

7535-01-U

NATIONAL CREDIT UNION ADMINISTRATION

12 CFR Parts 701, 702, 709, and 741

RIN: 3133-AF08

Subordinated Debt

AGENCY: National Credit Union Administration (NCUA).

ACTION: Proposed rule.

SUMMARY: The NCUA Board (Board) is proposing to amend various parts of the NCUA's regulations to permit low-income designated credit unions (LICUs), Complex Credit Unions, and New Credit Unions to issue Subordinated Debt for purposes of regulatory capital treatment. Specifically, this proposed rule would create a new subpart in the NCUA's final risk-based capital rule (RBC Rule) that would address the requirements for and regulatory capital treatment of Subordinated Debt. This new subpart would, among other things, contain requirements related to applying for authority to issue Subordinated Debt, credit union eligibility to issue Subordinated Debt, prepayments, disclosures, securities laws, and the terms of a Subordinated Debt Note.

All secondary capital issued after the effective date of a final Subordinated Debt rule would be subject to the requirements for Subordinated Debt. This change would not impact a LICU's ability to include such instruments in its Net Worth.

This proposal would also grandfather any secondary capital issued before the effective date of a final Subordinated Debt rule (Grandfathered Secondary Capital). It also would preserve the regulatory capital treatment of Grandfathered Secondary Capital for 20 years after the effective date of a final Subordinated Debt rule. Grandfathered Secondary Capital, under this proposal, would generally remain subject to the requirements in current §§ 701.34(b) through (d) (Current Secondary Capital Rule). For ease of reference, the requirements in the Current Secondary Capital Rule would be moved from their current location to a section in the new proposed subpart.

In addition to the above-mentioned changes, this proposed rule also makes various additions and amendments to other parts and sections of the NCUA's regulations. Specifically, this proposed rule would include: a new section addressing limits on loans to other credit unions; an expansion of the borrowing rule to clarify that federal credit unions (FCUs) can borrow from any source; revisions to the RBC Rule and the payout priorities in an involuntary liquidation rule to account for Subordinated Debt and Grandfathered Secondary Capital; and cohering changes to part 741 to account for the other changes proposed in this rule that apply to federally insured, state-chartered credit unions (FISCUs).

DATES: Comments must be received on or before [INSERT DATE 120 DAYS FROM DATE OF PUBLICATION IN THE FEDERAL REGISTER].

ADDRESSES: You may submit written comments, identified by RIN 3133-AF08, by any of the following methods (**Please send comments by one method only**):

- Federal eRulemaking Portal: <http://www.regulations.gov>. Follow the instructions for submitting comments.
- Fax: (703) 518-6319. Include “[Your Name]—Comments on Proposed Rule: Subordinated Debt” in the transmittal.
- Mail: Address to Gerard Poliquin, Secretary of the Board, National Credit Union Administration, 1775 Duke Street, Alexandria, Virginia 22314-3428.
- Hand Delivery/Courier: Same as mail address.

Public inspection: You may view all public comments on the Federal eRulemaking Portal at <http://www.regulations.gov>, as submitted, except for those we cannot post for technical reasons. The NCUA will not edit or remove any identifying or contact information from the public comments submitted. You may inspect paper copies of comments in the NCUA’s law library at 1775 Duke Street, Alexandria, Virginia 22314, by appointment weekdays between 9 a.m. and 3 p.m. To make an appointment, call (703) 518–6546 or e-mail OGCMail@ncua.gov.

FOR FURTHER INFORMATION, CONTACT: Tom Fay, Director of Capital Markets; or Justin M. Anderson, Senior Staff Attorney, Office of General Counsel, 1775 Duke Street, Alexandria, VA 22314-3428. Tom Fay can also be reached at (703) 518-1179, and Justin Anderson can be reached at (703) 518-6540.

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I. Background

A. HISTORY

1. Secondary Capital for LICUs

In 1996, the Board finalized § 701.34 of the NCUA's regulations to permit LICUs to raise secondary capital from foundations and other philanthropic-minded non-natural person members and non-members.¹ The Board issued the rule to provide an additional way for a LICU to build regulatory capital in order to serve two specific purposes: (1) support greater lending and financial services in the communities served by the LICU; and (2) absorb losses to prevent the LICU from failing.

In 1998, as part of the Credit Union Membership Access Act (CUMAA),² Congress amended the Federal Credit Union Act (the Act) to institute a system of prompt corrective action for federally insured credit unions based on a credit union's level of net worth. Relevant to this proposed rule, CUMAA specifically defined "net worth," among other things, to include secondary capital issued by a LICU provided that the secondary capital be uninsured and subordinate to all other claims against the LICU, including the

¹ See 61 FR 50696 (Sept. 27, 1996) (final rule); see also 61 FR 3788 (Feb. 2, 1996) (interim final rule); 12 CFR 701.34.

² Credit Union Membership Access Act of 1998, Pub. L. 105-219, § 301, 112 Stat. 913, 929 (codified at 12 U.S.C.1790d(o)(2)(C) (1998)).

claims of creditors, shareholders, and the National Credit Union Share Insurance Fund (NCUSIF).³

In 2006, the Board further amended § 701.34 to require regulatory approval of a LICU's secondary capital plan before the LICU could issue secondary capital.⁴ In the preamble to the final 2006 rule, the Board noted that LICUs had sometimes used secondary capital to achieve goals different from those for which it was originally intended. It also highlighted a pattern of "lenient practices" by LICUs issuing secondary capital, which contributed to excessive net operating costs, high losses from loan defaults, and a shortfall in revenue.⁵ The Board stated:

These practices include: (1) Poor due diligence and strategic planning in connection with establishing and expanding member service programs such as ATMs, share drafts and lending (e.g., member business loans ("MBLs") real estate and subprime); (2) Failure to adequately perform a prospective cost/benefit analysis of these programs to assess such factors as market demand and economies of scale; (3) Premature and excessively ambitious concentrations of [Uninsured Secondary Capital] to support unproven or

³ Id.

⁴ 71 FR 4234 (Jan. 26, 2006).

⁵ Id. at 4236. Before 2006, a LICU was required to submit a copy of its secondary capital plan to the NCUA, but it was not required to obtain preapproval.

poorly performing programs; and (4) Failure to realistically assess and timely curtail programs that, in the face of mounting losses, are not meeting expectations. When they occur, these lenient practices contribute to excessive net operating costs, high losses from loan defaults, and a shortfall in revenues (due to non-performing loans and poorly performing programs)—all of which, in turn, produce lower than expected returns.⁶

The Board also stated:

Promoting diligent practices in place of lenient ones cannot help but improve the safety and soundness of LICUs. Requiring prior approval of [an Uninsured Secondary Capital] Plan will strengthen supervisory oversight and detection of lenient practices in several ways. First, it will prevent LICUs from accepting and using [Uninsured Secondary Capital] for purposes and in amounts that are improper or unsound. Second, the approval requirement will ensure that [Uninsured Secondary Capital] Plans are evaluated and critiqued by the Region before being implemented. Third, for both the NCUA and the LICU, an approved [Uninsured Secondary Capital] Plan will document parameters to guide the proper implementation

⁶ Id. at 4236-37.

of [Uninsured Secondary Capital], and to measure the LICU's progress and performance.⁷

The Current Secondary Capital Rule⁸ provides that secondary capital accounts must:

- Be established as an uninsured secondary capital account or another form of non-share account;
- Have a minimum maturity of five years;
- Not be insured by the NCUSIF or any governmental or private entity;
- Be subordinate to all other claims against the LICU, including those of shareholders, creditors, and the NCUSIF;
- Be available to cover losses that exceed the LICU's net available reserves and, to the extent funds are so used, a LICU may not restore or replenish the account under any circumstances.⁹ Further, losses must be distributed

⁷ Id. at 4237.

⁸ 12 CFR 701.34. The last substantive amendment to the NCUA's secondary capital rule were in 2010 with the addition of language regarding secondary capital received under the Community Development Capital Initiative of 2010. 75 FR 57843 (Sept. 23, 2010).

⁹ This generally means that when net operating losses exceed Retained Earnings, a LICU needs to first use the secondary capital funds to cover the excess amount.

pro rata among all secondary capital accounts held by the LICU at the time the loss is realized;

- Not be pledged or provided by the investor as security on a loan or other obligation with the LICU or any other party;
- Be evidenced by a contract agreement between the investor and the LICU that reflects the terms and conditions mandated by the Current Secondary Capital Rule and any other terms and conditions not inconsistent with that rule;
- Be accompanied by a disclosure and acknowledgment form as set forth in the appendix to the Current Secondary Capital Rule;
- Not be repaid, including any interest or dividends earned thereon, if the Board has prohibited repayment thereof under §§ 702.204(b)(11), 702.304(b), or 702.305(b) of the NCUA’s regulations because the LICU is classified as “Critically Undercapitalized”; or, if a LICU is a New Credit Union (as defined under § 702.2 of the NCUA’s regulations), as “Moderately Capitalized,” “Marginally Capitalized,” “Minimally Capitalized,” or “Uncapitalized;”

- Be recorded on the LICU’s balance sheet;¹⁰
- Be recognized as net worth in accordance with the schedule for recognizing net worth value in subsection (c)(2) of the Current Secondary Capital Rule;
- Be closed and paid out to the account investor in the event of a merger or other voluntary dissolution of a LICU, to the extent the secondary capital is not needed to cover losses at the time of the merger or dissolution (does not apply in the case where a LICU merges into another LICU); and
- Only be repaid at maturity,¹¹ except that, with the prior approval of the NCUA and provided the terms of the account allow for early repayment, a LICU may repay any portion of secondary capital that is not recognized as net worth.¹²

¹⁰ While the Current Secondary Capital Rule requires a LICU to record secondary capital accounts on its balance sheet as “equity accounts,” generally accepted accounting principles in the United States require secondary capital accounts to generally be recorded as “debt.” *See* FASB (Financial Accounting Standards Board), ASC 942-405-25-3 and 25-4. The instructions to the 5300 Call Report require all federally insured credit unions to report any secondary capital in the Liability section of the Statement of Financial Condition.

¹¹ A LICU may not issue a secondary capital account that amortizes over its stated term.

¹² *See* 12 CFR 701.34(d).

The Current Secondary Capital Rule also includes requirements related to secondary capital plan submissions and approvals, redemption of secondary capital, disclosures, and regulatory capital treatment.

As noted above, since the passage of the CUMAA, a LICU that issues secondary capital is permitted to include the aggregate outstanding principal amount of that secondary capital in its Net Worth. Further, pursuant to the NCUA's currently effective risk-based net worth requirements, a LICU is also permitted to include such secondary capital in its risk-based net worth calculation. By contrast, a non-LICU lacks the authority to issue secondary capital and, to the extent it issues any instruments analogous to secondary capital, to include any such instruments in either its Net Worth or its risk-based net worth calculation.

In October 2015, the Board finalized a rule to replace the current risk-based net worth requirement with a risk-based capital (RBC) requirement.¹³ Under this revised standard, a LICU will be permitted to include secondary capital in its RBC calculations in the same fashion as it currently includes secondary capital in its risk-based net worth calculation. With this proposed rule, the Board now proposes to grant certain non-LICUs the authority to issue instruments in the form of subordinated debt and allow those

¹³ 80 FR 66626 (Oct. 29, 2015). The Board has twice delayed the effective date for the final RBC Rule. First, in 2018, the effective date was delayed by one year, from January 1, 2019, to January 1, 2020. 83 FR 55467 (Nov. 6, 2018). Second, based on Board action at the December 2019 Board meeting, the effective date has been delayed for an additional two years from January 1, 2020 to January 1, 2022.

instruments to be counted in their respective RBC calculations. This new authority, however, would not permit non-LICUs to include subordinated debt in Net Worth.

As discussed in more detail in the following subsections, under this proposed rule, certain non-LICUs would be permitted to issue Subordinated Debt and include such debt in their RBC calculation. In addition, under this proposed rule, all LICUs would be permitted to issue Subordinated Debt for Regulatory Capital treatment.¹⁴ Under this proposed rule, an Issuing Credit Union (defined in § 702.402 of the proposed rule) would be subject to the various requirements discussed in this preamble, including, but not limited to, securities laws, which are further discussed in section I. (E) of this preamble.

¹⁴ This proposal would not change the ability of a LICU to include Subordinated Debt in its Net Worth in the same manner in which it currently includes secondary capital in its net worth.

2. Subordinated Debt for LICUs and Certain Non-LICUs

RBC

In the proposed RBC rule issued in 2015,¹⁵ the Board requested stakeholder input on supplemental capital.¹⁶ Specifically, the Board posed the following six questions:

- (1) Should additional supplemental forms of capital be included in the RBC [ratio] numerator and how would including such capital protect the NCUSIF from losses?

- (2) If yes to be included in the RBC [ratio] numerator, what specific criteria should such additional forms of capital reasonably be required to meet to be consistent with [United States generally accepted accounting practices (U.S. GAAP)] and the [FCU] Act, and why?

¹⁵ 80 FR 4340 (Jan. 27, 2015).

¹⁶ *Id.* at 4384. The Board notes that when the agency began to consider authorizing non-LICU credit unions to issue instruments analogous to secondary capital instruments issued by LICUs, it used the term “supplemental capital” to refer to those instruments. In 2017, when the Board issued an advance notice of proposed rulemaking on this topic, the NCUA used the umbrella term “alternative capital” to refer to both supplemental capital and secondary capital. In light of FCUs’ authority only to issue *debt* instruments, however, the Board believes that it is more appropriate and accurate to use the umbrella term “Subordinated Debt” to refer to both secondary capital and what was once referred to as supplemental capital. It is important to note that, unless the context otherwise requires, the term “Subordinated Debt” refers to BOTH types of debt instruments.

- (3) If certain forms of certificates of indebtedness were included in the RBC ratio numerator, what specific criteria should such certificates reasonably be required to meet to be consistent with [U.S.] GAAP and the [FCU] Act, and why?
- (4) In addition to amending the NCUA's RBC regulations, what additional changes to the NCUA's regulations would be required to count additional supplemental forms of capital in the NCUA's RBC ratio numerator?
- (5) For [federally insured,] state-chartered credit unions, what specific examples of supplemental capital currently allowed under state law do commenters believe should be included in the RBC ratio numerator, and why should they be included?
- (6) What investor suitability, consumer protection, and disclosure requirements should be put in place related to additional forms of supplemental capital?¹⁷

In response to these questions, a majority of the commenters who addressed supplemental capital stated that it was imperative that the Board consider allowing credit unions to issue additional forms of capital. The commenters suggested this authority was

¹⁷ Id.

particularly important because credit unions are at a disadvantage in the financial marketplace because most lack access to additional capital outside of Retained Earnings.

While none of the commenters offered specific suggestions on how to implement supplemental capital, a few suggested that the Board promulgate broad, non-prescriptive rules to allow credit unions maximum flexibility in issuing supplemental capital.

2017 Advance Notice of Proposed Rulemaking (ANPR)

On February 8, 2017, the Board published an ANPR to solicit comments on alternative forms of capital that credit unions could use in meeting capital standards required by statute and regulation.¹⁸ In response, the Board received 756 comments.

Of the 756 comments received, 688 appeared to be derived from one form letter.¹⁹ The form letter opposed the NCUA proceeding with a supplemental capital proposal, reasoning that allowing credit unions to issue supplemental capital would result in credit unions having an ownership structure similar to most tax-paying banks. It also maintained that credit unions have poorly managed existing secondary capital and suggested that, when combined with the necessary compliance with federal and state securities laws, this would result in widespread credit union failures and taxpayer

¹⁸ 82 FR 9691 (Feb. 8, 2017).

¹⁹ While there were slight modifications to some letters, the substance of each letter was the same.

bailouts. In addition, commenters that opposed a supplemental capital proposal generally stated that the FCU Act does not permit credit unions to issue supplemental capital.

The Board disagrees with these assertions. First, most LICUs that have issued secondary capital generally have managed such capital well. Since the NCUA began requiring LICUs to obtain prior approval before issuing secondary capital, the Board is not aware of material losses to the NCUSIF resulting from the mismanagement of secondary capital. Further, the Board is proposing clear and robust requirements related to securities laws compliance, which will help ensure that Issuing Credit Unions are able to effectively navigate the complex framework of securities laws. Finally, as detailed more fully in section I. (B) of this preamble, § 1757(9) of the FCU Act grants a FCU the authority to issue debt instruments of the type contemplated by the ANPR and now by this proposed rule.²⁰ The authority of a FISCO to issue such instruments is derived from applicable state law.

In addition to the form comment letters, the Board received 68 unique comments in response to the ANPR. Most of those comments supported proposing a rule to allow non-LICUs to issue an alternative form of capital. A majority of the commenters in favor of a proposal cited compliance with the NCUA's RBC Rule as the main reason for their support. Other reasons for support included credit union growth, protection from economic downturns, and providing services demanded by members.

²⁰ 12 U.S.C. 1757(9).

In general, the comments lacked specificity, and very few commenters addressed all or even most of the questions that the Board posed. Nevertheless, they covered a wide range of topics and offered varying levels of support for certain provisions. A discussion of more specific commenter feedback follows. The Board notes that, as demonstrated by the remainder of this preamble, it considered all comments to the ANPR in developing this proposed rule.

Permissible Investors

Commenters opining on permissible investors typically addressed two distinct issues: membership of investors and classification of investors. Eighteen commenters addressed the membership of investors. More than half of these commenters believed that both members and non-members should be permitted to invest in supplemental capital, citing both market and flexibility advantages for Issuing Credit Unions. Five commenters believed that restricting investment to members would help preserve the mutual, member-owned structure of credit unions. One commenter argued that only non-members should be permissible investors.

On the topic of investor classification, commenters were split almost evenly between providing maximum flexibility by permitting all persons to purchase supplemental capital and restricting investors to only non-natural persons or accredited investors. Commenters in favor of limiting the classes of potential investors stated that by only permitting more sophisticated investors, it would allow the NCUA's supplemental capital rule to be more flexible with respect to required disclosures.

As discussed in more detail in section II. (C)(4) of this preamble, the Board is proposing to allow credit unions to issue Subordinated Debt to both members and non-members, provided the investor meets the definition of either “Entity Accredited Investor” or “Natural Person Accredited Investor.” These terms are further discussed in sections II. (C)(2) and (4) of this preamble.

Disclosures

Twenty-seven commenters addressed the issue of disclosures. The majority of these commenters urged the NCUA to model any required disclosures after those established by the Office of the Comptroller of the Currency (OCC) or the Securities and Exchange Commission (SEC). These commenters maintained that these disclosures provide the highest level of investor and credit union protection and are the most familiar to investors. As discussed in greater detail in section II. (C)(5) of this preamble, the Board generally modeled the proposed disclosures in this rule after those required by the OCC and SEC.

Registration

Nine commenters that addressed this issue advocated against requiring any form of registration with the NCUA before supplemental capital issuances. These commenters stated that the NCUA should require credit unions to follow SEC rules, which would likely exempt them from registration with the SEC. The commenters further cited flexibility and cost as reasons against registering with the NCUA. In addition, three

commenters advocated for registration, citing safety and soundness concerns and comparability with the OCC's rules for national banks and federal savings associations.

While the Board is not proposing a formal registration process similar to that employed by the SEC for securities issuances registered under the Securities Act of 1933, as amended (Securities Act), the proposed rule would require any credit union contemplating an offer or sale of Subordinated Debt Notes (as defined in § 702.402 of the proposed rule) to obtain the NCUA's prior written approval before engaging in that activity. In addition, under this rule, every such offer and sale of Subordinated Debt Notes would require the preparation and delivery of certain offering materials to investors that conform to this rule's requirements and all applicable federal and state securities law (Offering Documents). Depending on whether a potential investor is an Entity Accredited Investor or a Natural Person Accredited Investor (each as defined in section II. (C)(2)), the Issuing Credit Union may need to obtain the NCUA's prior written approval before it uses such offering materials to offer and sell the Subordinated Debt Notes. See II. (C)(4) and (C)(6) of this preamble for detailed discussions about these requirements.

Permissible Instruments

Thirty-four commenters addressed the topic of permissible instruments. Of these commenters, 22 favored a broad, principles-based approach to identifying permissible instruments, believing such an approach would allow credit unions to more easily meet the demands of investors and lower the cost of issuance. These commenters stated that

the Board should provide a list of broad qualifications for a capital instrument and that any instrument fitting those qualifications should count as regulatory capital. While commenters did not clearly describe qualifications the Board should impose, some cited Basel III²¹ and the Current Secondary Capital Rule as possible models for the qualifications.

Conversely, the remaining 12 commenters addressing this topic stated that the Board should only permit debt instruments to count as regulatory capital, citing purchasers of debt lack of voting rights, ownership, and influence over credit unions. These commenters argued that limiting the type of instrument to debt was an additional protection against erosion of the mutual structure and potential loss of the credit union tax exemption. Please see the following section in this preamble for a detailed discussion of permissible instruments.

B. LEGAL AUTHORITY

1. Authority to issue Subordinated Debt

The borrowing authority granted to FCUs by the FCU Act, along with FCUs' statutory authority to enter into contracts and exercise incidental powers necessary or required to enable the FCUs to effectively carry on their business, supports the legal

²¹ Basel Committee on Banking Supervision, *Basel III: A global regulatory framework for more resilient banks and banking systems*. (2011).

analysis that FCUs are authorized to incur indebtedness through the issuance of debt securities of the type contemplated by this proposed rule. Section 1757(9) of the FCU Act authorizes FCUs:

to borrow, in accordance with such rules and regulations as may be prescribed by the Board, from any source, in an aggregate amount not exceeding, except as authorized by the Board in carrying out the provisions of subchapter III of this chapter, 50 per centum of its paid-in and unimpaired capital and surplus: Provided, That any Federal credit union may discount with or sell to any Federal intermediate credit bank any eligible obligations up to the amount of its paid-in and unimpaired capital.²²

Other than the provisions of § 701.38 of the NCUA's regulations, which addresses borrowed funds from natural persons, the FCU Act does not provide any details as to the mechanisms that FCUs may employ to borrow.²³ Further, § 201(b)(7) of the

²² 12 U.S.C.1757(9).

²³ In contrast, certain provisions of Title 12 of the United States Code relating to the regulation of other types of financial institutions expand on the institutions' basic authority to borrow money, including through the issuance of securities. For example, a Farm Credit System member is specifically authorized to:

- (a) Borrow money from or loan to any other institution of the System, borrow from any commercial bank or other lending institution, issue its notes or other evidence of debt on its own individual responsibility and full faith and credit, and invest its excess funds in such sums, at such times, and on such terms and conditions as it may determine.

FCU Act implicitly allows credit unions to issue securities.²⁴ Conversely, nothing in § 1757(9) or other provisions of the FCU Act appears to impose any specific restrictions or limitations on the mechanisms FCUs may employ to borrow, through the use of specific limiting language, examples or illustrative transactions or situations, or otherwise. This stands in sharp contrast to many other subsections of § 1757 of the FCU Act which, for example, go into significant detail describing the types and terms of loans and extensions of credit that FCUs are permitted to make,²⁵ and define the types of investments FCUs are permitted to make.²⁶ In addition, the NCUA’s regulations do not impose any specific restrictions or limitations on the mechanisms an FCU may employ to borrow, through the use of specific limiting language, examples, illustrative transactions, or situations.

Overall, the lack of specific restrictions or limitations on the mechanisms that may be employed and the specific authority granted in § 1757(9) to borrow “from any source” indicate that borrowings need not be limited to the types of arrangements

(b) Issue its own notes, bonds, debentures, or other similar obligations, fully collateralized as provided in section 2154(c) of this title by the notes, mortgages, and security instruments it holds in the performance of its functions under this chapter in such sums, maturities, rates of interest, and terms and conditions of each issue as it may determine with approval of the Farm Credit Administration.

12 U.S.C.2153(a) (b).

²⁴ Id. § 1781(b)(7)

²⁵ Id. 1757(5).

²⁶ Id. 1757(7); (15).

typically entered into with banks, other credit unions, and other financial institutions—namely, loans, lines of credit, and similar arrangements. Further, the specific authority provided in § 1757(1) of the FCU Act empowering FCUs to enter into contracts²⁷ further supports the conclusion that FCUs have the power to enter into a variety of different arrangements with respect to borrowing.²⁸ In addition, in the absence of specific restrictions and limitations, the “incidental powers” granted to FCUs in § 1757(17) of the FCU Act give significant discretion to FCUs with respect to how borrowings are effected.

Further support for the position that FCUs have the authority to issue debt securities may be found in U.S. GAAP treatment of items that fall in the category of “borrowings.” Under U.S. GAAP, liabilities relating to borrowed money are presented as indebtedness on an entity’s balance sheet, and the interest paid is presented as interest expense on its income statement, whether the borrowings are related to typical loan transactions, advances under lines of credit, or the issuance of debt securities. While the details of the different types of indebtedness for borrowed money are presented as separate line items in an entity’s balance sheet and income statement, the treatment of

²⁷ Id. 1757(1).

²⁸ Typical loan and line of credit arrangements entered into with banks, other credit unions and other financial institutions are clearly contractual in nature. Debt securities are also generally viewed as primarily contractual in nature, in large measure because of the terms of the securities themselves or the terms incorporated into the securities through an indenture, an issuing and paying agent agreement or similar agreement. This view of debt securities has been expressed in a wide variety of court cases. *See, e.g., Katz v. Oak Industries, Inc.*, 508 A.2d 873, 878 (Del. Ch. 1986)) (“Under our law – and the law generally – the relationship between a corporation and the holders of its debt securities, even convertible debt securities, is contractual in nature.”).

“straight” indebtedness (indebtedness that does not have equity/residual ownership features, such as convertibility into shares) as liabilities, and interest paid thereon as interest expense, is essentially the same. In addition, while the details of the different types of indebtedness for borrowed money are presented as separate line items in the statement of cash flows, borrowings, whether in the form of loans from financial institutions or from the issuance of debt securities, are all presented in the “cash flows from financing activities” section of the statement.

