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May 9, 2017

Mr. Gerald Poliquin
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314

Re: ANPR for Alternative Capital

Dear Mr. Poliquin:

We are pleased to submit this letter in response to NCUA's request for public comment on the Advance Notice of Proposed Rule Making (the "ANPR") regarding alternative capital (82 Fed. Reg. 9691).

Womble Carlyle's attorneys have extensive experience in representing both mutual and stock institutions, privately and publicly held banks and thrift institutions, as well as credit unions. Our attorneys' experience in representing thrifts in mutual to stock conversions, including former credit unions, provides insight on the similarities in addressing a securities offering by a non-public company such as a credit union.

Our comments are set forth below in the order of the questions commencing in Section III of the ANPR.

1. **The Board is interested in receiving comments concerning projections on the volume of supplemental capital that credit unions would be likely to issue.**

   We do not believe that the volume of supplemental capital that may be issued by credit unions is quantifiable due to the various factors that will affect the volume, including interest rates, growth patterns, the national and local economic conditions and future capital requirements. The NCUA should avoid basing its rulemaking decision on projections of capital issuance in reliance on the relatively minimal past usage of secondary capital. Rather, the NCUA should base its decision on the degree to which it desires to allow credit unions flexibility, over time and in a variety of economic environments, to maintain regulatory capital levels, serve their members, grow their institutions and remain competitive with other financial institutions.

2. **The Board also seeks specific comments on the structures of supplemental capital instruments that would be beneficial, why credit unions will issue supplemental capital, and how it fits into the credit union's business model.**

   Credit unions will consider issuing supplemental capital when there is a need to provide capital support for certain types of loans on their balance sheet such as commercial loans, equity investments in CUSOs and delinquent residential mortgage, commercial and consumer loans. Although issuing supplemental capital is a relatively expensive form of capital, the credit union could rely on such capital to remediate a capital shortfall or to implement its strategic plan. The NCUA recognized three different forms of supplemental capital in its Supplemental Capital White Paper (April 2010), including subordinated debt. However, subordinated debt would appear to be the most attractive capital instrument of the three types to investors.

3. **The Board is also interested in any comments about who will purchase supplemental capital.**

   Members of the public who seek fixed-income investments for asset diversification, as is the case with insurance companies, foundations, endowments and mutual fund managers, may find this an attractive investment opportunity. If a sufficient number of institutions issue supplemental capital, these types of investors would be able to further mitigate risk by diversifying across multiple credit union issuers. In addition, in light of the current and near term interest rate environment and the resulting low rates paid on deposits, credit union members may find supplemental capital to be an attractive investment opportunity. By allowing small denominations (as in the case of certificates of deposit) member participation would be facilitated. Adequate disclosure of the terms of the instrument and the risks of investing is imperative, particularly with respect to individual investors. In that regard, the disclosure, solicitation and sales process used in mutual to stock conversions can be instructive since it was developed in connection with the institutions' members being provided the opportunity to purchase stock in the converting institutions.

4. **The Board seeks comments on how any regulations should address the issue of the cost of the instrument and any items that may be helpful in reducing the cost while maintaining adequate protection for investors and the Share Insurance Fund.**

   The cost of the instrument (i.e., the interest rate and any associated fees and expenses) will and should be based on market conditions, the issuer's financial condition and the type of offering (public or private). Imposing regulatory expense limits might reduce the availability of issuing secondary and supplemental capital to smaller institutions since in any size offering there are certain fixed costs. If the institution is able to obtain a rating by a recognized debt rating service that may assist it in reducing its interest cost, although the

NCUA should not require a rating since many institutions may not be able to obtain one. The analysis of cost is a key consideration in any strategic decision by an institution, and the issuance of secondary or supplemental capital should be assessed by each institution as part of its strategic plan. Costs should be taken into consideration in any final rule by designing an efficient approval process but should not take priority over investor protection or that of the National Credit Union Share Insurance Fund ("NCUSIF").

