFb and SEC regulations. This comment recognizes, however, that many of the logistical concerns regarding FHLB compliance with SEA 1934 are currently being worked out between the FHFb, SEC and the FHLBs (parties with experience and practical knowledge). Many of these logistical considerations also concern technical matters that are far beyond the capabilities of the author. That said, the above section merely attempts to point out some of the broad logistical concerns that are implicated by the FHFb's proposed rules.

⁴¹ See 12 U.S.C.A. §§ 1423 & 1452(a)(1) (West 2003).

retain a significant amount of oversight authority over the Housing GSEs. Furthermore, the business of the Bank System has begun to converge with that of Freddie Mac and Fannie Mae in the secondary mortgage market during the past few years. *See Hilzenrath, Challenging an Empire, supra*, at E01. Thus, there are currently twelve FHLBs in addition to Freddie Mac and Fannie Mae conducting business in the secondary mortgage market, with two separate federal administrative agencies to regulate these Housing GSEs.

For the above stated reasons, many commentators and lending industry leaders are currently seeking legislation that would consolidate the FHFB and OFHEO's oversight capabilities into a single independent administrative agency. *See, e.g., Hearing on H.R. 2575, the Secondary Mortgage Market Enterprises Regulatory Improvement Act, and the Administration's Proposals on GSE Regulation: Hearing Before the House Comm. On Financial Services, available at <http://www.fhlbsf.com/about/news/releases/2003/pr61.asp>, (2003) (statement of Dean Schultz, President and CEO, Federal Home Loan Bank of San Francisco).* These proposals for collapsing the oversight responsibilities of the FHFB with the OFHEO do not, however, come without caveats. Many commentators, including those that have not purported to take a position on regulatory restructuring concerning Housing GSE oversight, have indicated that the Housing GSEs should, at the very least, be regulated by a strong and politically independent agency. *See id.* (stating that the ideal administrative agency to oversee the Housing GSEs would be modeled after independent agencies such as the Office of Thrift Supervision); *see also* Letter from Andrew J. Jetter, President and CEO, FHLB of Topeka, to Member Financial Institutions (Oct. 2, 2003) (available at http://www.fhlbtopeka.com/pdf/SEC_letter.pdf). The foregoing suggests a dilemma as to how GSE oversight can be streamlined into a single agency that would be able to maintain its political independence, and properly administer the Bank System's new financial reporting requirements under the FHFB's proposed rules.

The FHFB and OFHEO are currently funded by periodic assessments from the Housing GSEs.⁴² *See* 12 U.S.C.A. § 1438(b) (West 2003); 12 U.S.C.A. § 4516 (West 2003); *see also* 12 C.F.R. § 906.2 (2003). This assessment method of funding would be essential to a single agency overseeing the Housing GSEs that wants to retain its political independence.⁴³ A single regulator overseeing the Housing GSEs would not be subject to brief winds of political change in the form of budgetary withholding threats if it would be totally funded by periodic assessments against the Housing GSEs. Furthermore, by

⁴² The FHFB imposes a semiannual assessment on all FHLBs that is paid pro rata based upon the ratio between the total paid-in value of each FHLB's capital stock and the aggregate total paid-in value of the capital stock in the Bank System as a whole. *See* 12 C.F.R. § 906.2(a) & (b)(3) (2003).

⁴³ This comment should not be construed to mean that absolutely no political pressure would ever exist in a Housing GSE regulator that derived its budget through periodic assessments. Administrative agencies within the federal government always present the potential for political partisanship and pressure. Nonetheless, an agency that maintains its budget through periodic assessments simply would not have to cater to political interests that would otherwise have the ability to withhold the agency's funding to force compliance.

retaining an assessment model of funding, a single Housing GSE regulator would not have to expend large amounts of time and resources with respect to budgetary requests and approval, and would be able to devote such time and resources to improving investors' perception of the Housing GSEs financial stability.