Throughout this proposed rule, the Board has included requirements to ensure that any Subordinated Debt issued by an Issuing Credit Union would be properly characterized as debt in accordance with U.S. GAAP. These requirements, as discussed in more detail in this preamble, include that the Subordinated Debt or the Subordinated Debt Note, as applicable, must:

- Be in the form of a written, unconditional promise to pay on a specified date a sum certain in money in return for adequate consideration in money;
- Have, at the time of issuance, a fixed stated maturity of at least five years and not more than 20 years from issuance. The stated maturity of the Subordinated Debt Note may not reset and may not contain an option to extend the maturity; and
- Be properly characterized as debt in accordance with U.S. GAAP.

The Board notes that a FISCUS's legal authority to issue Subordinated Debt derives from applicable state law and regulation. For the Subordinated Debt issued by a FISCUS to qualify as regulatory capital under this proposed rule, however, the FISCUS would be required to comply with all of the provisions of this rule, including the FISCUS-specific provisions that are detailed in section II. (C)(9) of this preamble.

2. The Board's authority to design RBC standards

In addition to credit unions' authority to issue Subordinated Debt, the FCU Act also provides the Board with broad discretion to design the risk-based net worth standards.²⁹ Specifically, the FCU Act provides, in relevant part:

The Board shall design the risk-based net worth requirement to take account of any material risks against which the net worth ratio required for an insured credit union to be "Adequately Capitalized" may not provide adequate protection.³⁰

In designing such a risk-based net worth standard, Congress did not restrict the types of instruments the Board may include in its calculation of risk-based net worth, except that such calculation must take account of material risks that the Net Worth Ratio alone may not protect against. The Board, as discussed in this preamble, is proposing this

²⁹ As discussed above, the Board finalized a rule to replace the regulatory risk-based net worth requirement with an RBC requirement.

³⁰ 12 U.S.C.1790d(d).

rule to grant authority to LICUs, Complex Credit Unions, and New Credit Unions to issue Subordinated Debt that will count as regulatory capital. Based on the requirements in this proposed rule, the Board believes Subordinated Debt will be an additional tool that accounts for material risks faced by credit unions against which the Net Worth Ratio alone may not protect.

While the Board has broad discretion to create the risk-based net worth standard, it does not have the authority to amend the statutory definition of net worth. Currently, the statutory definition of net worth includes secondary capital issued by a LICU that is uninsured and subordinate to all claims against the LICU. As such, the Board notes two points with respect to Subordinated Debt and Net Worth. First, Subordinated Debt issued by a non-LICU will not be included in that credit union's Net Worth or Net Worth Ratio. Second, Subordinated Debt issued by a LICU after the effective date of a final Subordinated Debt rule will be included in that credit union's Net Worth and Net Worth Ratio.

C. CREDIT UNION DATA³¹

As of June 30, 2019, there are 2,618 LICUs. Under this proposed rule, LICUs would continue to be eligible to issue Subordinated Debt. This proposed rule would newly authorize certain non-LICUs to be eligible to issue Subordinated Debt. Specifically, Complex Credit Unions and New Credit Unions would also be eligible to

³¹ Data from NCUA Call Report.

issue Subordinated Debt. The NCUA estimates that this proposed rule would allow an additional 285 non-LICUs, with total assets of \$730 billion, to issue Subordinated Debt.

Proposed Eligible	# of Credit Unions	Total Industry Assets	Average Net Worth Ratio
LICU	2,618	\$628 billion	13%
LICU – New Credit Union	10	\$24 million	23%
Non-LICU Complex Credit Union	281	\$730 billion	11%
Non-LICU New Credit Union	4	\$12 million	44%
Proposed Not Eligible			
Non-LICU Non-Complex Credit Union	2,409	\$162 billion	14%

Total Assets and average Net Worth Ratios rounded. Only one of the 281 Non-LICU Complex Credit Unions had a Net Worth Ratio category of “Undercapitalized.”

D. SUMMARY OF THE PROPOSED RULE

This proposed rule reflects not only the responses to the ANPR discussed above, but also research by NCUA staff, consultation with outside legal counsel, and a comprehensive review of the various current NCUA regulations, including the Current

Secondary Capital Rule. The Board believes this proposal represents a balance between flexibility for credit unions and its responsibility to safeguard the NCUSIF and protect the safety and soundness of credit unions.

This proposed rule would permit LICUs, Complex Credit Unions, and New Credit Unions to issue Subordinated Debt Notes for purposes of regulatory capital treatment.³² It contains a series of requirements with respect to the Subordinated Debt and Subordinated Debt Note, disclosures and offering materials, repayment (including prepayment), and regulatory capital treatment. It also includes an application procedure for both the issuance and repayment of Subordinated Debt Notes.

In addition, the Board is proposing requirements related to the various securities law issues applicable to the offer, issuance, and sale of Subordinated Debt Notes. See sections I. (E) and II. (C)(6) and (8) in this preamble for a detailed discussion of these requirements.

³² Regulatory capital treatment is based on the type of credit union issuing Subordinated Debt. As discussed throughout this preamble, a LICU may include Subordinated Debt in its RBC ratio and its Net Worth; a Complex Credit Union that is not a LICU may include Subordinated Debt in its RBC ratio; and a New Credit Union that is not a LICU may use Subordinated Debt to avail itself of various Prompt Corrective Actions.

Finally, the Board has made cohering changes to various section of the NCUA's regulations. Specifically, this proposed rule includes:

- A new § 701.25, which places limits on FCU loans to other credit unions;
- Recodification of § 701.34 (b), (c), and (d) as § 702.414 to address Grandfathered Secondary Capital;
- An update to § 701.38 that clarifies that FCUs can borrow from any source;
- Changes and additions to the final RBC Rule to account for Subordinated Debt issued by Complex Credit Unions and New Credit Unions;
- An update to the involuntary liquidation payout priorities in § 709.5 to account for Subordinated Debt; and
- Changes to part 741 to account for FISCUs investing in or issuing Subordinated Debt and the treatment of Grandfathered Secondary Capital.

These additional regulatory changes were necessary to ensure that this proposal represents a comprehensive review and revision of the NCUA's regulations to appropriately account for Subordinated Debt.

E. SECURITIES LAW ISSUES

1. Subordinated Debt Notes are Securities

The NCUA continues to believe that any Subordinated Debt Note would be deemed to be a “security” for purposes of federal and state securities laws. Section 2(1) of the Securities Act broadly defines the term “security” to include, among other things, any:

- Stock;
- Note;
- Bond;
- Debenture;
- Evidence of indebtedness;
- Investment contract; or
- Interest or instrument commonly known as a security.³³

The U.S. Supreme Court has repeatedly emphasized that the definition of “security” is quite broad. In a variety of cases analyzing the boundaries of the definition,

³³ 15 U.S.C. § 77b.

the Supreme Court has stressed that the substantive characteristics of the instrument in question and the circumstances surrounding its issuance, rather than the mere name or title of the instrument, are of primary significance in determining whether the instrument, contract or arrangement in question will be deemed a “security.” While lower federal courts and some state courts have sometimes taken a more narrow view than the Supreme Court, common factors the courts generally consider in their analysis (particularly in the context of a debt instrument, contract or arrangement) include:

- The terms of the offer;
- In particular, the character of the economic inducement being offered to the potential counterparty, and whether the characteristics are consistent with a loan or typical extension of credit, or such that the counterparty would anticipate a potential return on investment in addition to repayment of the obligation and any stated interest;
- The plan of distribution;
- In particular, how the instrument is marketed and to whom it is marketed, and whether the potential counterparties are traditional lenders/providers of credit or investors who would anticipate a potential return on investment in addition to repayment of the obligation and any stated interest; and
- The “family resemblance” of the instrument to other instruments or arrangements that have been found to fall within the definition of a

“security,” rather than having characteristics more akin to a loan or typical extension of credit.

The NCUA’s definition of a “security” is not as broad on its face as the Securities Act definition, but is generally consistent with the federal definition, relevant case law, and interpretations by the SEC. Section 703.2 of the NCUA’s regulations defines the term to include a share, participation, or other interest in property or in an enterprise of the issuer or an obligation of the issuer that:

- Either is represented by an instrument issued in bearer or registered form or, if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer;
- Is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment; and
- Either is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations.³⁴

For the foregoing reasons, the Board emphasizes that any issuance of a Subordinated Debt Note by an Issuing Credit Union must be done in accordance with applicable federal and state securities laws. Given the complexity of the securities law

³⁴ 12 CFR 703.2.

framework, any credit union contemplating an offer and sale of Subordinated Debt Notes needs to engage qualified legal counsel to ensure its compliance with securities laws before, during, and after any such offer and sale. The securities law information in this preamble does not constitute, and should not be construed or relied upon as, legal advice to any party.

2. Federal (SEC) Registration of Subordinated Debt Notes

Section 5(a) of the Securities Act expresses a fundamental premise of the federal securities laws—that any offers and sales of securities must be registered with the SEC under the Securities Act, unless an exemption from registration is available.³⁵ Sections 3 and 4 of the Securities Act outline a variety of exemptions from the registration requirements of Section 5(a).³⁶ Based on either of two exemptions discussed below, Issuing Credit Unions will be able to offer and sell their Subordinated Debt Notes without registering the offering with the SEC under the Securities Act. Specifically, an Issuing Credit Union should be able to rely on either Section 3(a)(5) of the Securities Act or Rule 506 under Regulation D promulgated under Section 4(a)(2) of the Securities Act.

Section 3(a) of the Securities Act provides a series of exemptions from Securities Act registration based on the character of the securities being offered, without regard to

³⁵ 15 U.S.C.77e.

³⁶ Id. 77c and 77d.

the nature of the offering or the nature of the purchasers in the offering. That is, the exemption applies to offerings:

- Conducted as public offerings or as private placements or a mix of the two;
- Made to investors that are institutions, individuals, or both; and
- Made to investors whether or not the investors meet one or more standards such as “accredited investors” or “qualified institutional buyers,” as each such term is defined in SEC regulations.

Relevant to credit unions, section 3(a)(5) of the Securities Act, in relevant portion, exempts securities that are issued “by a savings and loan association, building and loan association, cooperative bank, homestead association, or similar institution, which is supervised and examined by State or Federal authority having supervision over any such institution.” The Board anticipates that nearly all Issuing Credit Unions would rely on this exemption from the registration requirements in the Securities Act.

The Board notes that, in addition to the exemption in Section 3(a)(5), Section 4(a) of the Securities Act provides certain exemptions based on the nature of the securities transaction and the persons involved in the transaction. In particular, Section 4(a)(2) provides certain exemptions (and authorizes the SEC to adopt related rules) based on the nature of the offering and the character of the offerees and purchasers of the securities,

without regard to the character of the securities. That is, the exemptions apply to offerings of:

- Equity securities, including common and preferred stock and options, warrants, rights and other derivative securities;
- Debt securities, including bonds, notes and debentures; and
- Hybrid securities, including convertible securities.

Rule 506 of Regulation D, which was adopted by the SEC under Section 4(a)(2) of the Securities Act, provides the specific requirements of one form of what is commonly referred to as the “private placement” exemption. Under Regulation D, Rule 506, registration under the Securities Act is not required for offerings that are either (i) not made via any means of general solicitation or advertisement and where the number of purchasers who are not “accredited investors” is limited to no more than 35, or (ii) made via general solicitation or advertisement but where all purchasers are “accredited investors”.

Given the time and costs associated with offering and selling SEC-registered securities, the Board recognizes that many Issuing Credit Unions may avail themselves of an exemption from the registration requirements of Section 5(a) of the Securities Act. Under this proposed rule, the Board would not mandate a specific exemption on which an Issuing Credit Union could or should rely. An Issuing Credit Union should consult with its securities counsel in determining the appropriate exemption upon which to rely.

As discussed more fully in sections II. (C)(6) and (8) of this preamble, however, the Board is proposing to adopt a regulatory framework for the offer, issuance, and sale of Subordinated Debt Notes. This framework is independent of any available exemptions from the registration requirements of Section 5(a) of the Securities Act. It also generally aligns with certain disclosure requirements in the OCC's subordinated debt regulations. For example, the Board is proposing that every planned issuance of Subordinated Debt Notes would require an Issuing Credit Union to prepare and deliver an Offering Document to potential investors even though there are no SEC-mandated disclosure requirements for offerings of securities pursuant to the Section 3(a)(5) exemption, and there generally are no SEC-mandated disclosure requirements for offerings of securities pursuant to the Rule 506 private placement exemption as long as all purchasers in the offering are "accredited investors."

The Board believes that adopting this regulatory framework would benefit both Issuing Credit Unions and investors, as the framework would provide potential investors information that is important to making a decision to invest in Subordinated Debt Notes and would clearly define the obligations of the related Issuing Credit Unions. These are important benefits that can reduce the possibility of investor confusion or misunderstandings and can assist an Issuing Credit Union in defending against claims by investors that they had a different understanding about the Issuing Credit Union, the terms of the offering, or the securities based on statements made by the Issuing Credit Union or its agents.

Finally, the Board notes that the OCC also applies a regulatory framework to the offer, sale, and issuance of subordinated debt securities. The OCC's subordinated debt regulations require banks to comply with the OCC's registration requirements or otherwise qualify for an exemption under part 16 of those regulations. In particular, the OCC requires that any offers and sales of nonconvertible subordinated debt securities be made only to "accredited investors" and only after offering materials have been provided to potential investors.

3. State Registration of Subordinated Debt Notes

Each state has its own securities laws and regulations and regulators charged with the duty of enforcing those laws and regulations. The states have general authority to regulate securities offerings and related matters occurring within or affecting their states. However, the federal securities laws include a number of provisions that substantially limit or completely preempt certain types of state regulation.

Section 18 of the Securities Act³⁷ provides that securities that meet the definition of "covered securities" are not subject to any form of substantive state securities regulation. States do retain authority to pursue fraud-based enforcement claims and the ability, under some circumstances, to require issuers to submit notice filings to the state, which allows the state to collect a filing fee.

³⁷ 15 U.S.C. 77r.

Securities that fall within the Section 3(a)(5) exemption, as well as securities issued in an exempt offering under Regulation D, Rule 506, both meet the definition of “covered securities.” As a result, in connection with any Subordinated Debt Notes offerings by Issuing Credit Unions that comply with the requirements of Section 3(a)(5) or Regulation D, Rule 506, state securities regulators will not be permitted to:

- Impose any registration, qualification or pre-clearance requirements on the issuer, the terms of the offering or the securities being offered;
- Assess the merits of the issuer, the terms of the offering or the securities being offered; or
- Require the delivery of any disclosure to potential purchasers of the securities in connection with the offering.

4. Disclosure Requirements and Anti-Fraud Provisions

Although Section 3(a)(5) and Regulation D, Rule 506 provide exemptions from the registration requirements of the Securities Act, and reliance on those exemptions is not conditioned on the delivery of any required disclosure to potential investors (in the case of the traditional Rule 506 private placement under Rule 506(b), as long as all the investors are “accredited”), the marketing and sale of the securities remain subject to the broad anti-fraud prohibitions of the Securities Exchange Act of 1934, as amended (Exchange Act).

The Exchange Act's general anti-fraud prohibitions are embodied in § 10(b), which generally prohibits the use of manipulative or deceptive devices or contrivances that violate SEC rules in connection with the purchase or sale of securities.³⁸ Most of the litigation brought with respect to the rules promulgated under § 10(b) has been brought under the general anti-fraud provision, Rule 10b-5, which provides as follows:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) to employ any device, scheme, or artifice to defraud,

(b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.³⁹

³⁸ 17 CFR 240.10b-5.

³⁹ Id.

The primary intent of Rule 10b-5 (and, more broadly, the anti-fraud provisions of the Securities Act and the Exchange Act) is to prevent fraud, deceit, and incorrect or misleading statements or omissions in the offering, purchase and sale of securities. Given that intent, clear and complete disclosure is the critical factor in ensuring the anti-fraud provisions of the Securities Act and Exchange Act are not breached in any offering of securities, regardless of whether the offering is registered with the SEC under the Securities Act or exempt from registration.

In the absence of SEC-mandated disclosure delivery requirements, the practical concern for Issuing Credit Unions relying on either the Section 3(a)(5) or Regulation D, Rule 506 exemption is determining what type and amount of disclosure is appropriate to meet the anti-fraud standards. Relevant case law suggests that the type and amount of disclosure varies depending on a number of surrounding facts and circumstances, including:

- The nature of the potential investors (focusing on their level of sophistication);
- The nature of the security being offered (disclosure regarding the terms of debt instruments, preferred stock or more complex securities tends to be more detailed than disclosure regarding common stock);
- The nature of the business of the issuer and the industry in which the issuer operates (detailed disclosure may be more appropriate in the case of complex business structures and industries); and

- Market practices (focusing on the types of disclosure commonly provided by peer companies).

There are a number of advantages in using a well-written disclosure document in connection with any offering of securities. First, using a disclosure document provides both the issuer and potential investors with a centralized resource clearly and consistently setting forth the terms of the offering and the securities being offered. Second, the disclosure document can be used as a reference to reduce the possibility of investor confusion or misunderstandings and can be used by the issuer as a defense against claims by investors that they had a different understanding about the issuer, the terms of the offering, or the securities based on statements made by the issuer or its agents. For these reasons, the Board is proposing that every planned issuance of Subordinated Debt Notes would require the preparation and delivery of a written disclosure document, each of which must meet the standards of Rule 10b-5.

In brief, for any disclosure document to meet the standards of Rule 10b-5, the disclosure included in the document (a) must not contain any untrue statement of a material fact and (b) must not omit to state a material fact the absence of which renders any disclosure already being made misleading. To accomplish those ends, the disclosure must be clear, accurate, and verifiable. In addition, the disclosure should cover topics that are typically important to investors in making an investment decision. Common topics in this category include:

- Material risks relating to the issuer and the industry in which the issuer operates;
- Material risks relating to the security being offered;
- The issuer’s planned uses for the proceeds of the offering;
- Regulatory matters impacting the issuer and its operations;
- Tax issues associated with the security being offered; and
- How the securities are being offered and sold, including any conditions to be met in order to complete the offering.

Sections 702.405, 702.406, and 702.408 of the proposed rule detail the Offering Document requirements for a planned issuance of Subordinated Debt Notes. These requirements are independent of and, in some cases, additive to any requirements imposed by applicable securities laws. The Board reiterates its expectation that credit unions contemplating an issuance of Subordinated Debt Notes retain professional advisors experienced in securities law disclosure matters to assist them in the preparation of related Offering Documents.

Beyond the disclosure topics outlined above, a credit union considering issuing Subordinated Debt Notes may obtain guidance as to the type and amount of disclosure that is appropriate for its securities offerings from market participants. Sophisticated investors, rating agencies, underwriters, placement agents, and others often exert

significant influence over disclosure practices in exempt securities offerings. In some settings, such as municipal bond offerings and offerings under Securities Act Rule 144A⁴⁰ (made to highly sophisticated “qualified institutional buyers”), it is not uncommon for disclosure documents to approach the level of detail that typically would be provided in a registration statement for an offering registered with the SEC under the Securities Act.

5. Ongoing Disclosure and Reporting to Investors; Investor Relations

As discussed in this preamble, the SEC does not mandate any specific disclosure, either in form or substance, with respect to offers and sales of securities under the Section 3(a)(5) exemption or the Regulation D, Rule 506 exemption (if sales are made only to “accredited investors;” sales to other investors do require the issuer to deliver specific types of disclosure). Similarly, SEC rules do not require companies that have relied on those exemptions to distribute or make available any disclosure after the offering has been completed or at any time in the future. As noted above, the preemptive effect of Section 18 of the Securities Act prohibits states from requiring any ongoing disclosure to investors following completion of an offering of “covered securities.”

It is often the case, however, that investors will require that the issuer provide some form of ongoing disclosure. Securities purchase agreements, or companion “investor rights agreements,” often specify the form and content of the ongoing

⁴⁰ 17 CFR § 230.144A.

disclosure and the frequency of delivery of the disclosure. Practice varies from a requirement to deliver quarterly and annual financial statements to disclosure in form and substance that mimics the disclosure an SEC-registered company would be required to provide to its investors. In addition, for issuances of debt securities under an indenture or an issuing and paying agent agreement, the terms of those documents commonly include requirements to provide certain information to the trustee or paying agent on an ongoing basis, and that information is either passed on directly to investors or is generally available to investors by request to the trustee or paying agent.

Even in the absence of mandated or contractual requirements to provide disclosure, Issuing Credit Unions issuing Subordinated Debt Notes will likely face a variety of practical, disclosure-related issues. For example, investors frequently contact companies in which they hold an interest and ask for a variety of information about the company, its operations, its financial performance, and its prospects. While an Issuing Credit Union may prefer not to respond to those inquiries, from an investor relations standpoint, refusing to respond is not likely to be practical. Although this places certain burdens on an Issuing Credit Union's management, maintaining open lines of communication with investors can have significant practical benefits, including assessing possible interest in future offerings of Subordinated Debt Notes, negotiating possible buybacks of outstanding Subordinated Debt Notes, or negotiating amendments or modifications to obligations relating to any currently outstanding Subordinated Debt Notes.

From a securities law standpoint, the type of information an Issuing Credit Union provides—and whether that information is provided only to the requesting investor, to all investors, or the marketplace—generally raises a number of important issues. First, any information that is provided must be materially correct and complete, because the anti-fraud provisions of the securities laws could apply to those communications if an investor or potential investor relies on those communications in connection with the purchase or sale of a security. In addition, sharing material, non-public information with individual investors without making that information generally available to all investors could result in potential liability for the Issuing Credit Union.

As a result, for securities law compliance and risk management purposes, under the proposed rule, Issuing Credit Unions issuing Subordinated Debt Notes must adopt policies and procedures covering matters such as:

- Who is responsible and authorized to speak on behalf of the Issuing Credit Union;
- What information will and will not be provided to requesting investors;
- Whether that information will be made available to other investors; and
- How that information will be made available to other investors.

Although an Issuing Credit Union may not need to have full-time personnel dedicated to an investor relations function, some personnel will need to take on

responsibility for investor relations, and will need to be prepared to accurately answer questions and respond to appropriate requests. In addition, the responsible personnel will need to be trained regarding appropriate boundaries for responses to and discussions with investors. As noted above, there are a variety of securities law issues relating to communications with investors. As a result, for securities law compliance and risk management purposes, Issuing Credit Unions issuing Subordinated Debt Notes will need to adopt certain policies and procedures covering interactions with investors.

Finally, similar to commercial loans, lines of credit, and other types of debt financing, the debt security instrument itself and/or the documents relating to debt securities issuances (for example, note purchase agreement, indenture, issuing and paying agent agreement) customarily require the issuer of debt securities to report its compliance (or non-compliance) with any covenants included in the terms of the debt securities. The frequency of reporting and the contents of the report can vary from situation to situation, based both on the demands of the investors and the term structure of the particular debt security. These obligations will make it necessary for the Issuing Credit Union to implement compliance and reporting controls and procedures to ensure compliance with the terms of the Subordinated Debt Notes generally, and for compliance with any applicable reporting requirements.

6. Potential Broker-Dealer Registration Issues

Marketing activities by an Issuing Credit Union and its employees in connection with any offerings of Subordinated Debt Notes could require the employees to register as

broker-dealers because the SEC interprets the definition of “broker” broadly to cover persons who play almost any active role in offers and sales of securities, including, under certain circumstances, employees of the issuer of the securities or its affiliates.

There are exemptions available to both an Issuing Credit Union itself and its employees that can excuse them from the broker-dealer registration requirements. Credit unions that issue securities typically cannot be “brokers” of their own securities because they are not involved in the purchase or sale of securities for the account of other persons. Similarly, credit unions that issue securities typically cannot be “dealers,” because their normal business does not involve buying and selling their own securities for their own account. Credit union employees that participate in offering-related activities usually will be able to rely on the exemption provided by Rule 3a4-1 under the Exchange Act.⁴¹

Conditions to relying on this exemption include the employee:

- Not receiving commissions or other compensation relating to the offering;
- Not being disqualified under SEC rules due to past legal or regulatory issues;
- Not being associated with a broker or dealer during the offering; and

⁴¹ 17 CFR 240.3a4-1.

- Either limiting his or her offering-related activities, limiting the types of potential investors he or she interacts with, or limiting the number of offerings he or she participates in.

As a result, for securities law compliance and risk management purposes, discussed further in section II(C)(8) of this preamble, Issuing Credit Unions must adopt certain policies and procedures covering compliance with broker-dealer requirements.

7. Director and Officer (“D&O”) Liability Insurance Coverage for Issuing Credit Unions

Under the proposed rule, Issuing Credit Unions considering issuing Subordinated Debt Notes will need to evaluate the potential impact of those activities on their D&O coverage. The scope of D&O liability coverage, amount of premiums, and terms relating to retention (deductibles and self-insurance) are usually different for public companies versus private companies. While Issuing Credit Unions will not be “public” in the same way SEC-registered entities with securities traded on an exchange are, entities that begin issuing securities to more than a limited number of “outside” investors must often make adjustments to their existing D&O policies.

For the reasons identified in subsections I. (E)(5), (6), and (7) above, the Board is proposing to require a credit union to include draft written policies on these issues as part of its application to issue Subordinated Debt Notes. See section II. (C)(8) of this preamble for a more detailed discussion of the application requirements.

II. Proposed Changes

The following is a section-by-section analysis of the proposed changes. The Board invites comment on each proposed change and, where appropriate, has posed questions to solicit specific feedback on discrete aspects of the proposed rule. The Board notes that all references in this preamble to part 702 of the NCUA's regulations, including any subsection thereof, refer to the version of part 702 that gives effect to the final RBC Rule and which will become effective on January 1, 2022.

A. PART 701—ORGANIZATION AND OPERATIONS OF FEDERAL CREDIT UNIONS.

1. § 701.25 Loans to Credit Unions.

The Board proposes to add a new § 701.25 for FCUs making loans to other credit unions. This section will only apply to natural person credit unions; corporate credit union lending is subject to § 704.7.⁴² While this section applies to FCUs, FISCUs will be subject to these requirements and limitation through the proposed § 741.227 as discussed in section II. (E)(3) of this preamble. Loans from FCUs to other credit unions are not currently addressed in the NCUA's regulations. The Board believes adding a new section

⁴² The NCUA is evaluating a potential proposed rule to clarify the extent to which corporate credit unions could purchase Subordinated Debt issued by natural person credit unions.

for loans to credit unions will establish policy standards and limits to support safety and soundness and protect the NCUSIF.