5. **The Board is interested in commenter's thoughts on whether credit unions that are not designated as low-income use of supplemental capital could affect the availability of secondary capital for low-income designated credit unions.**

   Since secondary capital has been sparingly used by low-income credit unions ("LICU") it does not seem likely that supplemental capital use by non-LICUs would affect the availability of secondary capital to LICUs. Market conditions, including the amount and variety of instruments available for investment at any given time, will dictate the marketability of any particular issuance of supplemental capital. In addition, if supplemental capital is permitted to be issued on no less favorable terms than secondary capital, LICUs who do not have issues with net worth but need to address risk based capital may be more likely to issue supplemental capital instead of secondary capital. The NCUA could alleviate the concern that issuances by non-LICUs will negatively impact the availability of secondary capital to LICUs by permitting LICUS to issue limited amounts of secondary or supplemental capital, or in limited circumstances, with fewer requirements and restrictions than those imposed on supplemental capital issuances generally. Lastly, if the field of potential investors is expanded from that currently existing for secondary capital, the potential for sales is substantially increased for both forms of alternative capital. There is no overriding policy reason to restrict the field of investors provided that adequate investor protection is provided.

6. **The Board invites commenters to identify any other provisions of the Act they believe could provide alternative authority for federal credit unions to issue supplemental capital instruments other than as subordinated debt.**

   We are not aware of any other authority for federal credit unions to issue supplemental capital instruments that would serve a capital-like function, be attractive to investors and protect the NCUSIF.

7. **With respect . . . [to a federal credit union's] borrowing authority, the Board is interested in commenter's views on whether the Board should promulgate a more comprehensive borrowing rule as part of any authorization of supplemental capital, and what the rule should address.**

To address the NCUA's concern, as part of the adoption of a supplemental capital rule, the NCUA could make clear that federal credit unions may borrow from natural and non-natural persons. Borrowing from non-natural persons currently exists, as an example, in the form of Federal Home Loan Bank advances.

8. **As NCUA's borrowing limit for federally insured state chartered credit union is not statutory, the Board can entertain removing this limit and requests comment on this option.**

   The borrowing limit for state chartered credit unions should not be removed. Removing or increasing the limit may result in overleveraging by state chartered credit unions and present safety and soundness concerns in light of the debt service cost of subordinated debt. Retaining the limits also preserves parity for federal credit unions.

9. **The Board invites comments on . . . [the impact that supplemental capital would have on the tax-exempt status of credit unions] and would like to hear from stakeholders on the possible impact a supplemental capital rule may have on the federal credit union tax exemption.**

   Although unlikely, access to capital may call into question the tax-exempt status of credit unions. That status may likely only change through legislation in the case of federal credit unions or action by the IRS with respect to state credit unions through an interpretation that the Section 501(c)(14)(A) exemption of the Internal Revenue Code excludes credit unions that have issued some form of supplemental capital. The closer that any form of supplemental capital is to a form of debt, the less likely it should be viewed as capital stock. Since a supplemental capital instrument will confer no ownership, voting, profit participation or liquidation rights, it seems unlikely that it would be viewed as capital stock.

10. **The Board . . . requests comment on whether NCUA should 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.**

    The Board should not limit the types of instruments issued by federally insured state chartered credit unions ("FICU") to address this issue, but should consider imposing certain requirements as to the characteristics of instruments that will qualify as supplemental capital. For example, the rules could require that, in order for an instrument to qualify as supplemental capital, the instrument may (i) not be convertible into any other security, (ii) not be callable by the holder, (iii) provide for redemption at any time after five years, (iv) provide for redemption without penalty (or at a discount) in the event that (A) the IRS revises

guidance such that would characterize the instrument as capital stock or (B) the NCUA determines the security does not qualify as supplemental capital, (v) not contain any provisions that are typically associated with control (e.g., board observer rights, prohibitions or limitations on business or other activities, etc.) and (vi) not prevent the ability of holder to accelerate payment except in limited circumstances. In any event, as part of a supplemental capital approval filing, the NCUA will have an opportunity to review the terms of the instrument. These limitations should similarly apply to supplemental capital issued by federal credit unions.

