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Via email to: regcomments@ncua.gov

Mr. Gerard Poliquin
Secretary to the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314-3428

Re: Advance Notice of Proposed Rulemaking – Alternative Capital

Dear Mr. Poliquin:

Thank you for the opportunity to comment on the National Credit Union Administration ("**NCUA**") advance notice of proposed rulemaking (the "**ANPR**") seeking public input on alternative forms of capital federally insured credit unions could use in meeting capital standards required by statute and regulation.[1] According to the ANPR as published in the Federal Register,[2] the NCUA Board is considering both changes to the secondary capital regulation for low-income designated credit unions ("**LICUs**") and whether to authorize non-LICU credit unions to issue supplemental capital instruments that would count toward the risk-based net worth requirements applicable to federally insured credit unions.

A. NCUA should continue regulatory capital reform within the bounds of applicable law. While only Congressional action can provide comprehensive capital reform for credit unions, existing law authorizes NCUA to expand the availability and utility of alternative capital for credit unions, at least to a degree. Almost all forms of alternative capital contemplated by the ANPR would be in the form of debt instruments that are subordinated, at risk, and available to cover losses that exceed retained earnings. Such debt instruments are not only lawful under the Federal Credit Union Act, they promote operating discipline, stability, and growth for the issuing credit union, and they provide additional protection for the National Credit Union Share Insurance Fund (the "**Share Insurance Fund**"). **<u>Accordingly, NCUA should move forward with issuing a final alternative capital rule, including both appropriate changes affecting secondary capital for LICUs and authorizing supplemental capital for non-LICUs that would count toward the risk-based net worth requirements, after due consideration of the comments received on ANPR</u>**.

B. Supplemental capital for non-LICUs is consistent with and supports NCUA's new risk-based capital rule. NCUA has recently implemented a more complex and stringent regulatory risk-

[1] This commenter is a partner in the Miami, Florida office of Shutts & Bowen LLP. The views set forth in this letter are those of the commenter and do not necessarily reflect the views of Shutts & Bowen LLP.

[2] 82 F.R. 9691 (February 8, 2017), National Credit Union Administration: "Alternative Capital."

based capital framework.[3] Providing regulatory recognition of supplemental capital by including it in the risk-based capital ratio would aide credit unions in complying with the new risk-based capital rule and also be sound policy. Once again, supplemental capital would not only benefit credit unions and their members, it would protect the Share Insurance Fund.

C. NCUA's final alternative capital rule should be both broad enough and flexible enough to cover all contemplated forms of alternative capital. Although secondary capital for LICUs and supplemental capital for non-LICUs would have separate statutory underpinnings, they are sufficiently similar to warrant being covered in the same rule. A consolidated alternative capital rule treating both secondary capital and supplemental capital would reduce confusion among the public and promote consistency in the development of various capital instruments. Such a final rule, however, would not be the last step in the journey toward comprehensive credit union capital reform – again, that would require Congress to act. In the meantime, however, an alternative capital rule after due consideration of the comments received in response to the ANPR would create an initial framework for marketplace innovation. The rule would likely need to be modified to foster, and continue to keep pace with, such innovation. In that regard, **<u>NCUA's alternative capital rule should avoid prescribing specific instruments but instead set forth broad criteria that promote flexibility and marketplace innovation</u>**.

D. Supplemental capital instruments should be structured to avoid classification as "capital stock." Although the Federal Credit Union Act specifically exempts federal credit unions from taxation, state chartered credit unions are tax exempt pursuant to Section 501(c)(14)(A) of the Internal Revenue Code (the "**IRC**"). This Section establishes a three-prong test to determine the availability of the exemption: (1) the institution must be chartered as a "credit union"; (2) it must not issue "capital stock"; and (3) it must be "organized and operated for mutual purposes and without profit." As the ANPR notes, the Internal Revenue Service (the "**IRS**") has not defined "capital stock" in this context.[4] The ANPR goes on to posit that it is possible some state chartered credit unions in some states will have broad authority to issue supplemental capital instruments that have the characteristics of capital stock and, by doing so, could subject themselves to taxation.[5]

The ANPR asks whether NCUA should (1) limit the types of instruments issued by federally insured state chartered credit unions to those that would clearly not meet the definition of capital stock; (2) require a federally insured state chartered credit unions to provide a formal opinion from the IRS that the supplemental capital instrument it is issuing will not be classified as capital stock; or (3) require the credit union to provide projections in advance of issuing the supplemental capital demonstrating that it can afford to be taxed and the benefits of the supplemental capital outweigh the cost of any taxes to which it might become subject.[6]

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[3] 80 F.R. 66,626 (October 29, 2015).

[4] 82 F.R. 9691, at 9696.

[5] *Id*.

[6] *Id*.