The loans to other credit unions section includes the following FCU activities:⁴³

- Loans not subordinate to the NCUSIF or to a private insurer (for privately insured credit unions);
- Subordinated Debt;
- Grandfathered Secondary Capital; and
- Loans or obligations subordinate to a private insurer (for privately insured credit unions).

Specifically, the proposed § 701.25 will establish:

- Limits on loans an FCU makes to other credit unions;
- Approval and policy standards for an FCU to make loans to other credit unions; and
- Requirements and limits on an FCU making investments in Subordinated Debt.

⁴³ These requirements do not apply to natural person credit union investments in contributed capital of corporate credit unions, which is limited by 12 CFR 703.14(b).

The Board proposes § 701.25(a) to establish aggregate and single borrower limits for loans, including investments in Subordinated Debt, an FCU can make to other credit unions. The proposed aggregate limit is the same as the limit in the FCU Act on an FCU's authority to invest its funds in loans to other credit unions.⁴⁴ The single borrower limit is consistent with the single borrower limit in § 723.4(c) for commercial loans.

The Board notes that the FCU Act imposes an aggregate limit on the amount of loans an FCU may make to other credit unions. Specifically, the FCU Act authorizes an FCU to make loans to other credit unions that, in the aggregate, cannot exceed 25 percent of the FCU's paid-in and unimpaired capital and surplus.⁴⁵ Paid-in and unimpaired capital and surplus is defined in NCUA regulations as:

[S]hares plus post-closing, undivided earnings. This does not include regular reserves or special reserves required by law, regulation or special agreement between the credit union and its regulator or share insurer.⁴⁶

The proposed aggregate limit in this section, therefore, is not a substantive change, but a regulatory codification of the limit imposed by the FCU Act. The Board believes the proposed rule would clarify loan limits in this section and minimize the need

⁴⁴ 12 U.S.C.1757(7)(C).

⁴⁵ Id.

⁴⁶ 12 CFR. 700.

for readers to reference the FCU Act when determining aggregate limits for loans to credit unions.

The Board is proposing a new single borrower limit for FCUs making loans to other credit unions that would be the greater of 15 percent of the FCU's Net Worth or \$100,000, plus an additional 10 percent of the FCU's Net Worth if that amount is fully secured at all times with a perfected security interest by readily marketable collateral as defined in § 723.2. There is no current single credit union borrower limit in the NCUA's regulations. The Board notes that the proposed single borrower limit is consistent with the single borrower limit in the NCUA's commercial lending and MBL rule.⁴⁷ Because credit unions share many similarities with traditional corporate borrowers, the Board believes that basing the proposed single borrower limit in this rule on the commercial and MBL rule limit is appropriate. Furthermore, the 15 percent of Net Worth single borrower limit for FCUs making loans to other credit unions would generally limit catastrophic losses to an FCU if the borrower defaults. The proposed 15 percent of Net Worth threshold is also consistent with the longstanding FDIC single-obligor limit.⁴⁸ The Board would like to note that it is also considering a similar single obligor limit for uninsured deposits in future rulemakings.

⁴⁷ Id. 723.4(c).

⁴⁸ Id. 32.3(a).

The Board proposes § 701.25(b) to establish minimum approval and written policy standards for an FCU that is making loans to credit unions. The proposal would require that an FCU's board of directors approve all loans to other credit unions. The Board notes that the FCU Act already requires an FCU's board of directors to approve all loans to credit unions and, as such, this proposed requirement is not new.⁴⁹

The proposed rule also requires an FCU lending to another credit union to establish written policies that address how it would manage the risk of its loans to credit unions and the dollar limits, both aggregate and single borrower, on the amount of the loans. This would be a new requirement for FCUs making loans to other credit unions.

The Board is proposing to add this requirement because it believes that making loans to credit unions should have similar policy requirements as other loans and investments. The Board also believes written policies can help ensure FCU lending to other credit unions will operate in a safe and sound manner. Policies create a framework for a credit union to consistently perform credit analysis and creates limits that are consistent with the credit union's risk tolerance and regulatory limits to help ensure the credit union is operating in a safe and sound manner.

The Board believes that FCUs that make loans to other natural person credit unions may have traditionally included policies for this activity in their investment or loan policies. The Board believes including policies for loans to other credit unions in

⁴⁹ 12 U.S.C.1757(5)(C).

the investment policy or a loan policy is sufficient for compliance with this requirement, since the Board's concern is with the existence of sufficient policies, not where they reside.

The Board is proposing § 701.25(c) to establish minimum requirements and limits for an FCU that invests in Subordinated Debt, Grandfathered Secondary Capital or in loans and obligations issued by privately insured credit unions that are subordinate to a private insurer (PICU Subordinated Debt). The minimum requirements apply to both direct and indirect investments.

A direct investment would have the issuer of the Subordinated Debt as the borrower on the investing credit union's balance sheet. For example, credit union A purchases Subordinated Debt from credit union B. This results in credit union A having risk exposure (credit risk) to credit union B through its holding of the Subordinated Debt note.

An indirect investment is one in which the issuer of the Subordinated Debt is not identifiable on the investing credit union's balance sheet. An example of an indirect investment would be the purchase of shares in a mutual fund. For example, XYZ mutual fund purchases Subordinated Debt issued by credit union B. If credit union A purchases shares in this mutual fund, then credit union A would have an indirect investment in credit union B's Subordinated Debt, because only XYZ mutual fund would be recorded on credit union A's balance sheet.

The Board is proposing that an FCU must meet three criteria to make direct or indirect investments in Subordinated Debt, Grandfathered Secondary Capital or PICU Subordinated Debt. Specifically, the investing FCU:

- Has, at the time of the investment, a capital classification of “Well Capitalized;”
- Does not have any outstanding Subordinated Debt or Grandfathered Secondary Capital with respect to which it was the Issuing Credit Union; and
- Is not eligible to issue Subordinated Debt or Grandfathered Secondary Capital pursuant to an unexpired approval from the NCUA.

The Board is proposing the “Well Capitalized” capital classification requirement because it believes that only “Well Capitalized” FCUs should invest in obligations of natural person credit unions that are subordinate to the NCUSIF or to a private insurer. Because any of the aforementioned subordinated obligations are in a first loss position, even before the NCUSIF or a private insurer, an involuntary liquidation of the related Issuing Credit Union or significant write-downs of the subordinated obligations would potentially mean large, and likely total, losses for the holders of those subordinated obligations. Therefore, the Board believes it would not be safe and sound to allow FCUs that are classified less than “Well Capitalized” to invest in Subordinated Debt, Grandfathered Secondary Capital or PICU Subordinated Debt.

Conversely, the Board believes that a “Well Capitalized” FCU generally has sufficient Net Worth to invest in Subordinated Debt, Grandfathered Secondary Capital or PICU Subordinated Debt, provided that the risk is limited as discussed further in this section of the preamble.

The Board is also proposing that an FCU investing in Subordinated Debt, Grandfathered Secondary Capital, or PICU Subordinated Debt must not be an Issuing Credit Union of Subordinated Debt or Grandfathered Secondary Capital, or currently have approval from the NCUA to issue Subordinated Debt or Grandfathered Secondary Capital. The Board notes that an FCU would not be considered an Issuing Credit Union if it acquired Subordinated Debt or Grandfathered Secondary Capital issuance through a merger, as discussed further in section II. (C)(3) of this preamble. The Board believes that an Issuing Credit Union should not provide Regulatory Capital to other natural person credit unions. Furthermore, the potential to transmit losses between multiple Issuing Credit Unions that have both issued Subordinated Debt and invested in Subordinated Debt (loss transmission) could increase the risk of credit union failure and increase the risk to the NCUSIF. For example, if an Issuing Credit Union both purchased and issued Subordinated Debt, losses from the Subordinated Debt *purchased* by the Issuing Credit Union could create losses on the Subordinated Debt *issued* by the Issuing Credit Union, thereby creating a potential loss transmission from the purchased Subordinated Debt to the issued Subordinated Debt. The Board is concerned that, if it does not restrict covered credit unions in this way, a loss incurred by an Issuing Credit Union would simultaneously transmit to an investing credit union (the credit union that is the purchaser of the issuer’s Subordinated Debt Note). This inter credit union exposure

results in an imprudent transmission of losses because a single loss can impact both institutions rather than the issuer alone. The Board believes that failing to prohibit inter credit union subordinated debt transactions will create an unsafe and unsound condition for the NCUSIF.

Beyond loss transmission, if the Board were to allow Issuing Credit Unions to invest in Subordinated Debt, the level of Net Worth in the credit union system could appear to increase, while the actual loss-absorbing capacity of the system would remain unchanged. For example, two LICUs each have \$10 million in Net Worth, so the total Net Worth between the two credit unions is \$20 million. If each credit union issued \$1 million in Subordinated Debt and then sold it to the other, the Net Worth between the two credit unions would be \$22 million. This would result in an artificial \$2 million increase (ten percent) in Net Worth for the credit union system, and would increase potential loss transmission between the two credit unions as explained in the prior paragraph. The Board notes the increased total Net Worth in the system described above would also happen if only one credit union issued the Subordinated Debt and the other credit union purchased it, also artificially increasing the Net Worth in the system

The Board is proposing limits on the amount of investment an FCU can make in Subordinated Debt, Grandfathered Secondary Capital, or PICU Subordinated Debt. The proposed limit is only on an aggregate basis, because single borrower limits have been addressed in the proposed general single credit union borrower limit. The Board is proposing an aggregate limit of the lesser of 25 percent of Net Worth and any amount of Net Worth in excess of 7 percent of total assets.

The Board believes a cap of 25 percent of Net Worth is appropriate given the higher relative risk of loss with Subordinated Debt, Grandfathered Secondary Capital, or PICU Subordinated Debt. This risk comes from the Subordinated Debt, Grandfathered Secondary Capital, or PICU Subordinated Debt being in a position to incur losses before the NCUSIF or a private insurer. In other words, the Subordinated Debt and Grandfathered Secondary Capital will take losses after retained earnings before the NCUSIF. The loss profile of Subordinated Debt and Grandfathered Secondary Capital would also apply to PICU Subordinated Debt.

Past loss experience in credit union involuntary liquidations shows that it is not unusual for the NCUSIF to take losses in a liquidation. Any loss to the NCUSIF in a liquidation would result in a total loss of the Subordinated Debt and Grandfathered Secondary Capital. The risk for PICU Subordinated Debt would be similar to Subordinated Debt and Grandfathered Secondary Capital if a private insurer takes losses.

The Board believes the severity of the potential loss warrants an aggregate limit on Subordinated Debt, Grandfathered Secondary Capital, and PICU Subordinated Debt of 25 percent of Net Worth. The Board also contemplated aggregate limits of 15 percent and 40 percent of Net Worth, but believes an aggregate limit of 25 percent of Net Worth strikes an appropriate balance between granting FCUs flexibility to invest, and the risks associated with Subordinated Debt, Grandfathered Secondary Capital, or PICU Subordinated Debt. The Board requests specific comment on whether the NCUA should consider a different aggregate limit, such as 15 percent of an FCU's Net Worth or 40 percent of Net Worth. The Board notes that this limit does not apply to natural person

credit union investments in contributed capital of corporate credit unions, which is limited by § 703.14(b).

The Board is also proposing another measure of the aggregate limit, which could further restrict the amount of an FCU’s investments in Subordinated Debt, Grandfathered Secondary Capital, and PICU Subordinated Debt. This limit is the amount of Net Worth in excess of seven percent of total assets. An FCU would calculate the amount of Net Worth in excess of 7 percent and would use this measure as the aggregate limit if it is an amount less than 25 percent of its Net Worth.

The Board is proposing the aforementioned limit to ensure that total potential losses from Subordinated Debt, Grandfathered Secondary Capital, or PICU Subordinated Debt would not lower an FCU’s Net Worth to below seven percent, which is “Well Capitalized” when measuring using the Net Worth Ratio. As mentioned earlier, the Board believes this is an important measure to promote safety and soundness when an FCU invests in Subordinated Debt, Grandfathered Secondary Capital, or PICU Subordinated Debt.

Examples of the aggregate limit calculations are provided below.

ABC FCU has \$100 million in Net Worth and \$1 billion in assets.		
Limit Type	Limit Calculation	Total

Percent of Net Worth Limit	25 percent of \$100 million (Net Worth)	\$25 million
Amount of Net Worth in excess of 7%	\$100 million (Net Worth) minus [\$1 billion (current assets) times 7%]	\$30 million
Maximum amount of Subordinated Debt, Grandfathered Secondary Capital, and PICU Subordinated Debt ABC FCU invest in.	Lesser of the calculations	<u>\$25 million</u>

In the above example, the percentage of Net Worth limit is the lesser of the measures and therefore is the binding constraint.

LMN FCU has \$80 million in Net Worth and \$1 billion in assets.		
Limit Type	Limit Calculation	Total
Percent of Net Worth Limit	25 percent of \$80 million (Net Worth)	\$20 million
Amount of Net Worth in excess of 7%	\$80 million (Net Worth) minus [\$1 billion (current assets) times 7%]	\$10 million
Maximum amount of Subordinated Debt, Grandfathered Secondary Capital, and PICU Subordinated Debt ABC FCU invest in.	Lesser of the calculations	<u>\$10 million</u>

In the above example, the amount of Net Worth in excess of seven percent limit is the lesser of the measures and therefore is the binding constraint.

The Board is proposing a paragraph that would prescribe how the components of the aggregate limit are calculated. The limit is based on an FCU's aggregate outstanding:

- Investment in Subordinated Debt;
- Investment in Grandfathered Secondary Capital;
- Investment in PICU Subordinated Debt; and
- Loans or portion of loans made by the credit union that are secured by any Subordinated Debt, Grandfathered Secondary Capital, or PICU Subordinated Debt.

The Board is proposing this paragraph to ensure FCUs are more readily aware of the components that are subject to the aggregate limit in this section. In proposing to include loans, or portions of loans, secured by the first three components, the Board is including an exposure that could otherwise be unaccounted for by the lending credit union if the secured borrower defaults.

The Board is proposing a paragraph for the calculation of an FCU's indirect investment in Subordinated Debt, Grandfathered Secondary Capital, or PICU Subordinated Debt. The Board is proposing this paragraph to ensure FCUs consistently measure indirect investment exposure. The credit union would be required to determine

the percentage of a mutual fund's assets invested in such instruments and multiple that percentage by its own pro rata investment. This will ensure the credit union has an accurate evaluation of its indirect exposure to Subordinated Debt, Grandfathered Secondary Capital and PICU Subordinated Debt. In turn, this evaluation can be used to monitor compliance with the aggregate regulatory limit on such instruments. This calculation is similar to the full look-through approach for investment funds in Appendix A of the RBC Rule. An example of the calculation follows:

ABC Fund is a \$100 million fund and has \$5 million of its holdings in Grandfathered Secondary Capital. XYZ FCU owns \$10 million of ABC Fund.

- XYZ FCU's proportional ownership of the ABC Fund: \$10 million divided by \$100 million equals ten percent of the fund.
- Indirect exposure: \$5 million (Grandfathered Secondary Capital) in ABC Fund times ten percent equals \$500,000.

In the example above, XYZ FCU's indirect exposure, for aggregate limit calculation purposes, would be \$500,000. This is the amount that would need to be included in the calculation of the aggregate limit.

2. § 701.34 Designation of Low-Income Status.

The Current Secondary Capital Rule contains information on how a credit union can obtain a low-income designation and the procedures and regulations related to secondary capital. As discussed in section II. (C)(1) of this preamble, under this proposed rule, secondary capital and Subordinated Debt would be subject to nearly identical rules. As such, for ease of use, the Board is proposing to locate all regulations related to Subordinated Debt in proposed subpart D of part 702.

To accomplish this, the Board is proposing to delete subsections (b) through (d) and the appendix to the Current Secondary Capital Rule. (Subsection (a) of the Current Secondary Capital Rule would remain in place.) As discussed below, the Board is proposing to relocate subsections (b)-(d) to § 702.414 of proposed subpart D to part 702. The Board believes having one part that addresses capital and capital treatment will help users more easily review all related requirements, including Grandfathered Secondary Capital and Subordinated Debt provisions.

3. § 701.38 Borrowed Funds.

The Board is proposing to revise an FCU's borrowing authority under § 701.38 to permit borrowing from any source. This is a change from the current rule, which only addresses an FCU's borrowings from "natural persons." The Board is proposing to revise the current rule to clarify that an FCU may borrow from any source. This change is

consistent with § 1757(9) of the FCU Act and, in the Board's view, supports an FCU's legal authority to issue Subordinated Debt Notes.⁵⁰

The Board also is proposing other clarifying revisions to § 701.38(a). Under the proposed rule, an FCU's borrowings would be evidenced by a "written contract," as opposed to the more narrow language of current § 701.38(a), which provides that a borrowing must be evidenced by "a promissory note." The Board recognizes that, under current practice, borrowing contracts may take forms other than just a promissory note. The proposal still cites a promissory note as a primary example, but extends greater flexibility than current § 701.38(a) for what is an acceptable form of evidencing the borrowing.

The Board is also proposing to revise § 701.38(a)(2) to introduce the term "funds" to modify the description of a borrowing transaction to make it clearer to investors that such transactions are not shares of the Issuing Credit Union and, therefore, are not insured by the NCUA. The Board regards both of these changes as important clarifications that will benefit credit unions and investors.

Lastly, the Board is proposing to revise § 701.38(b) to reference the limitations on an FCU's maximum borrowing authority by citing § 1757(9) of the FCU Act and

⁵⁰ Id 1757(9) (FCUs are subject to a maximum borrowing authority "in an aggregate amount not exceeding, except as authorized by the Board in carrying out the provisions of subchapter III, 50 per centum of its paid-in and unimpaired capital and surplus: Provided, [t]hat any Federal credit union may discount with or sell to any Federal intermediate credit bank any eligible obligations up to the").

removing the current reference to § 741.2 of the NCUA’s regulations. However, under § 741.2, a FISCU would be subject to the same borrowing limits as an FCU under § 701.38. This technical refinement supports greater clarity in the regulation but does not change the amount of the limitation that currently applies to FCUs and FISCUs.

B. PART 702—CAPITAL ADEQUACY

1. § 702.2 Definitions.

The Board is proposing to add an introductory statement to the definitions section to indicate that all accounting terms not otherwise defined in the section will have the same meaning as in U.S. GAAP. The Board is adding this statement to clarify that, if an accounting term is not defined in the rule text, the reader should use any applicable definition provided under U.S. GAAP for that term. This clarifying statement supports the current practice of using U.S. GAAP definitions when an accounting term is undefined by the FCU Act or the NCUA’s regulations.

The Board is amending the definition of Net Worth. In the first sentence of the Net Worth definition, the Board is clarifying that the definition of Net Worth in this section is for natural person credit unions and is specifying the measurement of Net Worth is as of the date of determination. The definition in the current rule begins with “Net worth means,” and does not explicitly state that the Net Worth definition is for natural person credit unions. The Board is adding this phrasing to avoid the possibility of confusion that the definition of Net Worth could apply to corporate credit unions. The

Board is also adding the new qualifier, “as of any date of determination,” to clarify that there is an “as of” date, which is addressed below.

For clarification, the Board is proposing a technical, non-substantive refinement to the definition of Net Worth in paragraph (1) of current § 702.2 by adding “most recent” as a reference point for the date of determination. Current § 702.2 does not explicitly state that Net Worth is measured as of the most recent quarter end, but the Board believes that this reflects the common understanding within the credit union industry.

The Board is also proposing to change the wording regarding how U.S. GAAP is referenced when determining Net Worth from “as determined under U.S. GAAP” to “as determined in accordance with U.S. GAAP.” The Board believes that this non-substantive revision is more accurate than current § 702.2.

The Board is proposing to amend paragraph (2) in the Net Worth definition to include Subordinated Debt and to replace the term secondary capital accounts with Grandfathered Secondary Capital. It notes that these cohering changes are necessary based on other provisions of the proposed rule discussed throughout this preamble.

The Board is also proposing an addition to paragraph (2) that clarifies the amounts of Subordinated Debt and Grandfathered Secondary Capital that count towards

Regulatory Capital.⁵¹ In the current rule, the reader would need to know that secondary capital accounts have a schedule to reduce the recognition of Net Worth once they have a remaining maturity of five years or less. The Board believes that referencing the recognition of Net Worth in §§ 702.407 and 702.414 in the proposal would add clarity in calculating New Worth for LICUs that have issued Subordinated Debt or Grandfathered Secondary Capital. The Board is also proposing some formatting changes in paragraph (2) by adding two subparagraphs, (A) and (B), with text contained in a long paragraph in the current rule. The wording is unchanged except for “National Credit Union Share Insurance Fund” being spelled out. The Board is proposing this change to add ease for the reader.

The Board is also adding new definitions for Grandfathered Secondary Capital and Subordinated Debt, as current § 702.2 does not have these definitions. The definition of Grandfathered Secondary Capital is “any subordinated debt issued in accordance with current § 701.34 (recodified as § 702.414 of subpart D of this part) or, in the case of a FISCU, with § 741.204(c) before [INSERT THE EFFECTIVE DATE OF THIS REGULATION]. The Board is proposing to add the definition of Grandfathered Secondary Capital as a way to refer to secondary capital issued under the current rule, as discussed in more detail in section II. (C)(14) of this preamble.

⁵¹ Regulatory Capital is capital, both Net Worth and/or the RBC numerator, as defined by NCUA. See section II(C)(2) of the preamble for more details.

Finally, the Board is also proposing to add a definition of Subordinated Debt, which will be the same as the meaning in the proposed subpart D. The definition of Subordinated Debt is “an Issuing Credit Union’s borrowing that meets the requirements of this subpart, including all obligations and contracts related to such borrowing.” This definition is discussed in more detail in section II. (C)(2) of this preamble. The Board is adding a definition of Subordinated Debt so a reader of the proposed rule text outside of subpart D knows where to find the definition.

2. § 702.104 Risk-based capital ratio.

The Board is proposing to amend current § 702.104(b)(1)(vii) to include both Subordinated Debt and Grandfathered Secondary Capital in the RBC Ratio.⁵² Current § 702.104(b)(1)(vii) allows secondary capital accounts to be included in the RBC numerator. This change is necessary to properly give effect to Subordinated Debt and Grandfathered Secondary Capital in the RBC Ratio.

The Board is also clarifying that the amount of Subordinated Debt and Grandfathered Secondary Capital that is treated as Regulatory Capital, as discussed in

⁵² The RBC Ratio is calculated using a numerator and a denominator. The numerator includes (i) Undivided earnings; (ii) Appropriation for non-conforming investments; (iii) Other reserves; (iv) Equity acquired in merger; (v) Net income; (vi) ALLL, maintained in accordance with U.S. GAAP; (vii) Secondary capital accounts included in net worth (as defined in § 702.2); and (viii) Section 208 assistance included in net worth (as defined in § 702.2) and deductions for (i) NCUSIF Capitalization Deposit; (ii) Goodwill; (iii) Other intangible assets; and (iv) Identified losses not reflected in the RBC Ratio numerator. The denominator includes risk-weighted assets.

section II. (C)(7) of this preamble, would be included as part of the RBC Ratio.

Currently, the definition does not establish how secondary capital would be included in the RBC Ratio, but the Board intended that only the non-discounted portion of secondary capital would count in the RBC Ratio. Therefore, in this proposal, the Board is clarifying that only the portion of Grandfathered Secondary Capital and Subordinated Debt that counts as Regulatory Capital would be included in the RBC Ratio.

Currently, the RBC Rule does not specifically include secondary capital or obligations issued by privately insured credit unions that are subordinate to a private insurer in any risk weighting category. As such, secondary capital and obligations issued by privately insured credit unions that are subordinate to a private insurer would be risk weighted at 100 percent under the “(a)ll other assets listed on the statement of financial condition not specifically assigned a different risk weight under this subpart” category.⁵³

The Board is proposing to add a new § 702.104(c)(2)(v)(B)(9) that would assign a 100 percent risk weight to the exposure amount of natural person credit union Subordinated Debt, Grandfathered Secondary Capital, and loans or obligations issued by privately insured credit unions that are subordinate to a private insurer. The Board notes that this proposed change will not result in a different risk weighting than the RBC Rule requires. Given that Grandfathered Secondary Capital, Subordinated Debt, and obligations issued by privately insured credit unions that are subordinate to a private

⁵³ 12 CFR 702.104(c)(2)(v)(C).

insurer are similar instruments that share similar risks, the Board believes it is appropriate to include them in the same risk weighting category.

3. § 702.109 Prompt Corrective Action for “Critically Undercapitalized” Credit Unions.

Section 216(a)(2) of the FCU Act directs the NCUA to take Prompt Corrective Action (PCA) to resolve the problems of credit unions.⁵⁴ The FCU Act indexes various corrective actions to the following five net worth categories:

- Well Capitalized;
- Adequately Capitalized;
- Undercapitalized;
- Significantly Undercapitalized; and
- Critically Undercapitalized.⁵⁵

Credit unions that fail to meet capital measures are subject to increasingly strict limits on their activities. The mandatory and discretionary supervisory actions included

⁵⁴ 12 U.S.C. 1790d(a)(2).

⁵⁵ Id. 1790d(c).

in the current RBC Rule aid in accomplishing PCA's purpose and provide a transparent guide of supervisory actions a credit union can expect as its capital declines.

Section 702.109 of the RBC Rule provides for mandatory and discretionary PCA for "Critically Undercapitalized" credit unions. Among the discretionary actions in § 702.109 is one related to secondary capital. Specifically, current § 702.109(b) states that, beginning 60 days after the effective date of classification of a credit union as "Critically Undercapitalized," the NCUA may prohibit payments of principal, dividends, or interest on the credit union's uninsured secondary capital accounts established after August 7, 2000, except that unpaid dividends or interest shall continue to accrue under the terms of the account to the extent permitted by law.⁵⁶

The Board is proposing to retain the aforementioned discretionary action for Grandfathered Secondary Capital so as not to impact outstanding secondary capital agreements between LICUs and investors. The Board notes, however, that under this proposal the discretionary action, as discussed above, would be mandatory for Subordinated Debt. With this change, the Board intends to provide investors with certainty. As mentioned in section II. (C)(5) of this preamble, a credit union must disclose this mandatory action to all investors. The Board believes including this as a mandatory action will provide credit unions and investors with clear and transparent

⁵⁶ 12 CFR 702.109(b)(11).

regulations regarding the agency's actions in a PCA context regarding Subordinated Debt. The Board notes that the mandatory treatment of this action is also consistent with the OCC's subordinated debt requirements.⁵⁷

4. § 702.205 Prompt Corrective Action for Uncapitalized New Credit Unions.