The NCUA notes there does not appear to be an established definition of "capital stock" used by the IRS. However, there is some guidance in the IRS regulations governing Subchapter S corporations and the restriction imposed on disallowing a second class of stock. The regulations note that "straight debt" is not treated as a second class of stock. For this purpose, the term straight debt means, as is relevant in this case, "a written unconditional obligation, regardless of whether embodied in a formal note, to pay a sum certain on demand, or on a specified due date, which (A) does not provide for an interest rate or payment dates that are contingent on profits, the borrower's discretion, the payment of dividends with respect to common stock, or similar factors; and (B) is not convertible (directly or indirectly) into stock or any other equity interest of the S corporation." Assuming that the terms permissible for supplemental capital would at least follow those for secondary capital, the supplemental capital instrument should not be considered capital stock. See 26 C.F.R. § 1.1361-1(m)(1)(ii)(A). The fact that an investor may have the right to appoint a director or limit expenditures in the event of a default should not necessarily cause the instrument to be considered capital stock if it otherwise contains terms consistent with those for secondary capital and the IRS regulations.

While a credit union should have the option of obtaining a private letter ruling, the NCUA should not require a FICU to obtain a private letter ruling because that will substantially increase the issuance costs, delay the issuance process and increase the risk of interest rate fluctuations during the resultant delay. An opinion of counsel should be sufficient in this regard.

11. The Board also invites comments on the potential effect supplemental capital may have on the mutual ownership structure and governance of credit unions.

Certain of the features discussed in response to Question 10 will serve to limit the impact of supplemental capital issuances on mutual ownership and governance. In addition it is worth noting that investors in debt securities, particularly those issued by financial institutions, base their investment decisions on the credit quality of the issuers, along with current market conditions and the economic terms of the instrument, and generally not as a method of gaining control or exercising influence on the issuer's operations or strategy. Further, even if a supplemental capital instrument has provisions to address cost controls and similar

provisions in the event of default, the members would still have their membership rights with regard to voting on material matters such as board elections, mergers and charter changes and thus any rights associated with a supplemental capital instrument should not compromise the mutual ownership structure.

12. **The Board invites comments on how it should structure any potential rule to avoid issues impacting the mutuality of credit unions, and the members' rights to govern the affairs of the situation.**

    See response to Question 11.

13. **Specifically, the Board invites comments on restrictions it might impose on characteristics of supplemental capital to avoid these issues, such as: non-voting and limits on covenants in the investment agreement that may give investors levels of control over the credit union.**

    See response to Question 11. The NCUA should consider refraining from blanket restrictions but rather wait to review what the market requires. The NCUA should note, however, that the absence or presence of debt holder protections may have an effect on interest rates.

14. **The Board believes that both secondary and supplemental capital would be considered securities for purposes of state and federal securities laws. The Board invites comment on this topic and its relationship to credit unions issuing securities as supplemental capital.**

    Both secondary and supplemental capital would be considered debt securities under federal law and most, if not all, state laws. Securities issued by a credit union are generally excempt from registration under federal law, and the laws of a number of states. Accordingly, in the absence of registration requirements imposed by a securities regulator, the NCUA should impose the investor protections and other prudential safeguards that should apply to such instruments.

15. **Should the Board require credit unions issuing alternative capital to register with NCUA?**

    As noted in the ANPR, the OCC has adopted regulations (12 C.F.R. Part 16) that are similar to those of the SEC. The NCUA should adopt a similar approach with regard to the registration of public offerings.

16. How could NCUA protect the Share Insurance Fund against potential anti-fraud claims that could impair the alternative capital's ability to cover losses?

The NCUA can facilitate the protection of the NCUSIF as well as investors by requiring adequate investor protection through disclosures that follow the requirements of the OCC, as modified as appropriate for a non-stock issuer.