<u>The NCUA should not adopt either of these approaches</u>. First, it would be unreasonable for NCUA to limit the types of instruments to those that would "clearly not meet the definition" of capital stock as long as "capital stock" remains undefined. Also, the cost and delay of obtaining a formal IRS opinion would severely diminish supplemental capital's utility. Finally, even if a credit union could satisfactorily demonstrate that it could afford to be taxed and that the benefits of the supplemental capital outweigh the cost of such taxes, the negative precedent of even one credit union becoming subject to taxation in this manner could be damaging for credit unions as a whole. **<u>Rather, NCUA should require that, prior to issuing supplemental capital, a credit union must obtain an opinion of legal counsel to the effect that the instrument would not likely be deemed "capital stock" for purposes of IRC Section 501(c)(14)(A)</u>**. This is consistent with NCUA's approach in other areas, such as derivatives contracts and CUSO investments.

E. Credit unions should not be allowed to sell equity-like capital instruments to nonmembers. The ANPR asks several different questions that are based on the same concern – to what extent would capital instruments issued to nonmembers violate credit fundamental credit union mutual ownership and governance principles (as well as to what extent credit unions' tax exemptions might thereby be jeopardized)?[7] Because credit unions are authorized under numerous and varied circumstances to borrow from nonmembers, it is presumed NCUA does not have this concern with respect to alternative capital structured as subordinated debt sold to nonmembers. Thus, NCUA's concern appears to be focused on instruments that would be characterized as equity. To the extent that equity interests represent ownership or control, a credit union's issuance of such equity interests to nonmembers would *per se* be at odds with fundamental credit union mutual ownership and governance principles, which strictly mandate that ownership and control are vested exclusively in the members. **<u>Accordingly, NCUA's final rule should prohibit credit unions from issuing equity instruments to nonmembers.</u>**

While it is evident that credit unions should not be permitted to issue equity to nonmembers, it is not at all evident what constitutes equity. In many respects, defining equity is similar to defining "capital stock" for purposes of state chartered credit unions' tax exemption. While pre-default voting rights is a common feature of "capital stock," as well as a common indicator of "equity," there is no bright-line test under IRS rules or established in case law for defining either term. Rather, a review of relevant court opinions reveals that whether a given instrument will be classified as debt or equity depends on a facts and circumstances analysis of the extent to which a variety of features is present or absent.[8] For example, the presence of (a) voting rights, (b) the right to put the instrument back to the issuer, (c) appreciation in the instrument's value in accordance with the issuer's profitability, and (d) distributions at the discretion of the

[7] As the ANPR points out, Congress removed the tax exemption from thrift institutions in 1951 because they ceased to be operated on a mutual basis for the benefit of their members. Accordingly, it is both reasonable and prudent that the ANPR seek comments on the extent to which credit unions should be allowed to sell alternative capital with equity like characteristics to nonmembers, and if so, what controls are necessary to preserve the mutual ownership structure and democratic governance of credit unions. (*See* 82 F.R. 9691, at 9696, fn. 36.)

[8] *See, e.g., PepsiCo Puerto Rico, Inc. v. Commissioner and PepsiCo, Inc. & Affiliates v. Commissioner*, T.C. Memo. 2012-269 (Sept. 20, 2012).

issuer all tend to suggest equity treatment. On the other hand, an instrument is more likely to be characterized as debt where (x) repayment of the face amount is due at a certain time, (y) there is a rate of return unrelated to the issuer's profitability, and (z) a preferred rate of return are present. Given that a precise, never-changing definition of "equity" does not exist under either IRS rule or established case law, and is understood to require a facts and circumstances analysis in each case, NCUA should avoid trying to define "equity" in its rules. **Rather, NCUA's final rule should require that, prior to issuing alternative capital to any nonmember, a credit union must obtain an opinion of legal counsel to the effect that the instrument would not likely be deemed "equity" such that it would violate the rule**.

F. Although alternative capital instruments would be "securities" under applicable securities laws, most would be offered pursuant to one or more exemptions from SEC registration; alternative capital instruments would nonetheless be subject to the SEC's anti-fraud rules. The ANPR invites comment as to whether credit union alternative capital instruments would be considered "securities" under federal and state securities laws and, if so, what are the implications. Under Securities Exchange Commission ("SEC") rules and numerous court cases, the definition of a "security" is so broad virtually any alternative capital instrument imaginable would qualify. Much more importantly, and as the ANPR points out, "[b]eing subject to securities laws can impose requirements on the issuer [of the securities] to register with the Securities Exchange Commission (SEC), issue SEC mandated disclosures, and comply with the SEC's broad anti-fraud rules."[9]

Under federal securities laws, a company may not offer or sell securities unless the offering has been registered with the SEC or an exemption from registration is available. However, at least two types of exemptions generally would be available for most alternative capital offerings. First, alternative capital instruments would likely be exempt under Section 3(a)(5) of the Securities Act of 1933 (1933 Act), which applies to securities issued by certain financial institutions, including credit unions. Second, a "private placement" of alternative capital instruments to a limited number of persons or institutions (including those meeting certain financial sophistication, income or net worth thresholds) may be exempt pursuant to Section 506 of Regulation D under the 1933 Act.