The Board is proposing to make a technical correction to § 702.205 of the RBC Rule by changing the title of this section from “Mandatory liquidation of uncapitalized New Credit Union” to “Discretionary liquidation of uncapitalized New Credit Union.” The Board notes that the current text of this section states that the NCUA *may* place a New Credit Union into liquidation under § 1787(a)(1)(A) of the FCU Act.⁵⁸ Because the term “may” is discretionary, this proposed change will better align the title of this section with the accompanying text.

5. § 702.206 Revised Business Plans (RBP) for New Credit Unions.

The Board is proposing to delete paragraph (d) of § 702.206 of the RBC Rule, which reads as follows:

⁵⁷ Id. 5.47(d)(3)(ii)(B)(2).

⁵⁸ 12 U.S.C. 1787(a)(1)(A).

Consideration of regulatory capital. To minimize possible long-term losses to the NCUSIF while the credit union takes steps to become “Adequately Capitalized”, the NCUA Board shall, in evaluating an RBP under this section, consider the type and amount of any form of regulatory capital which may become established by NCUA regulation, or authorized by state law and recognized by NCUA, which the credit union holds, but which is not included in its net worth.

This section was intended as a placeholder for the eventual creation of a Subordinated Debt rule. As such, the Board is proposing to delete the text in this section and include a new § 702.207 in the RBC Rule related to the consideration of Subordinated Debt for a New Credit Union. The Board addresses this new section in the following section of this preamble.

6. § 702.207 Consideration of Subordinated Debt for New Credit Unions.

The Board is proposing a new section that would provide an exception from PCA for a New Credit Union that meets specific conditions related to Subordinated Debt. Specifically, under this section a New Credit Union would not be subject to mandatory and discretionary actions under PCA if the New Credit Union has outstanding Subordinated Debt that would be treated as Regulatory Capital if the credit union were a Complex Credit Union or a LICU. The Board notes that, to qualify for this proposed exception, a New Credit Union would have to have a Net Worth Ratio of at least

one percent and issue Subordinated Debt in accordance with the requirements of proposed subpart D.

As discussed in section II. (C)(3) of this preamble, a non-LICU New Credit Union may only issue Subordinated Debt if, at the time of issuance, it has retained earnings of at least one percent of total assets. Further, under this proposal, the NCUA would only consider, for purposes of this exception, the non-discounted portion of any issued Subordinated Debt. Finally, to qualify for this exception, the Board is proposing to require the ratio of the New Credit Union's Net Worth, plus its outstanding Subordinated Debt, to its total assets be at least seven percent.

To avail itself of relief from PCA under this section, a New Credit Union would also be required to increase its Net Worth in a manner consistent with the New Credit Union's approved initial business plan or revised business plan. The Board believes the proposed rule allows a New Credit Union to use Subordinated Debt in a manner that allows the credit union to avoid PCA while maintaining a sufficient buffer between losses and the NCUSIF.

Even if a New Credit Union meets the foregoing criteria, the proposed rule reserves the Board's authority to impose PCA on a New Credit Union in delineated circumstances. These circumstances include where a New Credit Union is operating in an unsafe or unsound manner or has not corrected a material unsafe and unsound condition that it was, or should have been, aware of. However, the Board would only

impose PCA in these circumstances after providing a New Credit Union with written notice and opportunity for hearing pursuant to § 747.2003 of the NCUA's regulations.

For FISCUs, the Board is also proposing to include a requirement that the NCUA consult and seek to work cooperatively with the appropriate state supervisory authority (SSA) before invoking the reservation to impose PCA. The Board believes this reservation of rights will allow the NCUA to quickly and appropriately address unsafe or unsound conditions in a New Credit Union, regardless of whether the New Credit Union has issued Subordinated Debt.

In addition, the Board is proposing to prohibit delegation of its authority to take PCA against a New Credit Union that would otherwise qualify for an exemption from PCA because of its issuance of Subordinated Debt. The Board is proposing to retain such authority because such action could have a direct and material impact to the NCUSIF and the subject New Credit Union. This proposed non-delegation provision is similar to others related to PCA in the RBC Rule.

The Board is also proposing to include in this section a statement that the NCUA will consider any outstanding Subordinated Debt issued by a New Credit Union in evaluating the credit union's revised business plan. Because Subordinated Debt acts as buffer between losses sustained by a credit union and the NCUSIF, the Board believes this change prudently allows New Credit Unions to avail themselves of the benefits of issuing Subordinated Debt while maintaining the safety and soundness of the NCUSIF.

Finally, the Board is proposing to include a provision that allows the Board to liquidate a New Credit Union under § 1787(a)(3)(A) of the FCU Act, provided that a New Credit Union's Net Worth Ratio *plus* outstanding Subordinated Debt that has been issued by that New Credit Union and that counts as Regulatory Capital is, as of the applicable date of determination, below six percent and the New Credit Union has no reasonable prospect of becoming "Adequately Capitalized." The Board believes it is prudent to include procedures whereby the Board can address a New Credit Union that does not have a reasonable prospect of being "Adequately Capitalized."

The Board notes that, while Subordinated Debt can be a helpful tool for credit unions to meet their capital requirements, it believes that a credit union's business model should not rely too heavily on the issuance of Subordinated Debt. As such, this proposed provision supports the Board in fulfilling its statutory mandate of protecting the NCUSIF if a credit union has no reasonable prospect of becoming "Adequately Capitalized" without giving effect to any Subordinated Debt issued by that credit union, and is failing to reach even marginal levels of capitalization with Subordinated Debt.

**C. SUBPART D—SUBORDINATED DEBT, GRANDFATHERED
SECONDARY CAPITAL, AND REGULATORY CAPITAL.**

1. § 702.401 Purpose and Scope.

This proposed section sets out the general purpose of subpart D of part 702. As discussed in more detail below, this section of the proposal also addresses the authority

for FISCUs to issue Subordinated Debt and the treatment of Grandfathered Secondary Capital.

With respect to FISCUs, the Board proposes to clarify that the requirements of proposed subpart D of part 702 would apply to FISCUs, but only to the extent FISCUs are permitted by applicable state law or regulation to issue debt securities of the type contemplated by this rule. That is, under this proposal, a FISCU may only issue Subordinated Debt if such issuance is permissible under its applicable state law. To the extent that a FISCU's state law is more restrictive than this proposed rule, the FISCU would be required to follow that state law.

With respect to secondary capital, the Board proposes to address in this section of the proposal both the treatment of outstanding Grandfathered Secondary Capital and the treatment of secondary capital issued in the form of Subordinated Debt after the effective date of a final Subordinated Debt rule.

With respect to any Grandfathered Secondary Capital, the Board is proposing to allow such Grandfathered Secondary Capital to continue to be governed by the regulatory requirements under which it was issued. For ease of reference, the Board is proposing to relocate subsections (b)-(d) and Appendix A of the Current Secondary Capital Rule to a new § 702.414. As discussed in section II. (C)(14) of this preamble, this new section would include all of the requirements in the Current Secondary Capital Rule, but would make clear that LICUs are not permitted to conduct new issuances under proposed § 702.414.

The Board is also proposing to prohibit Grandfathered Secondary Capital from receiving Regulatory Capital treatment as of 20 years from the effective date of a final Subordinated Debt rule. The Board notes that this proposed requirement would prevent Grandfathered Secondary Capital from perpetually receiving such grandfathered treatment. The Board believes 20 years would provide a LICU sufficient time to replace Grandfathered Secondary Capital with Subordinated Debt if such LICU seeks continued Regulatory Capital benefits of Subordinated Debt. The Board believes it is important to strike a balance between transitioning issuers of Grandfathered Secondary Capital to this proposed rule and ensuring that instruments do not indefinitely remain as Grandfathered Secondary Capital. The Board believes the structure of the proposed grandfather provision achieves this balance without unnecessarily disrupting the operations of LICUs, investors, and any outstanding secondary capital agreements.

Finally, the Board is also clarifying that this proposed rule would treat as Subordinated Debt all secondary capital issued after the effective date of a final Subordinated Debt rule. As such, any post-effective date application and/or issuance of secondary capital by a LICU would be subject to the requirements of this rule (except § 702.414, which, as noted above, only applies to Grandfathered Secondary Capital). As discussed above, this change would not alter the ability of a LICU to include Subordinated Debt in its Net Worth, the same way a LICU currently includes secondary capital in its Net Worth.

2. § 702.402 Definitions.

This section contains proposed definitions to subpart D of 702. However, subpart D references some terms referenced elsewhere in the regulations. Therefore, for consistency purposes, the Board is proposing to cross-reference definitions of terms found elsewhere in the NCUA’s regulations as follows:

Cross-Referenced Term	Definition
<i>Complex Credit Union</i>	The proposed rule defines the term as having the same meaning as in subpart A of part 702, as amended by the Board on November 6, 2018. ⁵⁹
<i>Grandfathered Secondary Capital</i>	The proposed rule defines the term as any subordinated debt issued in accordance with current § 701.34 before [INSERT THE EFFECTIVE DATE OF THIS REGULATION].
<i>Net Worth</i>	The proposed rule defines the term as having the same meaning as in § 702.2.
<i>Net Worth Ratio</i>	The proposed rule defines the term as having the same meaning as in § 702.2.
<i>New Credit Union</i>	The proposed rule defines the term as having the same meaning as in § 702.201, as amended by the Board on October 29, 2015. ⁶⁰

⁵⁹ 83 FR 55467. (Nov. 6, 2018).

⁶⁰ 80 FR 66625. (Oct. 29, 2015).

<i>Risk-based Capital (RBC) Ratio</i>	The proposed rule defines the term as having the same meaning as in § 702.2 as amended by the Board on October 29, 2015. ⁶¹
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In addition to the cross-referenced terms, the Board is proposing to define the following terms:

Accredited Investor. The proposed rule defines “Accredited Investor” as any Natural Person Accredited Investor or any Entity Accredited Investor, as applicable. The Board is aware that the SEC has recently published a proposed rule amending the definition of “accredited investor.” The Board will evaluate any final rule issued by the SEC and make changes to a final Subordinated Debt rule accordingly. Such changes may include substituting specific cross references contained in the definitions of Entity Accredited Investor and Natural Person Accredited Investor with a more general cross reference. In addition, the Board may opt to include a reference to sample accredited investor forms, rather than include such form in the rule, as the Board is proposing to do so in §702.406 of this proposal.

Appropriate Supervision Office. The proposed rule defines the term “Appropriate Supervision Office” as, with respect to any credit union, the Regional Office or Office of National Examinations and Supervision that is responsible for supervision of that credit

⁶¹ Id.

union. By doing so, it provides the Board flexibility in delegating the responsible office, which may change as a reflection of organization changes within the NCUA.

Entity Accredited Investor. The proposed rule defines the term “Entity Accredited Investor” as an entity that, at the time of offering and sale of Subordinated Debt to that entity, meets the requirements of 17 CFR §§ 230.501(a)(1), (2), (3), (7), or (8), which generally are the requirements applicable to corporate or trust entities and not natural persons.

Immediate Family Member. The proposed rule defines “Immediate Family Member” as a spouse, child, sibling, parent, grandparent, or grandchild (including stepparents, stepchildren, stepsiblings, and adoptive relationships). The proposed term is intended to be consistent with the definition found in the NCUA’s regulations.⁶²

Issuing Credit Union. For the purposes of this subpart D of part 702, the proposed rule defines “Issuing Credit Union” as a credit union that has issued, or is in the process of issuing, Subordinated Debt or Grandfathered Secondary Capital in accordance

⁶² Appendix A to 12 CFR part 701, Article XVIII, § 1.

with the requirements of this proposed rule. The definition is consistent with the term used by OCC's regulations.⁶³

Low-Income Designated Credit Union (LICU). The proposed rule defines the term "Low-Income Credit Union" as a credit union designated as having low-income status in accordance with § 701.34 of this chapter. This definition is consistent with references to LICUs in the FCU Act as, "a credit union that serves predominantly low-income members."⁶⁴

Natural Person Accredited Investor. The proposed rule defines the term "Natural Person Accredited Investor" as a natural person who, at the time of offering and closing of the issuance and sale of Subordinated Debt to that person, meets the requirements of 17 CFR § 230.501(a)(5) or (6), which generally are the requirements applicable to natural persons and not corporate or trust entities; *provided* that, for purposes of purchasing or holding any Subordinated Debt Note, this term shall not include any board member or Senior Executive Officer, or any Immediate Family Member of any board member or Senior Executive Officer, of the Issuing Credit Union.

⁶³ OFFICE OF THE COMPTROLLER OF THE CURRENCY, COMPTROLLER'S Licensing Manual: Subordinated Debt (2017), available at <https://www.occ.gov/publications-and-resources/publications/comptrollers-licensing-manual/files/licensing-booklet-subordinated-debt.html>. Per the OCC's Comptroller's Licensing Manual for Subordinated Debt, the bank issuing subordinated debt is referred to as the "issuing bank."

⁶⁴ 12 U.S.C.1752(5); 1757a(b)(2)(A),); 1757a(c)(2)(B).

Offering Document. The proposed rule defines the term “Offering Document” as the document(s) required by proposed § 702.408, including any term sheet, offering memorandum, private placement memorandum, offering circular, or other similar document used to offer and sell Subordinated Debt Notes.

Pro Forma Financial Statements means projected financial statements that show the effects of proposed transactions as if they actually occurred in a variety of plausible scenarios, including both optimistic and pessimistic assumptions, over measurement horizons that align with the credit union’s expected activities. For consistency, this term as defined here is consistent with the *Evaluating Secondary Capital Plans* supervisory guidance issued by the Board on September 16, 2019.⁶⁵

Qualified Counsel. The proposed rule defines the term “qualified counsel” as an attorney licensed to practice law in the relevant jurisdiction(s) who has expertise in the areas of federal and state securities laws and debt transactions of the type contemplated by the proposed rule. The Board believes that credit unions need to engage legal counsel that has the requisite experience and expertise to represent the credit union in all aspects of a Subordinated Debt transaction.

Regulatory Capital. The proposed rule defines the term “Regulatory Capital” as (i) with respect to an Issuing Credit Union that is a LICU and not a Complex Credit

⁶⁵ Supervisory Letter No. 19-01, September (Sept. 16, 2019), available at <https://www.ncua.gov/files/supervisory-letters/SL-19-01-evaluating-secondary-capital-plans.pdf>.

Union, the aggregate outstanding principal amount of Subordinated Debt and, until [INSERT 20 YEARS AFTER THE DATE OF THE FINAL SUBORDINATED DEBT RULE], Grandfathered Secondary Capital that is included in the credit union's Net Worth Ratio; (ii) with respect to an Issuing Credit Union that is a Complex Credit Union and not a LICU, the aggregate outstanding principal amount of Subordinated Debt that is included in the credit union's RBC Ratio; (iii) with respect to an Issuing Credit Union that is both a LICU and a Complex Credit Union, the aggregate outstanding principal amount of Subordinated Debt and, until [INSERT 20 YEARS AFTER THE DATE OF THE FINAL SUBORDINATED DEBT RULE], Grandfathered Secondary Capital that is included in its Net Worth Ratio and in its RBC Ratio; and (iv) with respect to a New Credit Union, the aggregate outstanding principal amount of Subordinated Debt and, until [INSERT 20 YEARS AFTER THE DATE OF THE FINAL SUBORDINATED DEBT RULE], Grandfathered Secondary Capital that is considered pursuant to proposed § 702.207. This definition reflects the expanded eligibility of credit unions that may count Subordinated Debt as Regulatory Capital.

Retained Earnings. The proposed rule defines the term "Retained Earnings" as in U.S. GAAP. The definition is consistent with the FCU Act, which defines Net Worth, in part, as a credit union's Retained Earnings balance under U.S. GAAP.⁶⁶ Additionally,

⁶⁶ 12 U.S.C. 1757a(c)(2)(A).

according to § 202 of the FCU Act, a credit union’s statement of financial condition is generally to be reported consistent with U.S. GAAP.⁶⁷

Senior Executive Officer. The proposed rule defines the term “Senior Executive Officer” as a credit union’s chief executive officer (for example, president or treasurer/manager), any assistant chief executive officer (for example, any assistant president, any vice president or any assistant treasurer/manager) and the chief financial officer (controller). The term Senior Executive Officer also includes employees and contractors of an entity, such as a consulting firm, hired to perform the functions of positions covered by the term Senior Executive Officer. For consistency, this term as defined here is consistent with § 701.14(b)(2) of the NCUA’s regulations.

*Subordinated Debt.*⁶⁸ The proposed rule would define “Subordinated Debt” as an Issuing Credit Union’s borrowing that meets the requirements of this proposed rule, including all obligations and contracts related to such borrowing.

3. § 702.403 Eligibility.

Currently, § 701.34 allows only LICUs to issue Secondary Capital. The proposed rule increases the current eligibility beyond LICUs in § 701.34(b) to also include Non-

⁶⁷ Id. 1782(a)(6)(C)(i). This section of the FCU Act, provides a de minimus exception for following U.S. GAAP for credit unions with assets less than \$10,000,000 unless prescribed by the Board or the appropriate SSA.

⁶⁸ Secondary capital issued by LICUs after [INSERT EFFECTIVE DATE OF RULE] would be considered Subordinated Debt.

LICU Complex Credit Unions and New Credit Unions. The Board is also proposing to grant eligibility to credit unions that anticipate being designated as a LICU or Non-LICU Complex Credit Union within 24 months following their planned issuance of the Subordinated Debt. The Board believes these proposed changes will allow additional credit unions to issue Subordinated Debt that would count as Regulatory Capital, which could aid these credit unions in complying with the PCA requirements in the FCU Act and the NCUA's regulations.

Under this proposed rule, all eligible credit unions, regardless of designation type, are required to submit an initial application for preapproval under § 702.408 of this section.

LICU Eligibility

Consistent with the FCU Act and the Current Secondary Capital Rule, the Board is proposing to maintain a LICU's authority to seek the NCUA's approval to issue Subordinated Debt. As of June 30, 2019, credit unions with a LICU designation represented 49 percent of all federally insured credit unions with total assets of \$628 billion or 41 percent of the total federally insured credit union assets.

Non-LICU Eligibility

For the first time, the Board is proposing that the following categories of non-LICUs would generally be eligible to issue Subordinated Debt:

(1) Complex Credit Unions

Under this proposed rule, a non-LICU Complex Credit Union must have a capital classification of at least “Undercapitalized,” as defined in the NCUA’s capital standards,⁶⁹ to be eligible to issue Subordinated Debt. The Board also notes that, under this proposed rule, the aggregate outstanding amount of Subordinated Debt issued by a non-LICU Complex Credit union may not exceed 100 percent of its Net Worth,⁷⁰ as determined at the time of each issuance of Subordinated Debt. The Board is proposing this limit so that the non-LICU Complex Credit Union’s regulatory capital is not primarily composed of Subordinated Debt, a lower quality form of capital. This approach is generally consistent with the Tier 1 and Tier 2 capital requirements for banks.

(2) New Credit Unions

The Board is proposing that all New Credit Unions, not just those that are a LICU, may be eligible to issue Subordinated Debt pending an NCUA-approved application as described in §§ 702.408 and 702.409. A “New Credit Union” means a federally insured credit union that has been both in operation

⁶⁹ See 12 CFR 702.102.

⁷⁰ See proposed 702.403(c) of the proposed rule.

for less than ten years *and* has \$10 million or less in total assets.⁷¹ For purposes of this proposed rule, a New Credit Union may be a LICU or a non-LICU. The Board is proposing that a non-LICU New Credit Union have Retained Earnings equal to or greater than one percent of total assets to be eligible to issue Subordinated Debt. This provision is included to ensure the non-LICU New Credit Union has some level of loss-absorbing capacity before any deficit in Retained Earnings would be charged against the Subordinated Debt.

(3) Credit unions that anticipate becoming a Complex Credit Union or LICU within 24 months of issuance

In certain circumstances, the Board is proposing to extend eligibility for Subordinated Debt issuance to a credit union that does not meet the eligibility criteria currently, but has a reasonable likelihood of doing so in the near future. Under this proposal, an ineligible credit union that can demonstrate through an acceptable pro forma analysis that it is reasonably projected to become eligible within 24 months after issuance (that is, expects to become a non-LICU Complex Credit Union or a LICU within that timeframe) can obtain approval as well. Pro forma analysis should include projections of expected earnings and growth in a variety of plausible scenarios that, at a minimum include the required 24-month measurement horizon. Aspiring credit unions are also subject to the requirements of §§ 702.408 and 702.409 for preapproval and must include

⁷¹ 12 CFR 702.2.

in their applications documents to evidence how they will successfully become a LICU (see § 701.34(a) requirements) or a Complex Credit Union within the 24-month period immediately following a planned issuance. The Board is providing this flexibility for aspiring credit unions that may consider Subordinated Debt as a potential source of funding within the required timeframe to support future growth while increasing Regulatory Capital.

FISCU Eligibility

A FISCU's authority to issue Subordinated Debt, if any, is set forth in applicable state law and regulation. Such state laws may be narrower or broader than those for FCUs. However, to the extent a FISCU may issue Subordinated Debt under applicable state law and regulation, it would be bound by proposed § 741.226.

Prohibition on Issuing and Investing in Subordinated Debt

For the reasons discussed in sections II. (A)(1) and II. (B)(3) of this preamble, the Board is proposing to prohibit, except in limited circumstances, a credit union from both issuing and investing in Subordinated Debt.

At the time of issuance of any Subordinated Debt, an Issuing Credit Union may not have any investments, direct or indirect, in Subordinated Debt or Grandfathered Secondary Capital (or any interest therein) of another credit union. If a credit union acquires Subordinated Debt or Grandfathered Secondary Capital in a merger or other consolidation, the Issuing Credit Union may still issue Subordinated Debt, but it may not

invest (directly or indirectly) in the Subordinated Debt or Grandfathered Secondary Capital of any other credit union while any Subordinated Debt Notes issued by the Issuing Credit Union remain outstanding.

4. § 702.404 Requirements of the Subordinated Debt and Subordinated Debt Notes.

The Current Secondary Capital Rule allows LICUs to issue secondary capital to “non-natural person members and non-natural person nonmembers.”⁷² Under the Current Secondary Capital Rule, a secondary capital account must:

- Be in the form of a written contract;
- Be an uninsured, non-share account;
- Have a minimum maturity of five years;
- Not be insured by the NCUSIF;
- Be subordinate to all other claims;
- Not be pledged or provided by the account investor as security on a loan or other obligation with the LICU or any other party;

⁷² Id 701.34(b).

- Be available to cover operating losses realized by the LICU that exceed its net available reserves, and to the extent funds are so used, the LICU must not restore or replenish the account under any circumstances. Losses must be distributed pro-rata among all Secondary Capital accounts held by the LICU at the time the losses are realized; and
- Be recorded as an equity account entitled uninsured Secondary Capital account.

Subordinated Debt Note Requirements

The Board is proposing changes to the requirements of the Current Secondary Capital Rule. The proposed changes include additional requirements to help ensure the Subordinated Debt Notes are clearly issued as debt, rather than equity, pursuant to the authority in the FCU Act for an FCU to borrow from any source.⁷³ Due to the cooperative structure of credit unions, and the members' rights to govern the affairs of them, FCUs do not have the authority to issue equity instruments. Therefore, it is essential for Subordinated Debt issued by FCUs to be considered debt rather than equity.

The Board notes that FISCUs may not be restricted under applicable state law and regulation to issuing only debt instruments. However, the Board is proposing that the debt requirement apply to both FCUs and FISCUs at this time. As insurer, the Board believes that the framework for the types of instruments that would qualify for

⁷³ 12 U.S.C. 1757(9).

Regulatory Capital should be consistent for all credit unions. The Board is requesting comments as to whether the NCUA should allow instruments other than debt instruments for FISCUs. If so, what specific instruments, including a detailed description, should be allowed?⁷⁴

As part of the Subordinated Debt Note requirements, the Board is proposing to require that a Subordinated Debt Note be in the form of a written debt agreement. This requirement aligns with requirements in debt transactions of the type contemplated by this rule, which typically require written debt agreements.

Under the proposed rule, Subordinated Debt Notes must, at the time of issuance, have a fixed stated maturity of at least five years but no more than twenty years from issuance. The Current Secondary Capital Rule requires the Secondary Capital account to have a minimum maturity of five years, but does not have a maximum. A minimum maturity of five years is proposed, as it should create sufficient stability and longevity within a credit union's capital base to be available to cover losses. The Board is proposing the maximum maturity of 20 years to help ensure the Subordinated Debt is properly characterized as debt rather than equity. Generally, by its nature, debt has a stated maturity, whereas equity does not. The proposal is consistent with the OCC's subordinated debt regulation for a minimum maturity of five years, although that regulation does not have a maximum.⁷⁵ Because U.S. national banks can issue equity,

⁷⁴ Instruments to be considered must be permissible under applicable state law.

⁷⁵ 12 CFR 5.47(d)(1)(i).

the distinction of a debt versus equity characterization for subordinated debt under the OCC's regulations is not as critical as it is for FCUs.

Under proposed § 709.5(b), the Board is proposing that an Issuing Credit Union's Subordinated Debt be subordinate to all other claims in liquidation and have the same payout priority as all other Subordinated Debt, including Grandfathered Secondary Capital issued by the Issuing Credit Union. This proposed provision is substantially similar to the Current Secondary Capital Rule and the OCC's subordinated debt regulations. The FCU Act requires secondary capital accounts to be subordinate to all other claims against the Issuing Credit Union.⁷⁶ Further, the Board is not proposing a separate class for Subordinated Debt issued by non-LICU Complex Credit Unions or non-LICU New Credit Unions at this time.