17. Should the Board mandate disclosures all credit unions issuing alternative capital must provide to investors? If the Board should mandate disclosures, should it base them on the SEC's, the OCC's, or create a unique set of disclosures for credit unions? If the Board creates a unique set of disclosures, what should it include in those disclosures? Should the level of disclosures vary based on the level of the investor (institutional, accredited, natural person)?

For public offerings, the NCUA should follow the approach of the OCC. For private placements, the NCUA should consider the disclosure requirements of the OCC, with only such deviations as are required to address issues specific to the credit union's mutual ownership structure and the risks related to regulations that are unique to credit unions (e.g., field of membership restrictions). The OCC regulations generally track the disclosure requirements of the SEC and have evolved over a number of years. The disclosure provided by issuers in private placements generally varies depending on the level of sophistication of the offerees. The NCUA should not promulgate regulations that dictate different disclosure for different offerees. This is already addressed by the SEC in Regulation D, which requires, for example, increased disclosure in the case of offerings to unaccredited individuals. Credit unions should be able to take full advantage of the exemptions from registration under the federal securities laws, including the safe harbor provided by regulations such as Regulation D, and should rely on competent counsel to advise them as to the required or recommended disclosure.

It is imperative that adequate disclosure be provided to protect the institution against a claim of securities fraud as well as reputational risk. An allegation of securities fraud could certainly have a negative effect on a program that is intended to provide capital access to credit unions. Coupled with this disclosure mandate the NCUA must provide rules on marketing practices, particularly if subordinated debt is to be offered in the branches to members and the general public. The rules developed by the OCC and the Office of Thrift Supervision should provide guidance in this regard.

18. Should the Board require credit unions to develop policies and procedures to ensure ongoing compliance with anti-fraud requirements before it begins issuing alternative capital?

There is no reason to delay implementing such policies and procedures and they should be adopted before the commencement of any offering. The credit union must be familiar with these requirements to avoid potential securities fraud problems. This exercise should also include board and management training by experienced securities and corporate counsel.

19. The Board invites comments on how it should ensure a credit union has determined if it or its employees are required to register [as a broker-dealer].

Most securities offerings, whether public or private, are conducted through a registered broker-dealer serving as underwriter or placement agent. Credit unions and their employees would generally not be involved in marketing efforts with respect to supplemental capital securities. Accordingly, credit unions and their employees would not be "engaged in the business of effecting transactions in securities for the account of others," and should not be required to register as a broker-dealer under the federal securities laws. See 15 U.S.C. §78c (a)(4)(A).

20. The Board . . . invites comment on . . . whether NCUA should require credit unions to have policies and procedures to ensure their activities do not trigger investment adviser registration requirements.

Credit union employees would not be required to register as an investment advisor unless they provide advice regarding the purchase of supplemental or secondary capital and are compensated for so doing. See 15 U.S.C. § 80b-2(a)(11). Policies and procedures should be adopted regarding selling practices to avoid this issue.

21. The Board invites comments on how it should ensure that any credit union issuing alternative capital has considered and complied with all applicable state laws.

The NCUA can require that as part of an application to issue secondary or supplemental capital the credit union must disclose how it will comply with applicable state law. As part of this submission the NCUA should require a certification from the institution.

22. The Board requests comments on if it should mandate that credit unions certify that they have evaluated their ... [director and officer liability] policies and have sufficient coverage before beginning secondary or supplemental capital activities.

A review of the credit union's director and officer liability policy would be a prudent exercise before issuing alternative capital. An institution should only be required to certify that it has insurance policies that are customary for an institution of its size and complexity. An institution should only be required to certification of the adequacy of the coverage.

23. **The Board requests comments on if it should mandate comprehensive policies addressing compliance with investment contracts, communications, and information sharing. The Board invites commenters to provide suggestions on the specific details that should be in the policy and if sufficient policies should be a prerequisite to engaging in supplemental or secondary capital activities.**

    The Board should mandate that these policies be adopted before the issuance of secondary or supplemental capital, particularly with regard to a public offering. Such policies are typically maintained by public companies and administered by in-house counsel or the compliance department.