Many commentators have thus far proposed to combine the FHFB and OFHEO into a single, independent agency within the Treasury Department. *See Hearing on H.R. 2575, the Secondary Mortgage Market Enterprises Regulatory Improvement Act, and the Administration's Proposals on GSE Regulation: Hearing Before the House Comm. On Financial Services, available at <http://www.fhlbsf.com/about/news/releases/2003/pr61.asp>, (2003) (statement of Dean Schultz, President and CEO, Federal Home Loan Bank of San Francisco).* In fact, the Housing Finance Regulatory Restructuring Act of 2003 ("Proposed Restructuring Act"), H.R. 2803, 108th Cong. (2003), which would purport to abolish the FHFB and OFHEO is currently pending before Congress. This Proposed Restructuring Act would consolidate Housing GSE oversight in to a new Office of Housing Finance Oversight, in addition to continuing existing FHFB and OFHEO regulations. *See id.* §§ 101 & 202. Furthermore, all FHFB and OFHEO employees would be transferred into the new Office of Housing Finance Oversight within the Treasury Department. *See id.* § 203. The main issue raised by the Proposed Restructuring Act, however, is the fact that, although it consolidates the FHFB and OFHEO, it still does not address the logistical issues that could arise through dual oversight between such agencies and the SEC. As discussed above, although ultimately beneficial, the FHFB's proposed rules requiring FHLBs to register a class of their securities pursuant to SEA 1934 raise a number of logistical concerns that will need to be worked out concerning the proper allocation of enforcement powers between the FHFB and the SEC. The proposed legislation combining Housing GSE oversight into a single agency within the Treasury Department does not, on its face, address those same logistical concerns raised by Housing GSEs being subject to the SEC's financial reporting requirements under SEA 1934. Thus, the relevant issue becomes crystallized as how to combine Housing GSE oversight into a single agency that can retain its political independence and ameliorate the logistical issues raised by dual oversight functions in the FHFB, OFHEO or proposed Office of Housing Finance Oversight and the SEC.

One way in which the above objective could be achieved would be to collapse the FHFB and OFHEO into a new SEC Division of Housing GSE Oversight. This new Division of Housing GSE Oversight within the SEC would be headed up by two directors, one of which would be in charge of the Bank System, while the other would be in charge of Freddie Mac and Fannie Mae. The first advantage of this model is apparent insofar as it consolidates the oversight responsibilities for the Housing GSEs. Second, because this Division of Housing GSE Oversight would be under the SEC, the logistical concerns over the proper allocation of enforcement power between the SEC and the Housing GSEs' regulator would be solved. Finally, because this Division of GSE Oversight would derive *all* of its funding from the existing periodic assessment mechanisms for the FHFB and OFHEO, this would enable the Division of Oversight to retain at least some political independence. Thus, although this new Division of GSE Enforcement would be under the administrative control of the SEC, it would be funded

only through assessments against the Housing GSEs and not through the typical budgetary allocation process. This would also address the concerns of many commentators that believe that the SEC has too many administrative obligations, and does not have enough resources to fully meet its oversight responsibilities. While this comment understands that such an administrative restructuring would require a large number of legislative and administrative feats to be accomplished, in addition to raising a number of internal logistical issues within the SEC itself, collapsing the FHFB and OFHEO into a new Division of Housing GSE Oversight within the SEC addresses many of the *major* concerns that have been raised concerning the restructuring of Housing GSE oversight.

VII. Conclusion

The FHFB's proposed rules requiring FHLBs to voluntarily register a class of their securities pursuant to SEA 1934 are well founded and will ultimately serve to benefit the Bank System and potential homeowners across the country. The fact that the FHFB's proposed rules implicate a number of logistical issues concerning the proper allocation of oversight and enforcement power points to a larger looming issue of Housing GSE oversight restructuring. While a solution of collapsing the FHFB and OFHEO into a new Division of GSE Oversight within the SEC does not purport to be the end-all solution to these potential problems, it addresses some of the major concerns expressed by commentators and the Bank System. I thank the Federal Housing Finance Board for its time in reading this comment.