The Board is proposing that any Subordinated Debt Note must be unsecured. This provision is consistent with the OCC's subordinated debt regulations,⁷⁷ and is not required in the Current Secondary Capital Rule. The Board is proposing this requirement because allowing arrangements that legally or economically secure Subordinated Debt would enhance the seniority of the Subordinated Debt in the event of liquidation of a credit union, which would be contrary to the proposed "subordinate to all other claims" requirement and the FCU Act, as discussed above. Additionally, if the Subordinated Debt Notes were secured by an asset of the Issuing Credit Union, it may interfere with

⁷⁶ See 12 U.S.C. 1757a(c)(2)(B)(ii); 1790d(o)(2)(C)(ii).

⁷⁷ 12 CFR 5.47(d)(iv).

the Issuing Credit Union's operations as it forces the Issuing Credit Union to direct assets or resources to secure the Subordinated Debt Note.

The proposed rule also prohibits two specific arrangements which, from an economic standpoint, would effectively act as a security arrangement for Subordinated Debt: (1) a sinking fund,⁷⁸ and (2) a compensating balance or any other funds or assets subject to a legal right of offset, as defined by applicable state law.⁷⁹ These arrangements, in essence, create a secured arrangement from an economic standpoint between the investor and Issuing Credit Union. In the event of the Issuing Credit Union's liquidation, these arrangements would function like collateral and be applied to the obligations of the Subordinated Debt. As a result, the Subordinated Debt Note could, in essence, become senior in right of payment to other credit obligations, thus limiting its ability to absorb losses and protect the NCUSIF.

The Board is proposing that, at the end of each of its fiscal years (or more frequently as determined by the Issuing Credit Union), the Issuing Credit Union must apply its issued Subordinated Debt to cover any deficit in Retained Earnings on a pro rata basis among all holders of the Subordinated Debt and Grandfathered Secondary Capital of the Issuing Credit Union. While this is similar to the Current Secondary Capital Rule, it clarifies the frequency and timing of applying the Subordinated Debt to credit union

⁷⁸ An example of a sinking fund arrangement is one that would require an FCU to periodically put aside money for the gradual repayment of the subordinated debt.

⁷⁹ An example of a compensating balance arrangement is where the investor would require an FCU to maintain a minimum balance in a bank account during the term of the debt.

losses, thus providing more transparency to investors of Subordinated Debt. The current rule is silent on the timing and frequency of applying Secondary Capital to credit union losses.

The Board is proposing that, except for approved prepayments discussed in sections II. (C)(11) and (12) of this preamble, the Subordinated Debt Note must be payable in full only at maturity. The Board is proposing this new provision to clarify that Subordinated Debt can only be prepaid with prior written approval from the NCUA as discussed in section II. (C)(11) of this preamble. While the Current Secondary Capital Rule does not include this provision, it does require the NCUA's approval to prepay secondary capital that no longer counts towards the credit union's Regulatory Capital.⁸⁰ As such, this provision would not impose additional burden on credit unions.

The Board is proposing to require disclosure by the Issuing Credit Union of any prepayment penalties or restrictions on prepayment of a Subordinated Debt Note. While the Current Secondary Capital Rule does not contain this restriction, the Board believes this proposed requirement provides additional protection and transparency for Subordinated Debt Note investors.

The Board is proposing changes to the permissible investors for Subordinated Debt. The proposed rule expands a credit union's current authority by allowing Subordinated Debt to be issued to Natural Person Accredited Investors and Entity

⁸⁰ 12 CFR 701.34(d).

Accredited Investors, except that no board member or Senior Executive Officer, and no Immediate Family Member of such board member or Senior Executive Officer, of the Issuing Credit Union may purchase or hold any Subordinated Debt Note issued by that Issuing Credit Union.

Under the proposed rule, Accredited Investors would be required to attest to their accredited status using a form that is substantially similar to the form contained in proposed § 702.406(c). This provision helps Issuing Credit Unions with their obligations to limit offers and sales of their Subordinated Debt Notes to qualified Accredited Investors.

Subordinated Debt Restrictions

The restrictions section of the proposed rule adds provisions similar to those found in the OCC's subordinated debt rule,⁸¹ and also include provisions found in the Current Secondary Capital Rule. In general, these provisions are necessary to avoid undue restrictions on a credit union's authority or ability to manage itself in a safe and sound manner, ensure the Subordinated Debt is characterized as debt in accordance with U.S. GAAP, and prevent agreements that would interfere with the NCUA's supervision of credit unions.

⁸¹ Id.5.47.

The Board is proposing a restriction that no Subordinated Debt or Subordinated Debt Note be insured by the NCUA. This provision is consistent with the Current Secondary Capital Rule, which requires secondary capital accounts to be uninsured per the FCU Act.⁸² Similarly, the OCC's subordinated debt regulations require that subordinated debt issued by national banks or federal savings associations not be insured by the FDIC.⁸³ One benefit of Subordinated Debt that counts as Regulatory Capital is that it acts as a buffer to protect the depositors at a credit union as well as the NCUSIF. To allow Subordinated Debt to be insured by the NCUA would be contrary to this benefit and the payout priorities discussed previously in this section and in section II. (D)(1) of this preamble.

The Board is proposing a restriction that the Subordinated Debt Note not include any express or implied terms that make it senior to any other Subordinated Debt or Grandfathered Secondary Capital. The Current Secondary Capital Rule contains a condition that Secondary Capital accounts are subordinate to all other claims. Similarly, the OCC's subordinated debt regulations require subordinated debt issued by national banks or federal savings associations to be subordinate to all depositors.⁸⁴ The proposed restriction clarifies the Current Secondary Capital Rule's intent by not allowing any

⁸² 12 U.S.C. 1757a(c)(2)(B)(ii); 1790d(o)(2)(C)(ii).

⁸³ 12 CFR 5.47(d)(ii).

⁸⁴ Id. 5.47(d)(1).

express or implied terms that may be contrary to the proposed requirement that Subordinated Debt be subordinate to all other claims as discussed earlier in this section.

The Board is proposing a restriction that the issuance of Subordinated Debt may not cause a credit union to exceed the borrowing limit in § 701.38 for FCUs or, for a FISCU, any more restrictive state borrowing limit. While this restriction is not explicit in the Current Secondary Capital Rule, the borrowing limit is not a new regulation and the restriction currently applies to the issuance of secondary capital. The Board is proposing to include this provision to clarify that the borrowing limit does apply to Subordinated Debt issuances as they are considered borrowings for the Issuing Credit Union.

The Board is proposing a new restriction not found in the Current Secondary Capital Rule that the Subordinated Debt Note not provide the investor with any management or voting rights in the Issuing Credit Union. To allow management or voting rights for Subordinated Debt investors would lead to some loss of control of the credit union by the credit union's board. Per the FCU Act, "the management of a Federal credit union shall be by a board of directors, a supervisory committee, and where the bylaws so provide, a credit committee."⁸⁵ Further, the FCU Act states the board of directors "shall have the general direction and control of the affairs of the Federal credit

⁸⁵ 12 U.S.C. 1761(a).

union.”⁸⁶ Therefore, allowing Subordinated Debt investors to have some control of the Issuing Credit Union would be contrary to requirements of the FCU Act.

The Board is proposing that Subordinated Debt Notes not be eligible to be pledged or provided by the investor as security for a loan from or other obligation owing to the Issuing Credit Union. This provision is consistent with the Current Secondary Capital Rule⁸⁷ and the OCC’s subordinated debt regulations.⁸⁸ Allowing such a transaction with the Subordinated Debt Note as collateral would result in the Issuing Credit Union loaning funds to the investor secured by debt owed by the Issuing Credit Union to the investor. As a result, such an arrangement does not provide a risk mitigation benefit to an Issuing Credit Union.

The Board is proposing a restriction that the Subordinated Debt Note may not include any term or condition that would require a credit union to prepay or accelerate payment of principal or interest. This provision is not in the Current Secondary Capital Rule, but is consistent with the OCC’s subordinated debt regulations.⁸⁹ The Current Secondary Capital Rule and this proposal both require preapproval to pay Grandfathered Secondary Capital or Subordinated Debt prior to maturity as discussed in section II. (C)(11) of this preamble. Therefore, including such a term or condition in the

⁸⁶ Id. 1761b.

⁸⁷ 12 CFR 701.34(b)(8).

⁸⁸ Id. 5.47(d)(1)(v).

⁸⁹ Id. 5.47(d)(1)(vii).

Subordinated Debt Note may place a credit union in default should the NCUA not approve a request to prepay.

The Board is proposing a restriction that a Subordinated Debt Note not include a term or condition that would trigger an event of default based on the credit union's default on other debts. This provision is not in the Current Secondary Capital Rule and the OCC's subordinated debt regulations do not specifically address this provision. However, the OCC's Comptroller's Licensing Manual for Subordinated Debt⁹⁰ includes an example of a reasonable default trigger as one where the trigger is based on the bank having defaulted on other debts, but it includes a threshold for the amount of defaulted debt, such as a certain percent of capital. The Board is seeking comment on whether it should include a threshold trigger, rather than restrict all defaults based on a credit union's default on other debts (and, if so, what the threshold should be).

The Board is proposing that the terms of a Subordinated Debt Note may not require the credit union to make any form of payment other than in cash. A similar provision is not in the Current Secondary Capital Rule. However, the Board believes this provision is appropriate, as to allow other forms of payment that may not be liquid or may have price volatility (for example, foreign currency) results in an Issuing Credit Union taking on more risk.

⁹⁰ OFFICE OF THE COMPTROLLER OF THE CURRENCY, COMPTROLLER'S LICENSING MANUAL: SUBORDINATED DEBT (2017), available at <https://www.occ.gov/publications-and-resources/publications/comptrollers-licensing-manual/files/licensing-booklet-subordinated-debt.html>.

Negative Covenant Provisions

Similar to the section above, the Board has added a negative covenants⁹¹ section. This section includes requirements similar to the OCC's subordinated debt regulations.⁹² Should a credit union agree to such provisions, the NCUA would consider the practice unsafe and unsound, for the reasons discussed below. Further, these provisions, if agreed to, could potentially interfere with the NCUA's supervision of a credit union.

The Board is proposing that a Subordinated Debt Note may not contain covenants that require an Issuing Credit Union to maintain a minimum amount of Retained Earnings or other financial performance provision. Although the Current Secondary Capital Rule does not contain this prohibition, this requirement is consistent with the OCC's subordinated debt regulations.⁹³ To require a credit union to maintain a minimum amount of Retained Earnings or other financial performance provision could impede the operations of the credit or cause the credit union to take on excessive risk to maintain this requirement and avoid default.

The Board proposes to prohibit covenants that unreasonably restrict an Issuing Credit Union's ability to raise capital through issuance of additional Subordinated Debt. This new provision is consistent with the OCC's Subordinated Debt regulations.⁹⁴ The

⁹¹ A "negative covenant" is a clause found in loan agreements that prohibits a borrower from an activity.

⁹² 12 CFR 5.47(d).

⁹³ Id. 5.47(d)(2)(i).

⁹⁴ Id. 5.47(d)(2)(ii).

ability to issue Subordinated Debt provides eligible credit unions a long-term, stable source of funding for expansion and the coverage of losses. Therefore, such a covenant could impede operations and the financial well-being of the Issuing Credit Union and would be considered unsafe and unsound.

The Board is proposing prohibiting covenants that provide for default of Subordinated Debt as a result of an Issuing Credit Union's compliance with any law, regulation, or supervisory directive from the NCUA (or SSA, if applicable). The Board believes it is unsafe and unsound to allow such a covenant, as it would hamper the NCUA's or SSA's ability to effectively supervise the credit union or subject the credit union to escalated administrative actions for failure to follow a directive to avoid default on the Subordinated Debt. Further, it could potentially cause monetary fines against the credit union from failure to follow a law or regulation in order to avoid default.

The Board is proposing a new provision which would prohibit covenants that provide for default of the Subordinated Debt as the result of a change in the ownership, management, or organizational structure, or charter of an Issuing Credit Union provided that the Issuing Credit Union or resulting institution, as applicable:

- Following such change, agrees to perform all obligations, terms, and conditions of the Subordinated Debt; and

- At the time of such change, is not in material default of any provision of the Subordinated Debt Note, after giving effect to the applicable cure period of not less than 30 calendar days.

The proposed prohibition is substantially similar to the OCC's subordinated debt regulations.⁹⁵ Change in management or organizational structure or charter of the Issuing Credit Union should have no impact on the Subordinated Debt as it would still be an obligation of the Issuing Credit Union under these circumstances. Further, to allow such a provision would provide a level of control to the investor over the affairs of the Issuing Credit Union. This would be contrary to the proposed Subordinated Debt restriction on allowing the investor with any management or voting rights in the Issuing Credit Union discussed earlier in this section.

Additionally, in the case of a merger, as discussed in section II. (C)(12) of the preamble, the Board is proposing that Subordinated Debt can be assumed by the continuing credit union. However, whether the Subordinated Debt counts as Regulatory Capital would still be based on the continuing credit union's eligibility as discussed in section II. (C)(3) of this preamble.

The Board is proposing a new provision that prohibits covenants that provide for default of the Subordinated Debt as the result of an act or omission of any third party. The Board believes that agreeing to such a provision would be unsafe and unsound for an

⁹⁵ 12 CFR 5.47(d)(2)(iii).

Issuing Credit Union. While credit unions are expected to perform due diligence over third parties utilized, a credit union does not control the acts or omissions of the third parties. As such, it is not a reasonable expectation for the actions of a third party to trigger default or acceleration of payment of the Subordinated Debt.

Default Covenants

The Board is proposing that Subordinated Debt Notes that include default covenants must provide the Issuing Credit Union with a reasonable cure period of not less than 30 calendar days. This new provision provides protection for Issuing Credit Unions by ensuring a reasonable cure period in the event of default. Further, this provision is consistent with the guidance issued by the OCC.⁹⁶

Minimum Denominations

In order to provide additional protections to purchasers of Subordinated Debt Notes who are Natural Person Accredited Investors, the Board is proposing that Subordinated Debt Notes sold or transferred to Natural Person Accredited Investors be made in minimum denominations of \$100,000. In addition, resales of Subordinated Debt Notes to Natural Person Accredited Investors could only be made in minimum

⁹⁶ OFFICE OF THE COMPTROLLER OF THE CURRENCY, COMPTROLLER'S LICENSING MANUAL: SUBORDINATED DEBT, 19 (2017), available at <https://www.occ.gov/publications-and-resources/publications/comptrollers-licensing-manual/files/licensing-booklet-subordinated-debt.html> (stating that "a bank should have a reasonable opportunity to cure the default.").

denominations of \$10,000. Requiring larger denomination notes, and preventing them from being broken into smaller denominations helps ensure that the purchasers of the Subordinated Debt Notes are sophisticated, high net worth individuals.

The Board notes that an Issuing Credit Union may establish a larger minimum denomination for any issue of Subordinated Debt Notes sold to Natural Person Accredited Investors, as long as any such minimum denominations are adequately disclosed to potential investors and reflected in the related transaction documents. Under the proposed rule, there would be no minimum denomination requirements for Subordinated Debt Notes sold to Entity Accredited Investors because those purchasers are corporate entities who, in the Board's view, are sufficiently sophisticated in financial matters such that the additional protections afforded by large minimum denomination are not necessary.

The Board notes that, since 1995, the OCC has imposed a \$250,000 minimum denomination requirement in sales of nonconvertible subordinated debt, which are limited to "accredited investors." Further, in 1992, the OCC proposed a minimum denomination of \$100,000 for such sales, but increased it to \$250,000 in the corresponding final rule.⁹⁷ Recognizing the potential for overlap in market participants for Subordinated Debt Notes issued by Issuing Credit Unions and national bank nonconvertible debt instruments, the Board specifically requests comment on whether the NCUA's minimum denomination requirements should correspond with the OCC's

⁹⁷ 59 FR 54789, 54792 (Nov. 2, 1994).

requirements. In other words, (a) should the NCUA require minimum denominations of \$250,000 in sales of Subordinated Debt Notes to Natural Person Accredited Investors, and (b) should the NCUA impose a minimum denomination requirement on sales of Subordinated Debt Notes to Entity Accredited Investors and, if so, should it be \$10,000, \$250,000, or a different threshold?

5. § 702.405 Disclosures.

As discussed in section I. (E)(2) of this preamble, the federal securities laws and related SEC rules do not require an issuer of securities to provide any particular level of disclosure to potential investors in securities that are offered, issued, and sold pursuant to most exemptions from the registration requirements of the Securities Act, nor do they mandate the content of any disclosure an issuer chooses to provide. Although the SEC makes it clear that its “anti-fraud” rules apply to all offers and sales of securities, whether registered or exempt from registration, disclosure practices vary widely.⁹⁸

The Board believes that adopting a regulatory framework for the offer, issuance, and sale of Subordinated Debt Notes will benefit both Issuing Credit Unions and investors. Such a framework will provide potential investors information that is important to making a decision to invest in Subordinated Debt Notes of Issuing Credit

⁹⁸ See 17 CFR § 230.501(a) (“Users of Regulation D (§§ 230.500 et seq.) should note the following: (a) Regulation D relates to transactions exempted from the registration requirements of section 5 of the Securities Act... Such transactions are not exempt from the anti-fraud, civil liability, or other provisions of the federal securities laws.”).

Unions, and will clearly define the obligations of Issuing Credit Unions. The framework will also clarify various other investment considerations that an Issuing Credit Union should disclose to potential investors before their investment.

The Board further believes this framework will help promote investor confidence, which is particularly important in view of credit unions' relative inexperience offering and selling securities. In addition, the Board believes that the proposed disclosure requirements will reduce the risk of investor claims against an Issuing Credit Union, which will provide at least two key benefits. Reducing investor claims may encourage credit unions concerned with the risks associated with the offer and sale of securities to take advantage of opportunities to raise capital through the sale of Subordinated Debt Notes. It also helps protect the interests of credit union members, as such claims could have an adverse effect on the safety and soundness of an Issuing Credit Union.

The proposed rule requires an Issuing Credit Union to deliver an Offering Document to potential investors in Subordinated Debt Notes and prescribes certain specific disclosures to be made in the Offering Document and in the Subordinated Debt Note itself. Section 702.405 covers the disclosure requirements for the Subordinated Debt Note, while the disclosure requirements for the Offering Document are addressed in § 702.408.

Section 702.405 requires that certain disclosure legends be prominently displayed on the face of the Subordinated Debt Note, and that certain additional disclosures be

included elsewhere in the body of the Subordinated Debt Note.⁹⁹ The Board's intention in proposing these requirements is to alert potential investors of a number of important matters regarding an investment in a Subordinated Debt Note. Because the required disclosures are required to be included in the Subordinated Debt Note itself, both initial investors (purchasers of the Subordinated Debt Note directly from the Issuing Credit Union) and persons who subsequently acquire the Subordinated Debt Note will have ready access to the information.

Paragraph (a) of § 702.405 requires that certain disclosure legends be prominently displayed on the face of the Subordinated Debt Note. Some of the required legends identify risks specific to an investment in any Subordinated Debt Notes of Issuing Credit Unions, including the:

- Prohibition on a holder of a Subordinated Debt Note from using the note as collateral for a loan from the Issuing Credit Union;
- Possibility that a portion of, or all of, the principal amount of a Subordinated Debt Note would be reduced to cover any deficit in retained earnings at the end of a credit union's fiscal year (or more frequently, as determined by the Issuing Credit Union), with the result that the amount equal to such reduction would no longer be payable on such Subordinated Debt Note; and

⁹⁹ A "legend" is a statement on a security, often noting restrictions on transfer or sale or other material limitations related to the security.

- Prohibition on redemption or prepayment of all or a portion of outstanding Subordinated Debt Notes prior to maturity, other than in limited circumstances involving advance approval of the NCUA or in connection with a voluntary liquidation of the Issuing Credit Union.

Other required legends, such as the requirement to inform investors that the Subordinated Debt Notes are not shares in the Issuing Credit Union and are not insured by the NCUA, are similar to those that are required in offerings of securities by other types of regulated financial institutions. The required legend noting that the issuance and sale of the Subordinated Debt Note are not registered under the Securities Act is intended to alert potential investors that the Subordinated Debt Note does not benefit from all of the protections that are provided by Securities Act registration, and the disclosure legend language identifying the restrictions on the sale or other transfer of Subordinated Debt Notes by holders informs holders of the notes that they are not freely tradeable, alerting them to the fact that the Subordinated Debt Notes may not be liquid investments supported by an active (or any) secondary trading market.

This last legend combines elements of legends typically included in securities offered, issued and sold in offerings made pursuant to certain exemptions from the registration requirements of the Securities Act and elements that relate to other parts of the proposed rule that are unique to offers and sales of Subordinated Debt Notes, including the prohibition on sales or resales to members of the Issuing Credit Union's board, Senior Executive Officers and/or Immediate Family Members of board members or Senior Executive Officers.

In paragraph (b) of § 702.405, the Board proposes a requirement that an Issuing Credit Union include certain additional disclosures in the body of the Subordinated Debt Note. As is the case with the disclosure legends required by paragraph (a) of § 702.405, the purpose of these disclosures is to inform potential investors of a number of important matters regarding an investment in the Subordinated Debt Note.

The disclosures required under paragraph (b) in the proposed rule are intended to draw attention to certain potential repayment risks if an Issuing Credit Union is:

- Subject to an involuntary liquidation;
- “Undercapitalized” (for credit unions that are not New Credit Unions) or “Moderately Capitalized” (for credit unions that are New Credit Unions) and fails to submit or implement an acceptable restoration plan; or
- Classified as “Critically Undercapitalized” (for credit unions that are not New Credit Unions) or “Uncapitalized” (for credit unions that are New Credit Unions).

The required disclosure regarding the consequences of an involuntary liquidation must describe the payout priority and level of subordination as provided in § 709.5(b). The disclosure regarding “Undercapitalized” or “Moderately Capitalized” status of an Issuing Credit Union must address the additional restrictions and requirements that would be imposed on the Issuing Credit Union if it fails to submit an acceptable net worth restoration plan, capital restoration plan, or revised business plan or if it materially fails to implement a plan that was approved by the NCUA (which restrictions and requirement

are those applicable to a “Significantly Undercapitalized” credit union, for credit unions that are not New Credit Unions) or a “Marginally Capitalized” credit union (for credit unions that are New Credit Unions).

The disclosure regarding an Issuing Credit Union that has been classified as “Critically Undercapitalized” or “Uncapitalized” must indicate that, beginning 60 days after the effective date of the “Critically Undercapitalized” or “Uncapitalized” classification, the Issuing Credit Union is prohibited from paying principal of, or interest on, its Subordinated Debt Notes until it is reauthorized to do so by the NCUA, in writing (although unpaid interest may continue to accrue).

Finally, paragraph (b) also requires an Issuing Credit Union to provide an overview of the risks associated with authority of the NCUA or any applicable SSA to conserve or liquidate a credit union under federal or state law. As noted in the discussion of § 702.408, in addition to making these disclosures in the Subordinated Debt Note, substantially similar disclosures will also be required to be included in the Offering Document.

Certain of the disclosures required by the proposed rule correspond to disclosure requirements set forth in the Current Secondary Capital Rule, including that Secondary Capital is not insured by the NCUA and that Secondary Capital is subordinate to all other claims on the assets of the Issuing Credit Union, including member shareholders, creditors, and the NCUSIF. The Board acknowledges, however, that the disclosure

requirements for all Subordinated Debt Notes in § 702.405 of the proposed rule exceed current disclosure requirements in the Current Secondary Capital Rule.

As discussed earlier in this section, the Board believes that its proposed regulatory framework for the offer, issuance, and sale of Subordinated Debt Notes will benefit both Issuing Credit Unions and investors in a number of ways, including promoting investor confidence and reducing investor claims. Further, the requirements underlying this framework, including these proposed disclosures, have been in use in securities offerings for a number of years and are familiar to investors, market professionals, and legal advisors. Accordingly, the Board believes that the benefit from these proposed disclosure requirements far outweighs any associated burden associated in complying with them.

6. § 702.406 Requirements related to the offer, sale, and issuance of Subordinated Debt Notes.

In addition to specifying the disclosures required to be provided to potential investors in Subordinated Debt Notes, the proposed rule addresses other key components of a regulatory framework for the offer, issuance, and sale of Subordinated Debt Notes.

The provisions of § 702.406 cover a number of those key components, including:

- Delivery requirements of Offering Documents to potential investors;
- Limitations on the types of investors who may purchase and hold Subordinated Debt Notes (either in the initial sale of the Subordinated

Debt Notes or in connection with any resales or other transfers of Subordinated Debt Notes);

- Qualification standards for trustees engaged by an Issuing Credit Union; and
- Policies and procedures to be followed by Issuing Credit Unions in connection with offers, issuances, and sales of their Subordinated Debt Notes.

Paragraph (a) of § 702.406 obligates an Issuing Credit Union to deliver an Offering Document that satisfies the requirements of § 702.408(e) to each purchaser of its Subordinated Debt Notes. While § 702.408(e) specifies certain disclosure topics that must be addressed in every Offering Document, paragraph (a) of § 702.406 reminds Issuing Credit Unions that those are the *minimum* required disclosures and, depending on the surrounding facts and circumstances, additional disclosure may be necessary to provide potential investors with material information relevant to an investment decision.

The proposed rule's obligation to provide such further material information as may be necessary to make the required disclosures, in the light of the circumstances under which those disclosures have been made, not misleading, is consistent with the anti-fraud concepts embodied in the federal securities laws. These include Rule 10b-5

under the Exchange Act.¹⁰⁰ As noted earlier, the anti-fraud rules apply to all offers and sales of securities, whether or not such offers and sales are registered under the Securities Act.

Paragraph (a) also addresses the timing of delivery of the Offering Document by an Issuing Credit Union, requiring that the document be delivered in a reasonable time before any issuance and sale. The “reasonable time” requirement is consistent with a number of SEC rules relating to securities offerings exempt from Securities Act registration.¹⁰¹ While the Board believes an Issuing Credit Union should determine what constitutes a reasonable time, the intent of the requirement is to ensure that potential investors receive the Offering Document sufficiently in advance of making a purchase decision so to provide them with a meaningful opportunity to review the document and, if desired, consult with financial and/or legal advisors.

Paragraphs (b) and (c) of § 702.406 impose limitations on who may invest in Subordinated Debt Notes, and cover both initial purchasers of Subordinated Debt Notes (purchasers buying Subordinated Debt Notes in the initial issuance from an Issuing Credit

¹⁰⁰ 17 CFR 240.10b-5. In pertinent part, the rule provides :

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange... (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading... in connection with the purchase or sale of any security.