24. **The Board requests comment on whether the sale of secondary and supplemental capital should be limited to only institutional investors, including accredited investors, or allow for anyone to purchase. If the Board were to allow credit unions to sell alternative capital to non-accredited investors, should there be limits on the amount individual investors can purchase? Also, should there be conditions on how the sale of non-accredited investors must be handled to minimize potential confusion about its lack of federal insurance?**

    In order to obtain the widest possible sales opportunities the NCUA should not limit the sale of secondary and supplemental capital to any particular class of investors. The experience to date of the sale of secondary capital should be an indication that restricting the universe of investors is not advisable. Robust disclosure and marketing rules should provide adequate investor protection. The existing rules of the OCC on mutual to stock conversions and the existing federal guidance on the sale of non-deposit investment products should provide an adequate framework for the NCUA to craft rules for the protection of investors at all levels. As with the program used in mutual to stock conversions, a minimum and maximum purchase limit could be prescribed to provide for the widest distribution in any particular offering and an opportunity for all members to participate. Should it become necessary in a particular offering, these levels could be adjusted with regulatory approval. The minimum purchase level should be designed to balance the administrative burdens related to a large number of small orders with encouraging member participation.

25. The Board requests 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 Response to Questions 10 and 11.

26. The Board invites comments on how it should structure any potential rule to avoid issues impacting the mutuality of credit unions, and the members' rights to govern the affairs of the institution.

See response to Questions 10 and 11.

27. The Board is seeking comment on the exclusion of dividend expenses as an operating expense and seeks comment on how to resolve the complexity that can result from excluding dividend expense from losses applied to secondary capital but not from losses applied to supplemental capital.

Dividend expenses should not be excluded from the calculation of operating losses for supplemental capital or secondary capital. The ANPR notes that operating expenses do not include payments of dividends on shares but provides no citation for the explanation. Since the payment of dividends (or interest) on deposits is an expense there should be no reason to exclude it unless there is a statutory basis.

28. The Board seeks comment on how to maintain protection of the Share Insurance Fund while minimizing the impact the criteria would have on the cost and marketability of the alternative capital instruments.

Protection of the insurance fund is provided by (1) ensuring that the credit union's proposed use of the capital is reasonable and supported by pro forma final projections and (2) ensuring that the offering materials, whether in a public or private offering, have adequate disclosure and investor protection. The cost and marketability of alternative capital instruments will be largely dictated by market conditions.

29. The Board seeks comments on the utility of a prior approval process and post-issuance notification process.

A prior approval process is necessary to ensure the investor materials are adequate and the business plan for the issuance is reasonable. To reduce costs and provide issuers with some

degree of timing certainty, the NCUA should establish time periods for providing comments and final action on an application. Following completion of the offering a report should be provided detailing the gross and net proceeds from the offering.

30. When prior approval would be necessary, however, the Board requests comments on what should be required in an application for authority to issue alternative capital, and how long the credit union would have to issue the alternative capital after approval.

The application for supplemental capital should include the same information as is required with respect to an issuance of secondary capital. In addition, the application for either form of capital should include (1) any certifications or legal opinions determined in connection with any final rule to be of utility (including those discussed elsewhere in this comment letter); (2) a copy of the registration statement, prospectus, private placement memorandum or similar document; (3) a copy of any other marketing materials to be utilized by the credit union, the underwriter or placement agent for the offering; and (4) a copy of the institution's business plan, including pro forma financial statements reflecting the proceeds of the issuance, the ability of the institution to service the debt and the use of proceeds to the extent known.

The credit union should be given three to six months to complete the offering with additional extensions subject to regulatory approval and updating the financial and other information to the most recent quarter.

31. In addition, the Board request comment on the evaluation criteria NCUA should use to approve or deny the application, including whether or not certain credit unions that are already in danger of failing should be precluded from issuing alternative capital as a form of investor protection.