Even if securities are issued pursuant to a valid exemption from SEC registration, federal and state courts have made it abundantly clear the "SEC's broad anti-fraud rules" apply to virtually ***all*** purchases and sales of ***all*** securities. Although federal securities laws and regulations contain several anti-fraud provisions, the most widely used in securities litigation is the SEC's Rule 10b-5.[10] In connection with the purchase or sale of any security, Rule 10b-5 prohibits: (a) using any "device, scheme, or artifice" to defraud, (b) making any untrue statement of a material fact or omitting a material fact, and (c) engaging in any fraud or deceit. Both the SEC and private citizens can bring legal action to enforce Rule 10b-5. If found to be in violation of Rule 10b-5, among other things, the

[9] 82 F.R. 9691, at 9696.

[10] 17 C.F.R. 240.10b–5.

issuer could be forced to repurchase the security at the price the investor paid and could even be required to pay treble damages. Thousands of Rule 10b-5 actions have been filed by the SEC and by private citizens in the past seven decades and multi-million dollar 10b-5 class action settlements against public companies are not uncommon.

NCUA is concerned that, "without mandated disclosures, credit unions may be at greater risk for anti-fraud suits, which, if successful, would impair not only the credit union but also the Share Insurance Fund's ability to use secondary or supplemental capital to cover losses."[11] While NCUA's concern about securities anti-fraud lawsuits is understandable, disclosures that are "mandated" by NCUA could to easily over time turn out to be unduly burdensome, inadequate, or – in some cases – focused on immaterial matters while failing to address essential matters. **Rather than incorporating "mandated disclosures," NCUA's final rule should require any credit union offering alternative capital instruments to certify that the statements of the credit union contained in any materials used in connection with the offering are true and correct as of the date thereof and that no such material contains any untrue statement of a material fact or omits to state a material fact necessary to make the statements contained therein not misleading**.

G. NCUA should not establish a separate registration and disclosure framework for alternative capital, rather NCUA should reinforce to credit unions that alternative capital instruments are subject to the SEC's registration and disclosure framework. The ANPR asks whether NCUA should require credit unions issuing alternative capital instruments to register with NCUA and whether NCUA should establish mandated disclosures based on the SEC's, those of the Office of the Comptroller Currency, or on criteria unique to credit unions.

As noted above, alternative capital instruments would be "securities," subject to federal and state securities laws, and subject to SEC registration, unless an exemption applies. The federal securities laws and the SEC's rules and regulations for ensuring appropriate disclosures and investor protection are extensive and encompassing, having been development since the 1930's. It would appear unnecessary and, arguably, wasteful for NCUA to create a separate regulatory registration and disclosure framework for alternative capital instruments, unless NCUA has determined (or, better yet, reached a formal agreement with the SEC and the various state securities regulators) that NCUA and state credit union regulators would have exclusive authority over credit union alternative capital.

The SEC's framework is designed to compel companies to disclose important information that enables the public to make informed investment decisions. In cases where securities are being offered broadly to the public (including less sophisticated consumers), the securities must be registered with the SEC and are subject to comprehensive mandated disclosure requirements. If the securities are being offered to a limited number of investors (including both entities and individuals) who are financially sophisticated and have the financial wherewithal to undertake the associated risk, the securities may be exempt from SEC registration. While it is true that exempt or

[11] 82 F.R. 9691, at 9697.

private offerings of securities are not subject to the comprehensive disclosure requirements that apply to registered offerings, in my experience, nearly all private placement memoranda include most of the same information as that required in a prospectus for a registered offering. This is because prudent issuers view the SEC's mandated disclosures as a roadmap for minimizing the risk of anti-fraud litigation based on inadequate or misleading disclosure.

To be sure, most securities issued by non-financial institution companies are not depended on for "loss absorption" purposes in the way and to the extent NCUA would count on alternative capital instruments to protect the Share Insurance Fund. When companies issue securities pursuant to an exemption from SEC registration, they are free to determine for themselves the nature and extent of the disclosures they will provide. A prudent desire to minimize the likelihood and cost of defending anti-fraud lawsuits *should* produce sufficient incentive to provide full and fair disclosure of all material information, but the company alone bears the risk of inadequate or misleading disclosure. This is not true for credit unions; if alternative capital instruments are impaired or extinguished, for example because of an adverse judgment or settlement in connection with securities litigation, the intended protection of the Share Insurance Fund could be jeopardized. Nevertheless, this does not justify the significant infrastructure NCUA would have to create to establish and maintain its own registration and disclosure framework, especially in light of the robust SEC's robust framework that already applies.

Accordingly, NCUA should not establish a separate registration and disclosure framework for credit union alternative capital. Rather, NCUA's final rule should require any credit union proposing to issue alternative capital instruments to certify that it has complied, and will comply, with all applicable federal and state securities laws in connection with the offer and sale of those instruments. NCUA should, however, require that all alternative capital instruments be subject to NCUA's prior approval of a written plan, in the same manner as currently provided in NCUA Rule 701.34(b) with respect to LICU secondary capital.

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Again, thank you for the opportunity to comment on the ANPR.

Very truly yours,

[Signature omitted for electronic filing purposes.]

François G. Henriquez, II