¹⁰¹ See, e.g., 17 CFR 230.506(b).

Union) and subsequent purchasers or transferees of Subordinated Debt Notes who acquire the securities from an existing holder of a note.

Paragraph (b) prohibits issuances and sales of Subordinated Debt Notes outside of the United States (any one of the states thereof, including the District of Columbia, its territories, and its possessions). The Board determined not to allow non-US investors from purchasing or holding any Subordinated Debt Notes because the risks and complexities associated with offshore offerings of securities outweighed the potential benefits to credit unions, especially given that credit unions generally are not significantly involved in foreign transactions. The Board specifically is requesting comment as to whether this restriction unduly limits the marketability and functionality of Subordinated Debt Notes issuances.

Paragraph (c) prohibits issuances and sales of Subordinated Debt Notes to persons other than Accredited Investors. The definition of “Accredited Investor” in § 702.402 includes two types of Accredited Investors; the definitions of “Entity Accredited Investors” and “Natural Person Accredited Investors” tie to the categories included in the definition of “Accredited Investor” in Rule 501(a) of Regulation D under the Securities Act, with one important exception.¹⁰² The definition of “Accredited Investor” omits certain persons affiliated with an Issuing Credit Union—board members and senior executive officers of an Issuing Credit Union are not “Accredited Investors” for purposes of the proposed rule, nor are Immediate Family Members of any such board member or

¹⁰² 17 CFR 230.501(a).

senior executive officer. As a result, board members and senior executive officers of the Issuing Credit Union and their Immediate Family Members are prohibited from purchasing or holding Subordinated Debt Notes of that Issuing Credit Union.

The Board believes that limiting the potential pool of investors is appropriate given the risks involved in investing in securities that share the characteristics of Subordinated Debt Notes. It also believes that investors should possess a level of sophistication that permits them to understand the terms of Subordinated Debt Notes and adequately assess the risks involved in an investment in this type of security and in the Issuing Credit Union. The Board notes that the OCC restricts sales of national banks' nonconvertible Subordinated Debt to Accredited Investors, but does not impose this restriction on other sales of Subordinated Debt instruments.¹⁰³ The Board specifically is requesting comment on whether restricting sales of Subordinated Debt Notes to Accredited Investors unduly limits the marketability and functionality of Subordinated Debt Notes issuances.

As noted above, the proposed rule also distinguishes between Natural Person Accredited Investors and Entity Accredited Investors. While this distinction matters in important ways for offers and sales of Subordinated Debt Notes, including minimum denomination requirements, Offering Document approval processes, and resale provisions, it does not alter the Board's belief that every investor in Subordinated Debt Notes must be sophisticated and able to assess the risks inherent in this type of

¹⁰³ 12 CFR part 5.

investment. Rather, the Board believes that Entity Accredited Investors are likely to be even more sophisticated investors than Natural Person Accredited Investors and, therefore, some of the restrictions that the proposed rule places on Natural Person Accredited Investors are not necessary for the protection of Entity Accredited Investors. The Board recognizes that the OCC does not distinguish between categories of Accredited Investors in this same way. Therefore, the Board specifically requests comment on whether this distinction between Entity Accredited Investors and Natural Person Accredited Investors unduly limits the marketability and functionality of Subordinated Debt Notes issuances.

The Board also believes it is inappropriate to permit an Issuing Credit Union's board members, Senior Executive Officers, or their Immediate Family Members to purchase or hold Subordinated Debt Notes due to conflict of interest and anti-fraud concerns that certain of those such individuals exercise control over the Issuing Credit Union and have, or could gain, access to material non-public information in respect of the Issuing Credit Union and/or the Subordinated Debt Notes. The Board specifically is requesting comment as to whether this restriction unduly limits the marketability and functionality of Subordinated Debt Notes issuances.

For the same reasons as there are restrictions on initial purchasers of Subordinated Debt Notes, paragraph (c), paragraph (g), and § 702.404(a)(10) operate together to prohibit the reissuance or resale of Subordinated Debt Notes to persons other than Accredited Investors. They also prohibit the reissuance, resale, or other transfer of

Subordinated Debt Notes to an Issuing Credit Union's board members, senior executive officers, or their Immediate Family Members.

Further, the ability to reissue or resell Subordinated Debt Notes after their initial issuance depends on the nature of the initial purchaser of the securities. Subordinated Debt Notes initially purchased by an Entity Accredited Investor may be reissued or resold *only* to another Entity Accredited Investor, while Subordinated Debt Notes initially purchased by a Natural Person Accredited Investor may be reissued or resold to an Entity Accredited Investor *or* a Natural Person Accredited Investor.

Paragraph (c) of § 702.406 also requires an Issuing Credit Union to take certain steps to verify the Accredited Investor status of potential purchasers. Issuing Credit Unions will be required to obtain a Certificate of Accredited Investor Status from each potential purchaser and take additional steps to verify a potential investor's status by reviewing specific financial information from tax returns, brokerage statements and similar documentation, or by receiving a certification of a potential investor's status as an Accredited Investor from a broker-dealer, registered investment adviser, attorney, or certified public accountant. These verification requirements and methods are substantially similar to the requirements and methods provided in Rule 506(c) of Regulation D under the Securities Act.¹⁰⁴ The Board believes that following practices that have been in use in securities offerings for a number of years and which are familiar to investors, market professionals, and legal advisors will allow Issuing Credit Unions to

¹⁰⁴ See 17 CFR 230.506(c).

more easily implement investor verification protocols that meet the requirements of the proposed rule.

Paragraph (d) of § 702.406 sets qualification standards for trustees engaged by Issuing Credit Unions in connection with issuances and sales of Subordinated Debt Notes. Under the proposed rule, an Issuing Credit Union is not required to engage a trustee.¹⁰⁵ However, if an Issuing Credit Union chooses to engage a trustee, the trustee must meet the qualification requirements of the Trust Indenture Act of 1939, as amended (TIA), related TIA rules, and any applicable state law qualification requirements.

Because of the significance of the trustee's role in issuances of debt securities, the Board believes it is appropriate to impose these standards to ensure the competence, independence, and financial soundness of the trustee, and that employing the market-accepted qualification standards set forth in the TIA sufficiently addresses those matters. Even if an offering of debt securities has a qualified trustee, however, the indenture administered by that qualified trustee does not need to meet all of the requirements of the TIA applicable to the form and content of indentures.¹⁰⁶

Paragraph (e) of § 702.406 covers sales practices of an Issuing Credit Union relating to offers, issuances, and sales of Subordinated Debt Notes, including at any office of the Issuing Credit Union. In this context, an "office" means any premises used

¹⁰⁵ With certain exceptions, trustees generally are required only in connection with offerings of debt securities registered under the Securities Act.

¹⁰⁶ 15 U.S.C. §§ 77aaa–77bbbb

by the Issuing Credit Union that is identified to the public through advertising or signage using the Issuing Credit Union's name, trade name, or logo.

The proposed rule permits sales activities by an Issuing Credit Union of its own Subordinated Debt Notes if the Issuing Credit Union completes a written application and receives approval from its Appropriate Supervision Office. The application requires, in significant part, that the Issuing Credit Union provide a written description of its plan to comply with the sales practices requirements delineated in paragraph (e).

The substantive requirements of paragraph (e) are intended to prescribe acceptable sales practices that are consistent with general industry norms for sales of securities, while discouraging sales practices the Board believes are inappropriate for credit unions and will help reduce the possibility that an Issuing Credit Union, affiliated credit union service organization (CUSO), or their respective employees violate applicable securities laws.

In particular, the proposed rule prohibits the payment of direct or indirect compensation in the form of commissions, bonuses, or similar payments to any employee of the Issuing Credit Union or a CUSO who assists in the marketing and sale of the Issuing Credit Union's Subordinated Debt Notes. The prohibition does not apply to payments made to securities personnel of registered broker-dealers or payments otherwise permitted by applicable law, provided that such payments are consistent with industry norms.

Paragraph (e) also places limits on the Issuing Credit Union and/or CUSO personnel who may engage in the marketing and sales efforts. Under the proposed rule, marketing activities and sales may only be undertaken by regular, full-time employees of the Issuing Credit Union and/or securities personnel who are subject to supervision by a registered broker-dealer (who may be employees of the Issuing Credit Union's affiliated CUSO that is assisting in the marketing and sale of the Issuing Credit Union's Subordinated Debt Notes).

All sales, including resales, of securities must comply with applicable securities laws. Paragraph (g) of § 702.406 prescribes the ways in which Subordinated Debt Notes may be resold following their initial sale by an Issuing Credit Union. Subordinated Debt Notes sold by an Issuing Credit Union pursuant to an exemption from registration under the Securities Act may only be resold pursuant to the same or another exemption from registration under the Securities Act. This resale exemption may be the same one on which an Issuing Credit Union relied in connection with the initial sale of the Subordinated Debt Notes or it may be another available exemption.

7. § 702.407 Discounting of amount treated as Regulatory Capital.

The Board is proposing to adopt the current § 701.34 requirements for discounting the Subordinated Debt amount for Regulatory Capital purposes with a technical refinement on the calculation of the amount.

The Current Secondary Capital Rule requires a credit union to use the lesser of the remaining balance of the accounts after any redemption and losses; or the original amount of secondary capital reduced by 20 percent annually starting once the remaining maturity of the Secondary Capital is less than five years. This treatment is consistent with the treatment of subordinated debt by the FDIC and the OCC.

The Board is proposing to simplify how a credit union would base its discounting calculation on the net amount outstanding at the time the credit union conducts its calculation. This means that, if a credit union prepays any of its Subordinated Debt, the amount that would be discounted would be the net amount that remains after the prepayment. By doing this, the Board is making the proposed rule more consistent with the FDIC and OCC treatment of subordinated debt that counts towards Tier 2 capital.¹⁰⁷

For example, if ABC FCU originally issued a \$20 million Subordinated Debt Note and prepays \$10 million of the original note, the balance treated as Regulatory Capital would be calculated using the remaining outstanding amount (\$10 million), not the original Subordinated Debt Note (\$20 million).

The following chart shows the outstanding balance of the Subordinated Debt, on a percentage basis that counts as Regulatory Capital:

¹⁰⁷ 12 CFR 3.20(d)(iv); 12 CFR 324.20(d)(iv).

Remaining maturity	Balance treated as Regulatory Capital
Four to less than five years	80 %
Three to less than four years	60 %
Two to less than three years	40 %
One to less than two years	20 %
Less than one year	0 %

The proposed rule would require an Issuing Credit Union to apply the percentage of the outstanding Subordinated Debt that counts as Regulatory Capital included in the Net Worth and/or the RBC Ratio to each quarter-end Call Report cycle, because Net Worth and the RBC Ratios are required to be calculated at quarter-end. For example, if ABC FCU has \$10 million in outstanding Subordinated Debt, the full amount would count towards Regulatory Capital if it matures in five years or more. Once the remaining maturity of the Subordinated Debt is less than five years, the amount of outstanding Subordinated Debt that counts towards Regulatory Capital will reduce by 20 percent annually. This means that the amount that would count towards Regulatory Capital would be:

- \$10 million if the remaining maturity is at least five years;
- \$8 million if the remaining maturity is at least four years and less than five years;

- \$6 million if the remaining maturity is at least three years and less than four years;
- \$4 million if the remaining maturity is at least two years and less than three years;
- \$2 million if the remaining maturity is at least one year and less than two years; and
- No amount would count towards Regulatory Capital if the maturity is less than one year.

As discussed in section II. (C)(11) of this preamble, the proposal would create a new authority to allow FCUs to prepay Subordinated Debt if the prepayment option is clearly disclosed in the Subordinated Debt Note and approval is granted by the Appropriate Supervision Office, in writing. As discussed above, if an FCU does prepay a portion of the Subordinated Debt, only the remaining outstanding balance of the Subordinated Debt would be used to calculate the balance treated as Regulatory Capital.

8. § 702.408 Preapproval to issue Subordinated Debt.

The Board is proposing that eligible credit unions be required to submit an application and receive written preapproval from the NCUA before issuing Subordinated Debt. Currently, under the Current Secondary Capital Rule, a federally chartered LICU must receive approval of its secondary capital plan by the NCUA before it may offer secondary capital accounts. A federally insured, state-chartered LICU must receive

approval of its secondary capital plan by the applicable SSA, with the NCUA's concurrence, before it may offer secondary capital.

The Board remains dedicated to a requirement for an eligible credit union to obtain written preapproval before issuing Subordinated Debt as it views this step as an important prudential safeguard. The Board believes a preapproval process is part of a credit union's sound management plan, and helps the NCUA ensure that planned debt securities are structured in such a manner as to appropriately protect the NCUSIF.

As discussed below, the Board proposes to require a credit union to include information on 15 specific topics in its initial application to issue Subordinated Debt. The Board recognizes the many potential benefits that an issuance of Subordinated Debt Notes may confer on an Issuing Credit Union, but it also appreciates the concomitant complexities and risks. The decision to offer and sell securities such as Subordinated Debt Notes should be made only after careful consideration, preparation, and diligence by the Issuing Credit Union, including with professional advisors as warranted. For this reason, the Board is proposing to continue to require *all* credit unions contemplating an offer, issuance, and sale of Subordinated Debt Notes to receive the NCUA's prior written approval before engaging in such activity.

Background

In 2006,¹⁰⁸ the Board amended § 701.34 to add a requirement for regulatory approval of a LICU's secondary capital plan before it could issue such accounts. The Board highlighted, by requiring prior approval of a secondary capital plan, that it was strengthening supervisory oversight and detection of lenient practices in several ways. First, it will prevent LICUs from accepting and using secondary capital for purposes and in amounts that are improper or unsound. Second, the approval requirement will ensure that secondary capital plans are evaluated and critiqued by the NCUA Regional Director before being implemented. Third, for both the NCUA and LICUs, an approved secondary capital plan will document parameters to guide the proper implementation of secondary capital, and to measure the LICU's progress and performance.¹⁰⁹

In September 2019, the NCUA issued a Letter to Credit Unions,¹¹⁰ "Evaluating Secondary Capital Plans," which included a Supervisory Letter to NCUA staff. The Supervisory Letter provided information about the authority of LICUs to offer secondary capital accounts and specified a consistent framework for the analysis and approval or denial of secondary capital plans submitted to the NCUA for approval.

¹⁰⁸ 71 FR 4234 (Jan. 26, 2006). The last substantive amendments to the NCUA's secondary capital regulations took place in 2010 with the addition of language regarding secondary capital received under the Community Development Capital Initiative of 2010. 75 FR 57843 (Sept. 23, 2010).

¹⁰⁹ 71 FR 4234, 4237 (Jan. 26, 2006).

¹¹⁰ Supervisory Letter No. 19-01, (Sept. 16, 2019), available at <https://www.ncua.gov/files/supervisory-letters/SL-19-01-evaluating-secondary-capital-plans.pdf>.

As part of this proposed rule, the Board is looking to enhance and clarify much of the existing secondary capital account plan requirements in paragraphs (b), (c), and (d) of the Current Secondary Capital Rule by adding similar provisions to the proposed § 702.408 of the proposed rule to govern the issuance of Subordinated Debt. All of the current secondary capital plan requirements are incorporated into these proposed rule requirements with additional provisions aimed at greater clarification of the NCUA's expectations for diligence and supporting analysis. The proposed review and analysis of a credit union's Subordinated Debt documents by the NCUA is intended to make the preapproval process more efficient while ensuring that credit union applicants comply with applicable laws and regulations and that the issuance of Subordinated Debt represents a safe and sound endeavor.

The NCUA's analysis of applications will be fact-specific to each credit union's situation at the time a credit union submits its Subordinated Debt application documents for approval. It is important to note that these proposed preapproval requirements specifically state that the requirements represent the *minimum* information an eligible credit union must include in the application.

Preapproval for FISCUs to issue Subordinated Debt

Under this proposed rule, a FISCU would be subject to the preapproval requirements in § 702.408. Under this proposal, FISCUs would also be subject to the requirements of § 702.409, which, as discussed in section II. (C)(9) of this preamble, would contain additional preapproval requirements for FISCUs.

Preapproval Requirements and Steps

The Board is proposing the following preapproval requirements as part of an initial application process. Questions from the NCUA arising during the proposed preapproval process could result in the need for a credit union to submit additional documents. In addition, certain credit unions will need preapproval of the Offering Documents depending on whether the investor is a Natural Person Accredited Investor or an Entity Accredited Investor as outlined in § 702.408(d).

Preapproval and Reporting Steps	Proposed Rule Section
Initial Application and NCUA Approval Process	§ 702.408(b)(c)
Offering Documents and NCUA Approval Process Submission of Offering Documents after use	§ 702.408(d)-(g)
Submission of All Documents after Issuance	§ 702.408(i)

Initial Application to issue Subordinated Debt

The Board is proposing that all eligible¹¹¹ credit unions be required to submit an initial application (§ 702.408(b)) to the Appropriate Supervision Office that, at a minimum, includes the following 15 items:

- (1) A statement indicating how the credit union qualifies to issue Subordinated Debt given the eligibility requirements of § 702.403 with additional supporting analysis if anticipating to meet the**

¹¹¹ Proposed 702.403.

requirements of a LICU or Complex Credit Union within 24 months after issuance of the Subordinated Debt The Board is proposing to grant credit unions that do not yet meet the eligibility requirements the opportunity to obtain preapproval if they can reasonably demonstrate they will become an eligible LICU or Complex Credit Union within the 24-month timeframe. A credit union's supporting analysis must indicate which of the eligibility criteria it anticipates meeting.

For an eligible credit union, the Board does not believe this proposed requirement will add any significant burden. For a credit union that is not yet eligible, this proposed requirement will allow the Board to determine if such credit union may reasonably become eligible within the required time period;

(2) The maximum aggregate principal amount of Subordinated Debt Notes and the maximum number of discrete issuances of Subordinated Debt Notes that the credit union is proposing to issue within the period allowed under subsection (k) of this section, which is one year from the approval of the initial application or Offering Document, depending on whether the investor is a Natural Person Accredited Investor or an Entity Accredited Investor. The Board is adopting the requirement from the paragraph (b)(1)(i) of the Current Secondary Capital Rule for the maximum aggregate amount and expanding this to include multiple issuances. The Board recognizes the

potential efficiency gains for both the NCUA and the credit union in providing a preapproval decision authorizing a number of discrete issuances within the period allowed as doing so could be more convenient in meeting the credit union's goals while eliminating the prospect of multiple application reviews by the NCUA. If an initial application contemplates more than one issuance in the period allowed,¹¹² the credit union should include details of each of the planned issuance amounts including, but not limited to; the dollar amounts for each issuance, the estimated issuance dates and maturities, and any other contractual terms of the individual Subordinated Debt Notes. The credit union must ensure its aggregate principal amount of Subordinated Debt issuance does not exceed the maximum borrowing limit set forth in § 741.2 of the NCUA's regulations or cause a credit union to be in violation of any other applicable regulatory limits or requirements, or any written agreement or other approved plan with the NCUA.

As part of this requirement, the Board is requesting an analysis to support that a credit union has considered all other borrowing needs, as well as contingent liquidity needs, over the life of the planned Subordinated Debt issuance and has measured the aggregate amount of all borrowing activities. If a credit union's proposed Subordinated Debt issuance would increase the overall borrowing amounts to an unsafe level at any time over

¹¹² Proposed 702.408(k)

the life of the Subordinated Debt, the NCUA will deem this exposure to be unsafe and unsound.

(3) The estimated number of investors and the status of such investors (Natural Person Accredited Investors and/or Entity Accredited Investors) to whom the credit union intends to offer and sell the Subordinated Debt Notes. Paragraph (b) of the Current Secondary Capital Rule limits eligible investors in secondary capital to member or nonmember non-natural person investors.¹¹³ The Current Secondary Capital Rule's limitation prevents the sale of secondary capital to consumers who could lack the ability to understand the risks associated with an uninsured secondary capital account.

The Board is proposing to revise the investor requirement from non-natural person investors to Accredited Investors in accordance with the provisions of Regulation D of the Securities Act.

The specific identification and certification of an Accredited Investor is a requirement of the proposed § 702.406(c). The certification requires a credit union receive an unambiguous, signed, one-page certification from any potential investor of a Subordinated Debt Note. Depending on whether the Subordinated Debt Notes are sold exclusively to Entity

¹¹³ 12 CFR 701.34(b).

Accredited Investors or whether the potential investors include at least one Natural Person Accredited Investor determines if a credit union would need to have its Offering Documents approved for use by the NCUA.

The Board is proposing to require a credit union to specify the number of investors because this information will be used in the NCUA's evaluation of a credit union's analysis of the use of Subordinated Debt and its safe and sound management. Further, the Board is proposing to require credit unions to identify the classification of potential investors, because such classification will impact additional review steps in the proposed preapproval process.

(4) A statement identifying any outstanding Subordinated Debt and Grandfathered Secondary Capital previously issued by the credit union. The Board does not see this as a significant burden for credit unions because they have an incumbent risk management responsibility to track and manage their issuance. The Board is proposing to require this information because it will assist the NCUA in verifying if a credit union has prior experience with Subordinated Debt;

(5) A copy of the credit union's strategic plan, business plan, and budget, and an explanation of how the credit union intends to use the Subordinated Debt in conformity with those plans. The Board is clarifying the expectation that a credit union demonstrate how a planned

issuance complies with each of its strategic, business, and budgeting plans consistent with its board's approved intentions. The NCUA issued a Supervisory Letter in September 2019 providing guidance to field staff regarding the authority of LICUs to offer Secondary Capital accounts.¹¹⁴ The Supervisory Letter clarifies the framework the NCUA uses to analyze and approve or deny Secondary Capital plans.

With the proposed rule, the Board's expectation is that a credit union have a clear business objective for offering Subordinated Debt as envisioned and must explain how the additional costs and risks are acceptable and consistent with the credit union's business model. The plan must explain why the Subordinated Debt plan is consistent with a credit union's mission, budget, and strategic goals.

An eligible credit union must also explain how (when necessary) its strategic plan, business plan, and budget will need to be updated if the initial application to issue Subordinated Debt is approved.¹¹⁵ As part of this endeavor, a credit union will need to make clear in its application that it has the expertise to safely and soundly manage the planned use(s) of

¹¹⁴ Supervisory Letter No. 19-01, (Sept. 16, 2019), available at <https://www.ncua.gov/files/supervisory-letters/SL-19-01-evaluating-secondary-capital-plans.pdf>.

¹¹⁵ An eligible credit union does not need to explicitly incorporate the secondary capital plan into its board-approved strategic plan, business plan, and budget until the plan is approved by the NCUA, and then only to the extent it is necessary and material enough to warrant a change to the credit union's approved plans and budget.

Subordinated Debt or has budgeted to obtain the necessary expertise and will secure it before deploying an approved Subordinated Debt issuance. The Board believes this requirement will demonstrate a credit union's due diligence in developing a plan to issue Subordinated Debt or Grandfathered Secondary Capital.

(6) An analysis of how the credit union will provide for liquidity to repay the Subordinated Debt upon maturity of the Subordinated Debt. The Board sees this as a critical requirement of the initial application and notes that this is a requirement in the Current Secondary Capital Rule. Generally, Subordinated Debt plans involve a combination of new services and balance sheet activities, which introduce the potential to increase risk to earnings and capital if they are not adequately identified, measured, monitored, and controlled.

A credit union should also guard against future threats to its liquidity; this is of particular importance to the final determination about whether an application is a safe and sound endeavor. A credit union's ability to demonstrate it can reliably estimate liquidity needs and changes in its liquidity positions that result from Subordinated Debt over a multi-year horizon is necessary for both a credit union and the NCUA to understand the potential future threats.

A credit union that uses a leveraged growth strategy that significantly increases its credit, interest rate, and liquidity risks may find it has potentially excessive liquidity risk under some adverse scenarios.

Excessive liquidity risk can arise from large increases in nonperforming loans and/or significant unrealized losses on investments. The credit union should understand how these risks arise, what drives such risks (for example, unmet growth targets, rising unemployment, recession, rapid changes in interest rates, etc.), and understand whether the risks could pose a threat when a Subordinated Debt obligation comes due.

A credit union's reliance on Subordinated Debt can be destabilizing if the credit union fails to replace the Subordinated Debt with net worth (typically by building its retained earnings) over time. If the Subordinated Debt matures during a time when it is experiencing financial distress and is in a weakened capital position, a credit union may not be able to replace Subordinated Debt with a new issuance. A market for such a credit union to issue new Subordinated Debt could disappear, leaving the credit union with an abrupt decline in loss-absorbing capital when it is most needed.

These factors, and availability of investors at the time of potential reissuance, underscore why a credit union needs to have a reasonable and supportable projection of its future liquidity positions and earnings under a variety of plausible scenarios, including both optimistic and pessimistic assumptions, over measurement horizons that align with the credit union's expected activities.

The analysis must include an explanation of how Subordinated Debt is to be repaid and how the credit union's liquidity planning is utilizing a range of possible economic conditions or its initial application may be found deficient for safety and soundness reasons. The analysis should also incorporate the credit union's reliance on other funding alternatives.

(7) Pro Forma Financial Statements (balance sheet, income statement, and statement of cash flows), including any off-balance sheet items, covering at least five years. Analytical support for key assumptions and key assumption changes must be included in the application. Key assumptions include, but are not limited to, interest rate, liquidity, and credit loss scenarios. The Board notes that current § 701.34 requires a LICU to submit a minimum of two years of Pro Forma Financial Statements.¹¹⁶ As discussed below, the Board is proposing to expand and clarify this requirement to ensure credit unions evaluate risks associated with issuing Subordinated Debt. Analytical support for key assumptions and the respective changes must be included in the application. Key assumptions include, but are not limited to, interest rate, liquidity, and credit loss scenarios.

¹¹⁶ 12 CFR 701.34(b)(1)(v).

The Board is proposing to extend the time horizon of the pro forma financial statements to five years compared to the Current Secondary Capital Rule of two years.¹¹⁷ Given the minimum maturity requirement of five years¹¹⁸ and the full amount available for Regulatory Capital treatment with a remaining maturity in excess of five years, the Board is proposing that the analysis supporting the pro forma financials be extended to the same five years. The Board is interested in receiving comments on this change.