In general, the basic principles for evaluation should be the adequacy of the disclosure materials and the viability of the business plan. The rules should provide that any institution that does not satisfy particular capital and other quantifiable financial standards is not eligible to apply to issue alternative capital. This will eliminate applications by institutions that cannot be approved, and allow the NCUA to focus on viable applications. It seems unlikely such institutions would issue alternative capital in any event since it carries a debt service burden unlike common stock that might be issued by a bank in similar circumstances.

32. Also, the Board seeks comment on the manner of and what should be included in any post-issuance notice credit unions should file with the NCUA.

See response to Request 29.

33. The Board seeks comments on how capital regulations could be designed to limit the amount of supplemental capital included in regulatory capital calculations.

The regulations should provide that the amount of supplemental capital that can be counted toward the risk based capital requirement cannot exceed 50% of the net worth of the credit union in order to prevent over-leveraging.

34. The Board seeks comments on [reduction of inclusion in capital] and how to reflect the increasingly limited utility as loss absorbing capital for supplemental capital approaching maturity.

The NCUA should follow the current rule for the capital phase-out for secondary capital which begins in the fifth year prior to maturity. This schedule is also consistent with the FDIC capital regulations. This reduction provides the issuer with sufficient time to make adjustments that will address the impending loss of capital.

35. The Board invites comments on the topic of prepayment and call provisions for alternative capital and how it should structure any related requirements.

Prepayment at the option of the issuer should be a required feature, as that allows the issuer to eliminate the interest expense if it is able to otherwise maintain the required regulatory capital ratios. Call provisions at the option of the holder should be prohibited as these provisions could cause an institution to become undercapitalized.

36. The Board requests comment on how the NCUA should address. . . [reciprocal holdings].

Supplemental or secondary capital held by other credit unions, through reciprocal holdings or otherwise, should not be counted as capital because the risk has not been transferred out of the credit union deposit insurance system.

37. The Board seeks comment on the issue of merging credit unions and how alternative capital should be treated post-merger.

As with any bank or corporate merger, all of the target's assets are acquired and all of the target's liabilities are assumed by the acquirer. The liabilities associated with any supplemental capital issued by the target would become liabilities of the acquirer.

Supplemental capital issued by the target should count as capital of the acquirer to the extent that the acquirer would, following the transaction, not exceed regulatory limits on supplemental capital. The ability or inability of an acquirer to count significant amounts of the target's supplemental capital as regulatory capital post-closing, and the costs of any acquired supplemental capital, would likely be significant considerations by the acquirer in evaluating any potential transaction.

38. The Board seeks comments on this issue of contractual restrictions for alternative capital instruments.

The examples that the NCUA provides in the discussion regarding contractual restrictions should be avoided in the terms of the instrument. In the event of a default, however, the note holders should have certain rights to protect their interests such as some control over expenditures, capital investment, etc.

39. Due to the potential use of alternative capital as a funding source similar to public units and nonmembers, the NCUA Board is seeking comment on §701.32 of NCUA's regulations as it prescribes limits placed on these accounts.

Assuming secondary capital and supplemental capital instruments will be permitted only as subordinated debt, neither form of capital should constitute "share accounts." If the NCUA reaches a different conclusion, then the limits of §701.32 should apply. The regulatory burden could be reduced, however, by including a provision that an application to issue supplemental capital that exceeds the limits of §701.32 is deemed to satisfy the requirements for a waiver application under §701.32.

40. Because the [§701.32] limitations the NCUA board may prescribe to these accounts is not statutory, the NCUA Board is interested in comments on revisions to this regulation which would reduce the regulatory burden of the waiver process but still provide for adequate protection of the Share Insurance Fund.

See Response to Question 39.

Thank you for your consideration of this submission. If the NCUA staff has any questions please do not hesitate to contact me.

Very truly yours,

Richard S. Garabedian

RSG:pas
cc: Adam Wheeler