The pro forma financial statements are a critical part of the credit union's analysis to show the effects of proposed transactions as if they actually occurred. Pro forma financial statements are a routine, yet essential, tool for documenting and testing the soundness of the assumptions a credit union relies on to project future performance. Subordinated Debt can have a significant impact on a credit union's revenues and expenses. Such borrowings are interest bearing and can have a higher cost than most forms of borrowing because they are uninsured and subordinate to all other claims. There are also other potential costs associated with a credit union's safe and sound oversight of Subordinated Debt (for example,

¹¹⁷ Id.

¹¹⁸ This is a requirement of both the current rule (12 CFR 701.34(b)(4)) and the proposed rule (proposed 702.404(a)(2)).

staffing needs, expanded credit union systems, third-party assistance, and other costs associated with expanding services).

When developing pro forma financial statements, an eligible credit union should include projections of expected earnings in a variety of plausible scenarios, including both optimistic and pessimistic assumptions, over measurement horizons that align with the credit union's expected activities. In addition, analyses should address the sensitivity of any key underlying assumptions to reasonable changes in their amount/degree. Forecasting earnings and Regulatory Capital under different market risk factors is a sound practice for credit unions. To properly identify and measure the range of potential outcomes, a credit union needs to conduct scenario analysis to see how different key assumptions affect earnings and net worth for a variety of plausible scenarios.

A credit union needs to determine if the aggregate amount of Subordinated Debt, coupled with other planned uses identified in its plan is appropriate given the institution's risk-management processes and staff experience. Both the people and the processes should be prepared to handle the use of Subordinated Debt. A credit union's board of directors should ensure that the credit union can manage the volume and/or complexity of planned activities, especially in cases where such activities represent a material increase above what has been managed historically.

The NCUA expects a credit union to use sound practices when producing pro forma financial statements. When evaluating pro forma financials, the NCUA will consider, in particular, whether a credit union:

- Performed a cost/benefit analysis (including impact on balance sheet and operations) for any new products or services;
- Developed pro forma financials that take into account a range of plausible assumptions (optimistic and pessimistic) for both growth and portfolio performance metrics;
- Used reasonable and supportable underlying assumptions to generate scenario analyses;
- Used underlying assumptions and treatment of assets and liabilities consistently across the various supporting analyses. For example, a credit union should be consistent, where appropriate, across the various risk assessments and forecasts, such as projected activity levels, interest rates on assets and liabilities, measures of on-balance-sheet liquidity, and underlying assumptions about growth and performance of assets and liabilities (defaults, prepayments, maturities, replacement of maturities, etc.).
- Addressed its ability, under pessimistic scenarios, to respond to adverse event risks under its contingency funding plan strategies

(for example, credit deterioration in a recessionary environment, unmet growth objectives, adverse rate environments, etc.).

- Modeled the risk characteristics of increased borrowings and/or adding higher risk loans and investments to portfolios (if relied on in the Secondary Capital plan) adequately for credit, liquidity, and interest rate risk purposes.

(8) A statement indicating how the credit union will use the proceeds

from the issuance and sale of the Subordinated Debt. The Board has proposed to retain this requirement from the Current Secondary Capital Rule,¹¹⁹ as a credit union must identify the purpose of issuing Subordinated Debt with specific reason(s), or strategy, behind the planned use of Subordinated Debt. The intended reason or strategy for using Subordinated Debt should be the primary basis for the maximum aggregate amount an eligible credit union states in its plan.

The complexity of Subordinated Debt strategies ranges from straightforward plans (for example, those that call for a one-for-one redeployment of proceeds into cash, loans, and/or investments of the same aggregate amount) to more complex plans that reflect a combination of

¹¹⁹ 12 CFR 701.34(b)(1)(ii).

additional borrowings and asset redeployments, increasing risk and/or the size of a credit union's balance sheet.

The Board recognizes various ways a credit union may use Subordinated Debt to its benefit, which include, but are not limited to:

- Restoring Regulatory Capital to a minimum desired level due to unexpected losses or strong and sustained asset growth that outpaced its ability to build Regulatory Capital through Retained Earnings;
- Increasing Regulatory Capital to a desired level relative to the level of risk inherent in its operations;
- Increasing Regulatory Capital to a desired level to support future growth or other member service initiatives; and
- Enhancing earnings by increasing the level of lending or investing a credit union could otherwise achieve.

The potential incremental increase in risk taken by issuing Subordinated Debt can be significant, and the NCUA generally views growth strategies that involve a high degree of leverage as higher risk.¹²⁰ When adopting such a strategy, a credit union should carefully assess its plan to identify

¹²⁰ For the purposes of this letter, "leverage" refers to funding activity outside a credit union's customary deposit base.

any material risks to earnings and net worth, and properly identify and measure the degree of risk posed by the strategy;

- (9) A statement identifying the governing law specified in the Subordinated Debt Notes and the documents pursuant to which the Subordinated Debt Notes will be issued.** The Board is requesting the credit union to identify the governing law in respect of the Subordinated Debt Notes and the documents pursuant to which the Subordinated Debt Notes will be issued. The intent of this requirement is to ensure that an Issuing Credit Union has engaged with legal counsel qualified to render legal advice in that jurisdiction and has considered the venues where controversies, should they arise, could be litigated.
- (10) A draft written policy governing the offer, and issuance, and sale of the Subordinated Debt, developed in consultation with Qualified Counsel.** For this requirement, an Issuing Credit Union must include a draft written policy that governs the offer, issuance, and sale of the Subordinated Debt with its initial application.

The proposed rule would require an Issuing Credit Union to develop the policy in consultation with qualified legal counsel. Given the complexities and risks inherent in any securities offering, the Board believes it is important for an Issuing Credit Union to consult with legal advisors with expertise in securities offerings of the type contemplated by

the proposed rule and the application of the related federal and state securities laws.

The draft policy required by paragraph (10) of the proposed rule specifies the *minimum* topics an Issuing Credit Union must assess and address for securities law compliance and risk management purposes, including its investor relations and communications plans. An Issuing Credit Union can, and should, include any other topic it determines is appropriate and/or necessary for a complete securities program in the draft policy. See section I. (E)(5) of this preamble for more information about considerations an Issuing Credit Union should address in its investor relations plans.

(11) A schedule that provides an itemized statement of all expenses incurred or expected to be incurred by the credit union in connection with the offer, issuance, and sale of the Subordinated Debt Notes to which the initial application relates, other than underwriting discounts and commissions or similar compensation payable to broker-dealers acting as placement agents. The schedule must include, as applicable, fees and expenses of counsel, auditors, any trustee or issuing and paying agent or any transfer agent, and printing and engraving expenses. If the amounts of any items are not known at the time of filing of the initial application, the credit union must provide estimates, clearly identified as such. Such a schedule

must include, as applicable, fees and expenses of counsel, auditors, any trustee or issuing and paying agent or any transfer agent, and printing and engraving expenses. If the amounts of any items are not known at the time of filing of the initial application, a credit union must provide estimates, clearly identified as such.

The Board is proposing this requirement to ensure an Issuing Credit Union takes into account the other potential costs to it associated with overseeing Subordinated Debt in a safe and sound manner (for example, staffing needs, expanded credit union systems, third-party assistance, and other costs associated with expanding services). This initial application requirement can be submitted as part of a budgeting plan in the initial application requirement number four, but must have the itemized statement of all expenses related to the issuance of Subordinated Debt.

(12) In the case of a New Credit Union, a statement that it is subject to either an approved initial business plan or revised business plan, as required by this part, and how the proposed Subordinated Debt would conform with the approved plan. Unless the New Credit Union has a LICU designation pursuant to § 701.34, it must also include a plan for replacing the Subordinated Debt with Retained Earnings before the credit union ceases to meet the definition of New Credit Union in § 702.2 of this part. The Board believes this will add minimal

burden to a New Credit Union that is applying for Subordinated Debt authority, while also increasing the efficiency of the NCUA's review.

Unless a New Credit Union has a LICU designation pursuant to § 701.34(a), it must also include a plan for replacing the Subordinated Debt with Retained Earnings before the credit union ceases to meet the definition of New Credit Union in § 702.2. The Board is proposing this requirement to ensure that, when a New Credit Union no longer meets the definition of New Credit Union as defined in § 702.2, the credit union is either eligible to continue receiving Regulatory Capital treatment for its Subordinated Debt, or the credit union has a plan to replace the Subordinated Debt with Retained Earnings. Such a plan would ensure that, when a New Credit Union ceases to meet the definition of New Credit Union, it would remain safe and sound.

The Board notes that, without such a plan, when a New Credit Union's Subordinated Debt ceases to be counted as Regulatory Capital, it would immediately be subject to PCA.

(13) A statement describing any investments the credit union has in the Subordinated Debt of any other credit union, and the manner in which the credit union acquired such Subordinated Debt, including through a merger or other consolidation. Eligibility details can be seen in proposed § 702.403. The Board believes such a requirement will

impose minimal burden on an applicant credit union, while aiding the NCUA in determining a credit union's compliance with § 702.403(b) of this proposed rule;

(14) A signature page signed by the credit union's principal executive officer, principal financial officer or principal accounting officer, and a majority of the members of its board of directors. Amendments to an initial application must be signed and filed with the NCUA in the same manner as the initial application. The Board is proposing this requirement to ensure that both a credit union's senior management and board are aware of and have approved the credit union's plan for issuing Subordinated Debt; and

(15) Any additional information requested in writing by the Appropriate Supervision Office. The Board is proposing this requirement to ensure the NCUA has adequate information to assess an applicant credit union's suitability to issue Subordinated Debt in a manner the agency determines to be safe and sound. The Board notes that this is not a new requirement; current § 701.34 states that the information required to be provided by a credit union is the *minimum* information necessary for the NCUA to review a secondary capital plan.¹²¹

¹²¹ 12 CFR 701.34(b)(1).

Decision on Initial Application

The NCUA's review of an initial application to issue Subordinated Debt is intended to evaluate an eligible credit union's compliance with applicable laws and regulations and determine whether its application and documents represent a safe and sound endeavor for the credit union. The NCUA's analysis will be fact-specific to each credit union's situation at the time a credit union submits its initial application for approval.

With this proposed rule, the Board is increasing the review time of the initial application to 60 days from the Current Secondary Capital Rule's period of 45 days.¹²² The Board is also proposing to remove the automatic approval provision in circumstances in which an applicant is not notified by the NCUA within the 60-day review period. The Appropriate Supervision Office may also extend the deadline for the review of the initial application in cases where it has requested additional documents or has determined that the application is incomplete. The Board believes the expanded requirements for initial applications are broader than the current rule requirements and that the enhanced description of diligence expectations will require a more thorough review by the Appropriate Supervision Office.

The Board is also proposing a conditional approval by which the Appropriate Supervision Office may approve the initial application with certain conditions. For

¹²² Id. 701.34(b)(2)).

example, the Appropriate Supervision Office may approve an aggregate principal amount less than the original request given the overall risk to the credit union. The NCUA may allow other conditional approvals such as maintaining a minimum level of net worth during the term of the Subordinated Debt, limiting the uses as prescribed in the initial application of the Subordinated Debt proceeds, or other limitations or conditions the NCUA deems necessary to protect the NCUSIF. The Appropriate Supervision Office will state the reasons to support the partial or conditional approval as part of the written determination. The Board notes that this is current agency practice with respect to secondary capital applications, and allows the Appropriate Supervision Office to adequately address concerns it may have with an application without unduly restricting a credit union's ability to issue Subordinated Debt.

Upon receiving an initial application, the Appropriate Supervision Office will evaluate a credit union's:

- Compliance with the proposed initial application requirements and all other NCUA regulations;
- Ability to manage and safely offer, issue, and sell the proposed Subordinated Debt; and
- Financial condition, operational condition, risk management practices and board oversight.

In addition, the Appropriate Supervision Office will evaluate the safety and soundness of the proposed use of the Subordinated Debt, and any other factors the Appropriate Supervision Office determines are relevant. This reflects the *minimum* of the information the Appropriate Supervision Office will evaluate.

Financial Condition

In evaluating a credit union's request to issue Subordinated Debt, the NCUA will evaluate a credit union's current and prospective financial condition. If a credit union is already experiencing serious financial difficulties, it may not have the financial or operational capacity to handle any additional challenges associated with Subordinated Debt, especially riskier endeavors. In particular, the NCUA will evaluate a Subordinated Debt application to determine whether:

- Planned activities potentially result in a concentration of high-risk characteristics (credit, liquidity, or interest rate risk) that can pose an undue threat to the credit union's earnings or Regulatory Capital;
- Planned activities potentially worsen factors and trends that are contributing to existing safety and soundness concerns that have not yet been resolved; and
- A credit union has a reasonable exit strategy if its actual growth and financial performance were to fall short of necessary breakeven levels.

Operational Condition

In evaluating a credit union's initial application, the NCUA will also consider its existing knowledge of the credit union's current operational condition, its track record in managing new programs successfully, and prior experience (if any) with Subordinated Debt. A key consideration is whether a credit union has the resident knowledge, experience, expertise, and resources necessary to handle any higher levels of risk. This includes having personnel in the right positions, as well as having staff with adequate experience and knowledge.

The NCUA will also evaluate whether management and the board have demonstrated the ability to promptly and successfully address existing and potential problems and risks, and the potential need to recruit additional staff or outsource specific activities to a third party.

As part of its assessment of an initial application, the NCUA will determine if a credit union is venturing into new or higher-risk programs and activities that appear to be outside the institution's prior experience. A credit union should also assess this and explain how it intends to address any material gaps in the adequacy of technical staff and managerial oversight, and any lack of experience with the proposed strategies and activities in the application documents.

If a credit union is contemplating an increase in risk limits (and exposure) above its historical tolerance levels, it is critical that the board of directors has been adequately informed. The credit union board may also need to authorize changes in other board-approved policies. A credit union's application should clearly and conspicuously

acknowledge the risk implications and reflect a commitment from the board that any necessary changes to policies, procedures, and personnel (or third-party support) will be approved.

The Appropriate Supervision Office will appraise the quality, capability, and leadership expertise of the individuals who guide and supervise a credit union. Credit unions should address the following as part of the initial application requirements, including (but not limited to):

- Does the credit union operate in compliance with laws and regulations?
- Does the credit union perform satisfactorily in key areas, such as its capital level, asset quality, earnings, liquidity, and interest rate risk management?
- Does the board of directors appropriately govern the credit union's operations, including the establishment of its strategies and the approval of budgets?
- Does the board understand the key risks facing the credit union?
- Are management decisions consistent with the direction set by the board of directors?
- Does management respond quickly to address shortcomings resulting from failed internal control processes, audits, and examinations?

- Does management implement policies and a culture that promotes the safe and effective operation of the credit union?
- Does management inform the board of its progress in executing strategies and performance against budget?

These questions speak to the capability of a credit union's leadership team, which are reflected in the Management (M) component of a credit union's CAMEL rating. The Appropriate Supervision Office uses this information when considering a request for approval of an initial application because a credit union's leadership is crucial in overseeing risk management for planned activities.

Risk-Management Processes and Credit Union Board Oversight

A credit union's board of directors is responsible for establishing an adequate risk management framework through its policies, procedures, and risk limits. Policies and practices need to be consistent with the credit union's business strategies and reflect the board's risk tolerance, taking into account the credit union's financial condition. In reviewing a credit union's application documents, the Appropriate Supervision Office needs to determine whether the credit union has or will take appropriate steps to address:

- Existing policies and procedures that will need to be updated, and/or new policies and procedures that will need to be adopted,

- The necessary staff expertise and qualifications to handle new activities are in place or will be retained, and
- The impact of any planned borrowing and increased balance sheet leverage will be integrated properly into the credit union's risk reporting and contingency funding plan.

While a credit union's board of directors is ultimately responsible for the credit union's strategic direction and policies, it is expected that they generally delegate the responsibility for executing and maintaining an appropriate risk management framework to senior management. Senior management then becomes responsible for both an initial assessment and the subsequent governance of Subordinated Debt activities.

Board members should ensure that the types and levels of risk inherent in any Subordinated Debt issuance are within their approved tolerances, and direct senior management to revise a plan when appropriate. Ultimately, the board should approve the initial application for submission to the NCUA. The board ensures that the credit union is staffed appropriately to handle the planned activities, and should understand the associated risks. They should remain informed by being briefed periodically by responsible staff. This is consistent with the NCUA's expectations for governance over any major risk activity.

The NCUA will also assess the extent of credit union management's involvement in the development of the application and whether a credit union relied on third-party

vendors in supporting its analysis. The NCUA assesses the use of third parties when reviewing an application from a credit union that has engaged the services of a vendor to evaluate due diligence to determine whether any third-party agreements adequately preserve the credit union's legal and business interests.

Offering Document

Once an Issuing Credit Union has completed the application and approval process specified in paragraphs (a) through (c) of § 702.408, it may proceed with an offer, sale, and issuance of Subordinated Debt Notes, but only if it meets certain additional requirements regarding the form and content of the Offering Document it intends to use in connection with its planned offering. Paragraphs (d) through (g) of § 702.408 address the required use of Offering Documents, disclosure requirements specifying the minimum scope and coverage of disclosures to be included in Offering Documents, and the NCUA's review process for Offering Documents intended to be used in offerings where the potential investors include one or more Natural Person Accredited Investors.

Consistent with the requirements of § 702.406(a), paragraph (d) of § 702.408 proposes that an Issuing Credit Union that has received initial approval of its application must prepare an Offering Document for each planned issuance of Subordinated Debt Notes. If potential investors in a planned offering of Subordinated Debt Notes include one or more Natural Person Accredited Investors, the Issuing Credit Union may only distribute an Offering Document to any potential investor after the Offering Document has been declared "approved for use" by the NCUA. Paragraph (d) also reiterates the

requirement set forth in § 702.406(a) that an Offering Document be provided to each potential investor a reasonable time prior to any issuance and sale of Subordinated Debt Notes. The intent of the requirement is to ensure that potential investors receive the Offering Document with sufficient time to review the Offering Document before making a purchase decision and, if desired, consult with financial and/or legal advisors.

Requirements for all Offering Documents

Paragraph (e) of § 702.408 specifies the minimum scope and coverage of disclosures a credit union must include in its Offering Documents. The required disclosures include basic information about the Issuing Credit Union, the Subordinated Debt Notes, and any underwriter(s) or placement agent(s) engaged by the Issuing Credit Union to assist it in connection with the offering. The Offering Document must also include a discussion of risk factors that describes the material risks associated with the purchase of the Subordinated Debt Notes. The Board recognizes that these risks may vary from one Issuing Credit Union to another, so an Issuing Credit Union should tailor the required disclosures and discussion of material risk factors to address any special or distinctive characteristics of its business, field of membership, or geographic location that are reasonably likely to have a material impact on the Issuing Credit Union's future financial performance.

Paragraph (e) also requires that the Offering Document contain disclosures that cover the same items addressed in paragraphs (a) and (b) of § 702.405, which requires certain disclosure legends to appear on the face of the Subordinated Debt Note itself and

certain additional disclosures to be included in the body of the Subordinated Debt Note. Those requirements are discussed in detail in “—§ 702.405 Disclosures.” Consistent with the requirements of § 702.405, paragraph (e) also states that Issuing Credit Unions are obligated to provide such further material information as may be necessary to make the required disclosures, in the light of the circumstances under which those disclosures have been made, not misleading. This obligation is consistent with the anti-fraud concepts embodied in the federal securities laws, including Rule 10b-5 under the Exchange Act, which apply to all offers and sales of securities.

Further, paragraph (e) of § 702.408 requires an Issuing Credit Union to provide details regarding the material terms of the Subordinated Debt Notes being offered. Because the terms of the Subordinated Debt Notes are likely to vary from one offering to another, the Board believes it is important that Issuing Credit Unions provide details regarding specific terms and provisions of the particular Subordinated Debt Notes being offered and sold in each instance. To that end, the disclosure is required to address the following, *at a minimum*:

- (1) Principal amount, interest rate, payment terms, maturity date, and any provisions relating to prepayment of the Subordinated Debt Notes;
- (2) All material covenants, both affirmative and negative, that govern the Subordinated Debt Notes, including the covenants required to be included pursuant to the proposed rule;

- (3) Any legends required by applicable state law (which legends are in addition to any legends required to be included on the face of the Subordinated Debt Notes by the NCUA's regulations or any applicable state law);
- (4) An additional legend in the form prescribed by the proposed rule that informs potential investors that securities regulators, including the SEC, and the NCUA have not passed on the merits of or approved the offering, or any of the terms of the Subordinated Debt Notes or the disclosures provided to potential investors by the Issuing Credit Union in the Offering Document; and
- (5) That the offer and sale of the Subordinated Debt Notes have not been registered with the SEC under the Securities Act and the securities will be issued pursuant to exemptions from those registration requirements.

The Board notes that these types of legends are routinely included in securities Offering Documents, including those used by other types of financial institutions. Such legends serve to inform potential investors that the NCUA and other regulators do not assess the merits of any investment offering and, further, that the Issuing Credit Union is responsible for the disclosure in the Offering Document, whether or not the NCUA or any other regulator has reviewed the document.

Paragraphs (f) and (g) of § 702.408 outline certain important differences in the offering process for Subordinated Debt Notes that will be offered to any Natural Person Accredited Investors (whether the offering is directed only to Natural Person Accredited Investors or to both Natural Person Accredited Investors and Entity Accredited Investors) versus the offering process for sales that will be made solely to Entity Accredited Investors. The Board believes that Natural Person Accredited Investors, while sophisticated and able to assess the risks inherent in investing in Subordinated Debt Notes, can benefit from receiving an Offering Document that has been subject to review by the NCUA. On the other hand, the Board believes that Entity Accredited Investors are likely to be even more sophisticated investors than Natural Person Accredited Investors and, therefore, more capable of assessing the disclosures provided in the Offering Document, even one that has not been subject to the NCUA's review.

For offerings that will include Natural Person Accredited Investors as potential purchasers (no matter how many), an Issuing Credit Union must submit a draft of its Offering Document to the NCUA for review, complete the review process, and have the draft declared "approved for use" by the NCUA before its first use.¹²³ The purpose of the review process is to permit the NCUA to assess an Issuing Credit Union's compliance with the proposed rule's disclosure requirements and provide the Issuing Credit Union the opportunity to address the NCUA's questions and comments. Through this process,

¹²³ The NCUA expects that this review process will be an iterative one between NCUA staff and the Issuing Credit Union, similar to that between the OCC and national banks or between the SEC and parties seeking to have their registration statements declared effective by the SEC.

the Issuing Credit Union will provide any additional information requested by the NCUA and file any amendment(s) to its Offering Documents in response to the Agency's questions, comments, and concerns so as to allow the NCUA to reach a conclusion either to declare an Offering Document "approved for use" or to disapprove the Offering Document as inadequate.

An Issuing Credit Union that issues Subordinated Debt Notes that will be offered exclusively to Entity Accredited Investors will not be required to submit a draft of its Offering Document to the NCUA for review and declaration as "approved for use." Once the Issuing Credit Union has received the approval of its application under paragraph (c) of § 702.408 and has completed the drafting of an Offering Document that it affirms meets all the disclosure requirements included in the proposed rule, the Issuing Credit Union may use that Offering Document immediately, without the need to receive any "approved for use" declaration or other clearance from the NCUA.

In all instances, the proposed rule will require an Issuing Credit Union to file a copy of each Offering Document with the NCUA within two business days of its first use. This requirement ensures that the NCUA has contemporaneous notice of activity in the credit union Subordinated Debt market, and it generally aligns with filing requirements imposed by other federal regulators on issuances of securities.

Material Changes to Initial Application or Offering Documents

In the event that an Issuing Credit Union's circumstances materially change after the NCUA has approved an initial application, but before the closing of the relevant offer and sale of Subordinated Debt Notes, paragraph (h) requires an Issuing Credit Union to submit an amended application before it continues its Subordinated Debt Notes offering. In the amended application, the Issuing Credit Union must describe the event or change and receive approval from the NCUA before it may complete the offer and sale of the related Subordinated Debt Notes. This amended application filing and approval requirement applies to *any* offering—whether an offering made solely to Entity Accredited Investors or an offering that includes Natural Person Accredited Investors. An Issuing Credit Union must determine what constitutes a “material change” in its circumstances and whether that change warrants the submission of an amended application. The Board encourages credit unions to consult with legal and other professional advisors in making that determination, and further recognizes that credit unions may be guided by concepts of materiality found in the securities laws.

Similarly, if, after an Offering Document has been “approved for use” but before the closing of the relevant offer and sale of Subordinated Debt Notes, a material event arises or a material change in fact occurs that, individually or in the aggregate, results in an “approved for use” Offering Document containing any untrue statement of material fact, or omitting to state a material fact necessary in order to make statements made in the Offering Document not misleading in light of the circumstances under which they were

made, paragraph (h) requires the Issuing Credit Union (and any person acting on its behalf) to discontinue any offers or sales of the Subordinated Debt Notes.

The proposed rule requires an Issuing Credit Union to revise the Offering Document and to submit any such amended Offering Document to the NCUA to be “approved for use” before the credit union resumes any offers or sales of Subordinated Debt Notes. If there is a material change in circumstances after an Issuing Credit Union has first used an Offering Document in an offer and sale of Subordinated Debt Notes made exclusively to Entity Accredited Investors, the proposed rule requires an Issuing Credit Union to determine, in accordance with applicable securities laws, whether such change warrants delivery of a revised Offering Document to potential investors. However, the Board reminds all Issuing Credit Unions of the continuing applicability of the anti-fraud provisions of the federal securities laws to in-progress offerings and the importance of considering whether continued use of an Offering Document that has not been amended to reflect material events or changes could be inconsistent with those provisions. An Issuing Credit Union must file any revised Offering Document with the NCUA within two business days of its first use.

The failure of an Issuing Credit Union to comply with the application amendment and/or Offering Document amendment requirements could result in the NCUA imposing administrative remedies available under the FCU Act, including prohibiting the Issuing Credit Union from issuing any additional Subordinated Debt for a specified period and/or determining not to treat the Subordinated Debt as Regulatory Capital.

Notification of Subordinated Debt Issuance

Paragraph (i) of § 702.408 proposes a notice and recordkeeping provision that would require an Issuing Credit Union to notify its Appropriate Supervision Office no later than ten business days after the closing of a Subordinated Debt Note issuance and sale and, as part of the notice filing, to submit documents relating to the issuance and sale to the NCUA, including, but not limited to:

- A copy of the executed Subordinated Debt Note;
- Any purchase agreement used;
- Any indenture or other transaction document used to issue the Subordinated Debt Notes;
- Copies of signed Accredited Investor Certificates from all investors;
- Documents (other than Offering Documents previously filed with the NCUA) provided to investors related to the offer and sale of the Subordinated Debt Note; and
- Any other material documents governing the issuance, sale or administration of the Subordinated Debt Notes.

Resubmissions

Paragraph (j) of § 702.408 provides that, if the NCUA provides a written adverse determination in respect of any application to offer and sell Subordinated Debt Notes

and/or any Offering Document (if the offer and sale will be made to any Natural Person Accredited Investors), an Issuing Credit Union may amend such application or Offering Document to cure the deficiencies noted in the written determination and re-file such application or Offering Document with the NCUA in accordance with the rule's provisions. The Board notes that both the application and Offering Document approval processes may be iterative, at times requiring multiple submissions by an Issuing Credit Union before the NCUA provides its approval.

The Board notes, however, there could be instances when an Issuing Credit Union's application and/or Offering Document will not be approved by the NCUA. In such instances, the NCUA will provide a written determination specifying the reasons for the disapproval. Paragraph (j) also provides that an Issuing Credit Union may appeal the NCUA's decision in respect of any application and/or Offering Document under subpart A of part 746 of the NCUA's regulations.¹²⁴

The Board proposes to expire an Issuing Credit Union's authority to issue Subordinated Debt Notes one year from the later of the date the Issuing Credit Union received NCUA approval of its initial application, if the proposed offering is to be made solely to Entity Accredited Investors, or the "approved for use" date of the applicable Offering Document if the proposed offering will include any Natural Person Accredited Investors. The Board specifically is requesting comment as to whether this one-year limit, which is intended in part to ensure that an Issuing Credit Union does not offer and

¹²⁴ 12 CFR part 746, subpart A.

sell Subordinated Debt Notes following a material change in the information on which the NCUA relied in approving the offer and sale of that Issuing Credit Union's Subordinated Debt Notes, unduly limits the marketability and functionality of Subordinated Debt Notes issuances.

The proposed rule provides the right for an Issuing Credit Union to file a written request for one or more extensions of the one-year limit with the Appropriate Supervision Office, provided any such request is filed at least 30 calendar days before the expiration of the applicable period noted above. A credit union's extension request must demonstrate good cause for an extension(s) and address whether such an extension will pose any material securities law implications.

Filing Requirements

Paragraph (l) of § 702.408 specifies the mechanics of filing required disclosure and transactional documents with the NCUA, while paragraph (m) notes that the NCUA may require filing fees to accompany certain filings. The Board notes that other federal regulators assess, or have reserved the right to assess, filing fees in connection with securities offerings under their jurisdiction.

The Board is requesting comment as to whether the imposition of filing fees would unduly limit the marketability and functionality of Subordinated Debt Notes issuances. Specifically, if the NCUA were to assess any such filing fees, on what should the NCUA base the fee structure and why? For example, should the NCUA follow the

filing fee structures of other federal regulators and, if so, which regulators? Should LICUs and/or New Credit Unions be exempt from any filing fee requirements, or should they have a reduced fee structure?

9. § 702.409 Preapproval for FISCUs to issue Subordinated Debt.

The Board is proposing to include a section that details the application procedures specific to FISCUs. Under the Current Secondary Capital Rule, a FISCU must submit its secondary capital plan to both the NCUA and its SSA. The SSA is responsible for rendering a decision on such plan with the concurrence of the NCUA. The Board notes that this requirement has proved problematic in some instances. Specifically, some states do not have regulations that address the evaluation of secondary capital plans. In some cases, this has resulted in a conflict between the requirements of the Current Secondary Capital Rule and the applicable state laws of some SSAs.

Based on lessons learned from the Current Secondary Capital Rule and the fact Subordinated Debt stands in front of the NCUSIF as loss absorbing capital, the Board is proposing to change the approval process for FISCUs seeking to issue Subordinated Debt. Under this proposed rule, a FISCU must still submit the information required under § 702.408 to both the NCUA and its SSA. However, the Board is proposing to shift the responsibility for rendering a decision from the states to the NCUA. As such, the proposed rule states that the NCUA will render all decisions on FISCU Subordinated Debt applications, but will only approve a Subordinated Debt application after obtaining the concurrence of the credit union's SSA. The Board believes this maintains the

supervisory authority of the SSA while shifting the responsibility for rendering decisions to the NCUA. The Board notes that while it is changing the process for FISCU application approvals, it is not changing the current process for approvals of FISCU applications to prepay Subordinated Debt. As discussed in section II. (C)(11) of this preamble, a FISCU seeking approval to prepay Subordinated Debt must still seek approval from its SSA before submitting an application to prepay to the NCUA.

In addition, the Board is considering adding a requirement in a final Subordinated Debt rule that would require a FISCU to submit with its application an attestation that it has consulted with its SSA and the Subordinated Debt it is proposing to issue is permissible under state law. The Board believes this requirement may be useful to and efficient for both the NCUA and a FISCU. Such a requirement would ensure a FISCU is permitted to issue Subordinated Debt under state law before the credit union and the NCUA expend resources on the credit union's application. The Board invites feedback on this requirement.

This section of the proposed rule also states that the NCUA will notify a FISCU's SSA before issuing a decision to "approve for use" a FISCU's Offering Document and any amendments thereto, under proposed § 702.408. Because rendering a decision to "approve for use" an Offering Document is an iterative process, the Board is not proposing to seek the SSA's concurrence on this decision. The Board believes that obtaining such concurrence may delay the review process and negatively impact credit unions, while providing little utility to the supervision by an SSA. The Board believes that concurrence in the decision to approve a FISCU's application and notice of a

decision to “approve for use” a FISCO’s Offering Document strikes a balance between involvement by the appropriate SSA and the NCUA’s role as insurer.

The Board is also proposing to include in this section a requirement stating that if the Appropriate Supervision Office has reason to believe that a Subordinated Debt issuance by a FISCO could subject that FISCO to federal income taxation, the Appropriate Supervision Office may require the FISCO to provide:

- (1) A written legal opinion, satisfactory to the NCUA, from nationally recognized tax counsel or letter from the Internal Revenue Service indicating whether the proposed Subordinated Debt would be classified as capital stock for federal income tax purposes and, if so, describing any material impact of federal income taxes on the FISCO’s financial condition; or
- (2) A Pro Forma Financial Statement (balance sheet, income statement, and statement of cash flows), covering a minimum of five years, that shows the impact of the FISCO being subject to federal income tax.

This proposed section further provides that, should such information be required, a FISCO may determine in its sole discretion whether the information it provides is in the form articulated in either (1) or (2) above.

The Board notes that FISCUs are exempt from federal income taxation under § 501(c)(14) of the Internal Revenue Code.¹²⁵ Conversely, FCUs are exempt from federal income taxation under the FCU Act.¹²⁶ Section 501(c)(14) of the Internal Revenue Code exempts state-chartered credit unions that are operating on a not-for-profit basis, organized without capital stock, and operating for mutual purposes. While FCUs may only permissibly issue Subordinated Debt under their borrowing authority, it is possible that a FISCU, under state law, could issue an instrument that otherwise meets that requirements of subpart D of part 702, but may have a structure akin to capital stock. The Board is therefore proposing a backstop provision to protect the safety and soundness of FISCUs that may propose to issue an instrument that an Appropriate Supervision Office has reason to believe could be treated as capital stock.

In such limited situations, the Board is proposing to require a FISCU to demonstrate that the instrument will either not be treated by the Internal Revenue Service as capital stock or that, if an instrument is treated as capital stock (thereby subjecting the FISCU to federal income taxation), the associated costs can be safely absorbed by the FISCU. While the Board expects there to be few instances in which this provision is invoked, if any, its inclusion in the proposed rule protects against all possible circumstances to ensure the ongoing safety and soundness of FISCUs that issue Subordinated Debt. The Board believes this proposed provision would ensure that a FISCU conducts thorough due diligence on the ramifications of issuing an instrument that

¹²⁵ IRC 501(c)(14).

¹²⁶ 12 U.S.C. 1768.

could subject it to federal income taxation, and demonstrate that either such instrument will not subject the credit union to taxation or that it has the financial capabilities to remain in a safe and sound condition with the added expense of federal income taxation.

10. § 702.410 Interest payments on Subordinated Debt.

In purchasing Subordinated Debt from credit unions, investors face certain regulatory uncertainties. For example, the FCU Act and the NCUA’s regulations provide authority to prohibit dividend or interest payments in specified scenarios. In its PCA regulations, the Board specifically lists restrictions on the payment of interest on secondary capital as an option for “Critically Undercapitalized” credit unions.¹²⁷ Even for a credit union with a more favorable net worth classification, PCA authorities allow the Board to “restrict or require such other action as [it] determines will carry out the purpose of [the PCA provisions] better than” the specifically listed authorities.¹²⁸ These discretionary authorities may make it difficult for investors to gauge risks related to Subordinated Debt purchases, resulting in more extensive disclosure requirements and higher costs for Issuing Credit Unions.

¹²⁷ As discussed in section II. (B)(3) of this preamble, the Board is proposing to make cohering changes to this section of the PCA regulations to address Grandfathered Secondary Capital and Subordinated Debt.

¹²⁸ 12 CFR 702.107; 702.108.

To address this investor uncertainty, the Board is considering multiple approaches. First, the Board is proposing provisions that would prohibit interest payments on Subordinated Debt for any “Critically Undercapitalized” credit union. The proposed rule would make this mandatory for Subordinated Debt (it is currently a specified discretionary authority under the NCUA’s regulations).¹²⁹ This approach aligns with banking law,¹³⁰ which prohibits interest on subordinated debt for “Critically Undercapitalized” banks, except where the institution requests and receives regulatory approval. Standardizing this preclusion is consistent with what the market is accustomed to for subordinated debt of national banks. The Board has included proposed disclosures that would be required to address this risk of PCA requirements (see section II. (C)(5) of this preamble).

Second, the Board is proposing a safe harbor for interest payments on Subordinated Debt for any credit union in a net worth category more favorable than “Critically Undercapitalized.” Under this safe harbor, the NCUA would not prohibit interest payments on Subordinated Debt for such credit unions, provided that a list of criteria are satisfied (see proposed § 702.410(c)). These qualifying criteria provide that a credit union must have issued the Subordinated Debt in an arms-length transaction, in the ordinary course of business, with no evidence of intent to hinder or defraud the Issuing Credit Union or its creditors. In addition, the Subordinated Debt must comply with the proposed issuance requirements. The proposed rule also clarifies that the safe harbor

¹²⁹ Id. 702.109(b)(11).

¹³⁰ 12 U.S.C. 1831o(h)(2).

neither waives nor affects other authorities the NCUA may exercise in any of its regulatory, conservatorship, or liquidating agent capacities.

The Board invites comment on whether it should retain the proposed interest safe harbor or eliminate it. While the safe harbor could make debt pricing more favorable for Issuing Credit Unions, such an impact remains to be seen. Conversely, such a safe harbor could cost the NCUSIF, as the Board may be unable to limit interest payments for Issuing Credit Unions subject to PCA.

In considering the interest safe harbor, the Board notes that neither the FDIC nor the OCC provide similar relief in connection with the subordinated debt of their regulated banking institutions. While the scope of this safe harbor would be unique in the subordinated debt market, the Board believes it could make Subordinated Debt issued by Issuing Credit Unions a more viable product at a lower cost. In hopes of increasing viability, the Board is willing to consider this interest safe harbor and welcomes comment on this issue.

11. § 702.411 Prior written approval to prepay Subordinated Debt.

Consistent with the Current Secondary Capital Rule, the proposed rule requires a credit union to receive prior written approval from the Appropriate Supervision Office to prepay Subordinated Debt. However, the Board is proposing to expand a credit union's authority to prepay any portion of the Subordinated Debt. Under the Current Secondary Capital Rule, only the portion of the secondary capital that no longer counts as

Regulatory Capital may be approved for prepayment. The Board believes this proposed change will provide credit unions additional flexibility to effectively manage issued Subordinated Debt.

In addition, the Board notes that if the terms of the Subordinated Debt Note allow prepayment (call option), the prepayment option and the requirements of this proposed section of the regulation must clearly be disclosed in the Subordinated Debt Note. The Board is adding this requirement to ensure investors receive adequate disclosure of a credit union's option to prepay the issued Subordinated Debt and the regulatory requirements related to such prepayment.

To obtain approval to prepay, the proposed rule requires a credit union to submit an application to the Appropriate Supervision Office. To provide regulatory relief, the proposed requirements of the application are less prescriptive than the Current Secondary Capital Rule, and more comparable to the OCC's subordinated debt regulations.¹³¹ To request early redemption of secondary capital, the Current Secondary Capital Rule requires a LICU to demonstrate to the NCUA that the:¹³²

- LICU will have a post-redemption net worth classification of “Adequately Capitalized” per part 702 of this chapter;

¹³¹ 12 CFR 5.47(f)(2)); (g)(1)(ii).

¹³² Id 7022.34(d)(1).

- Discounted secondary capital has been on deposit for at least two years;
- Discounted secondary capital will not be needed to cover losses prior to maturity;
- LICU's books and records are current and reconciled;
- Proposed redemption will not jeopardize other current sources of funding;
and
- LICU's board of directors authorized the request to redeem.

Under this proposal, a credit union must provide an application for prepayment to the Appropriate Supervision Office. However, the required items are a change from the Current Secondary Capital Rule. The Board believes that normally, the proposed required items for prepayment should provide the Appropriate Supervision Office with the appropriate information to make a sound decision on prepayment. A credit union must provide, *at a minimum*, a copy of the Subordinated Debt Note (including any agreements reflecting the terms and conditions of the Subordinated Debt) and an explanation of why the credit union believes it still would hold an amount of capital commensurate with its risk post redemption. The Board believes this information will allow the Appropriate Supervision Office to adequately determine the safety and soundness of prepaying Subordinated Debt.

The Board notes, however, that this proposed rule clarifies that the information discussed above is the *minimum* information required in an application for approval to

prepay Subordinated Debt, and that an Appropriate Supervision Office may request additional information if needed. The OCC's subordinated debt regulations have similar flexibility. Allowing a request for additional information ensures the Appropriate Supervision Office has all the relevant information to make an appropriate decision regarding the prepayment.

FISCU Application to Prepay Subordinated Debt

Before submitting an application seeking prepayment authority to the NCUA, a FISCU must obtain written approval from its SSA. This process differs from the proposed original issuance approval process under § 702.409 as discussed in section II. (C)(9) of this preamble, which would allow for simultaneous submission to the NCUA and SSA. The proposed requirement of prior approval by the SSA before a credit union applies to the NCUA for prepayment approval provides the SSA the first review and opportunity to render a decision on a FISCU's application to prepay, and acknowledges the SSA's role with safety and soundness relative to FISCUs. The NCUA's role as final approver reflects the nature of Subordinated Debt as protection for the NCUSIF.

NCUA Decision on Application to Prepay Subordinated Debt

The Board is proposing to retain a 45-day timeline to review and respond to a prepayment request. However, the proposed rule would make one change to the approval process. Currently, if an Issuing Credit Union does not receive a response from the Appropriate Supervision Office within 45 days, the request to prepay is deemed

approved. Under the proposed rule, automatic approvals no longer occur. This change is consistent with the removal of automatic approvals for the proposed original issuance approval process as discussed in section II. (C)(8).

**12. § 702.412 Effect of a merger or dissolution on the treatment of
Subordinated Debt as Regulatory Capital.**

Paragraph (b)(9) of the Current Secondary Capital Rule states that “...in the event of merger or other voluntary dissolution of a LICU, other than merger into another LICU, the secondary capital accounts will be closed and paid out to the account investor to the extent they are not needed to cover losses at the time of merger or dissolution.”¹³³ The Board is proposing to retain the general framework in current paragraph (b)(9), but to make several adjustments to account for the additional types of credit unions that may issue Subordinated Debt and provide additional flexibility to a resulting credit union in a merger.

Specifically, the Board is proposing to permit the acquisition of Subordinated Debt in a merger or assumption transaction regardless of the classification of the resulting credit union. Currently, this is only permissible if both the resulting and merging credit unions are LICUs. The Board believes this change will provide additional flexibility to credit unions, while, as discussed in the next paragraph, maintaining controls on the Regulatory Capital treatment of Subordinated Debt. The Board also notes that this

¹³³ Id.34(b)(9).

provision could be a benefit to investors, as the Subordinated Debt could remain outstanding and earning interest versus being repaid.

Under this proposed rule, the Regulatory Capital treatment of any acquired Subordinated Debt would be contingent on several factors. First, if the resulting credit union is a LICU, Complex Credit Union, or New Credit Union, it may acquire the Subordinated Debt of the merging credit union, and the non-discounted portion of such Subordinated Debt will continue to be treated as Regulatory Capital. Irrespective of the foregoing, if the resulting credit union is not a LICU, the acquired Subordinated Debt will not count toward that credit union's Net Worth. Acquired Subordinated Debt will only count toward a resulting credit union's Net Worth if such credit union is a LICU.

If the resulting credit union is not a LICU, Complex Credit Union, or New Credit Union, the Board is proposing to provide two options for addressing the assumed Subordinated Debt. First, if permitted by the terms of the Subordinated Debt Note, the resulting credit union can apply to the NCUA for approval to prepay the Subordinated Debt. If the NCUA grants such approval, the Subordinated Debt may be repaid in accordance with the requirements related to prepayment, discussed in section II. (C)(11) of this preamble.

Second, the resulting credit union may continue to hold the acquired Subordinated Debt, but such Subordinated Debt will not be treated as Regulatory Capital unless the resulting credit union becomes a LICU, Complex Credit Union, or New Credit Union. In the event the resulting credit union becomes one of the aforementioned types of credit

unions, the Board is proposing to allow any non-discounted portion of acquired Subordinated Debt to immediately be treated as Regulatory Capital upon the resulting credit union being designated as a LICU, Complex Credit Union, or New Credit Union. If the resulting credit union never becomes a credit union eligible to receive Regulatory Capital treatment of the acquired Subordinated Debt, such Subordinated Debt may continue to be held by the resulting credit union or prepaid, in accordance with the prepayment section of this proposed rule, but, in either case, such Subordinated Debt will never receive Regulatory Capital treatment. Further, acquisition of Subordinated Debt in a merger does not permit an ineligible credit union to issue its own Subordinated Debt. This proposed rule only allows an ineligible credit union to hold acquired Subordinated Debt until maturity.

The Board believes the proposed treatment of acquired Subordinated Debt is consistent with the safety and soundness goals of this proposed rule and provides resulting credit unions with flexibility to exercise business judgment in determining how to proceed with acquired Subordinated Debt.

The Board is also proposing to address voluntary liquidations in this section of the rule. Specifically, the Board is proposing to permit a credit union to prepay Subordinated Debt as part of a voluntary liquidation. Any such prepayment must, however, be conducted in accordance with the prepayment requirements of the proposed rule (see § 702.411). The Board believes it is appropriate to require a credit union to apply for approval to prepay Subordinated Debt in a voluntary liquidation, as it is incumbent upon

the NCUA to determine if the Subordinated Debt will or could be needed to cover any losses that a credit union may incur during liquidation.

13. § 702.413 Repudiation safe harbor.

The FCU Act provides multiple authorities to the Board as conservator or liquidating agent that could affect Subordinated Debt. For example, in both conservatorships and liquidations the FCU Act provides the Board the authority to repudiate contracts.¹³⁴ The Board can also enforce contracts that might otherwise have provided for default, acceleration, or the exercise of other rights upon insolvency or appointment of a conservator or liquidating agent. Any of these authorities could affect a potential investor's evaluation of an Issuing Credit Union's Subordinated Debt.

With respect to repudiation, the Board, including its lawfully appointed designee, has the authority to repudiate any contract within a reasonable period following appointment as conservator or liquidating agent for an insured credit union. This authority is subject only to a conservator's or liquidating agent's discretionary decision that the contract is both burdensome and that repudiation will promote orderly administration of a credit union's affairs. Repudiation generally limits recourse by introducing limits on both time and type of recourse. The time for determination of damages is the date of appointment of the conservator or liquidating agent and the type of recourse is limited to "actual direct compensatory" damages. Punitive or exemplary

¹³⁴ 12 U.S.C. 1787(c).

damages, damages for lost profit or opportunity, and damages for pain and suffering are excluded from the scope of actual direct compensatory damages, and case law further defines the boundaries of permitted damages. Permissible damages elements that are approved as a claim (after proceeding through the administrative claims process) become eligible for payment at their related priority under 12 CFR § 709.5(b), subject to availability of funds.

Thus, a conservator's or liquidating agent's repudiation authority is broad and could affect a Subordinated Debt investor's rights to payment. While the extent of impact could vary substantially based on individual circumstances, the Board believes the exercise of this power in connection with Subordinated Debt would have the least consequence in involuntary liquidation scenarios. In such a scenario, a credit union will generally be insolvent (or at least "Critically Undercapitalized"), and only in unusual cases will funds be available to fully pay approved claims beyond those of the NCUSIF and uninsured shareholders.¹³⁵ In many cases Subordinated Debt may have been entirely extinguished to cover deficits before a liquidation occurs. Therefore, the Board believes the issue of repudiating Subordinated Debt contracts in liquidation contexts is unlikely to make a measureable difference to any Subordinated Debt purchaser.

On the other hand, the conditions under which the Board may invoke its conservatorship authorities are broader than those that apply to liquidations. They include a credit union's consent, violation of an order to cease and desist, or concealment

¹³⁵ 12 CFR 709.5(b)(6).

of books and records, among others. In the case of conservatorships, a conservator has the power to repudiate Subordinated Debt contracts in situations where a credit union remains solvent. Such repudiation, if exercised, could substantially affect the timing of a holder's receipt of principal, along with interest payments that may have otherwise continued. While conservatorships are rare, the possibility of such action creates additional uncertainty regarding a purchaser's ability to value the Subordinated Debt at the time of purchase. This additional uncertainty could, in turn, affect the cost and marketability of Subordinated Debt issued under the proposed rule.

To address this uncertainty, the Board has included a safe harbor in the proposed rule by which it would prevent the conservator's exercise of repudiation authority when a conserved credit union is solvent. Like the proposed safe harbor related to interest payments, the proposed rule establishes a list of criteria that, if satisfied, would qualify a Subordinated Debt instrument for the repudiation safe harbor. To qualify, a credit union must have issued the Subordinated Debt in an arms-length transaction, in the ordinary course of business, with no evidence of intent to hinder or defraud the Issuing Credit Union or its creditors. In addition, the Subordinated Debt must comply with all of the proposed requirements of the proposed rule. The safe harbor described in the proposed rule also clarifies that it neither waives nor affects other authorities the NCUA may

exercise in any of its regulatory, conservatorship, or liquidating capacities.¹³⁶ In liquidation contexts, the safe harbor would not apply, for the reasons stated above.

The Board invites comment on whether it should retain the proposed repudiation safe harbor or eliminate it. While the safe harbor could make Subordinated Debt pricing more favorable for credit unions, such an impact remains to be seen. Conversely, the safe harbor could cost the NCUSIF, as the Board may be unable to repudiate Subordinated Debt contracts that a conserved credit union is unable to service, creating or increasing financial distress.

14. § 702.414 Regulations governing Grandfathered Secondary Capital.

As discussed in section II. (C)(1) of this preamble, the Board is proposing to grandfather secondary capital issued by LICUs before the effective date of any final Subordinated Debt rule. For clarity and ease of use, therefore, the Board is proposing to include the Current Secondary Capital Rule in subpart D as § 702.414, with minor modifications. The Board believes this proposed change would aid LICUs in quickly finding the rules applicable to Grandfathered Secondary Capital, while maintaining the Board's objective to house all capital related rules for natural person credit union in one

¹³⁶ These criteria are similar to those that apply to assets transferred in connection with a securitization or participation, as set forth in 12 CFR 709.9. In the securitization and participation context, the NCUA's safe harbor in 12 CFR 709.9 does not extend to repudiation itself, but is limited to the reclamation of related collateral when the Board exercises the repudiation power. Unlike the safe harbor for securitization and participations, the proposed safe harbor would prohibit repudiation altogether in the circumstances described.

part. The Board is also proposing to delete the Current Secondary Capital Rule to avoid having two nearly identical rules on secondary capital.

The Board notes that, under this proposed rule, there would be some technical differences between the Current Secondary Capital Rule and proposed § 702.414. Such differences serve to clarify that a LICU may only follow the rules in this section for Grandfathered Secondary Capital, and that the proposed rule does not permit a LICU to continue offering secondary capital under the Current Secondary Capital Rule.

In addition, proposed § 702.414(a)(2) would include a statement indicating that any issuances of secondary capital not completed by the effective date of a final Subordinated Debt rule are, as of such effective date, would be subject to the requirements applicable to Subordinated Debt discussed elsewhere in this preamble. The Board is proposing this requirement to ensure all issuances of secondary capital not yet completed would be subject to the requirements of this proposed rule. The Board is, however, requesting specific comment on what it should set as the implementation date for such provision. While the Board wants to ensure future issuances of secondary capital are subject to the requirements of this rule, it is not intending to negatively impact LICUs that are close to issuing secondary capital under a secondary capital plan that was approved before the effective date of a final Subordinated Debt rule. The Board encourages commenters to identify what would be a reasonable amount of time to allow LICUs to conduct such issuances.

This proposed section also makes a minor technical correction in proposed § 702.414(b)(1), which instructs a LICU how to properly account for secondary capital on its balance sheet. The Current Secondary Capital Rule requires a LICU to record secondary capital as equity. This is, however, inaccurate, as U.S. GAAP requires such instrument to be accounted for as debt rather than equity. As such, this proposed change merely reflects the proper accounting treatment of secondary capital, and is not a substantive change.

D. PART 709—INVOLUNTARY LIQUIDATION OF FEDERAL CREDIT UNIONS AND ADJUDICATION OF CREDITOR CLAIMS INVOLVING FEDERALLY INSURED CREDIT UNIONS IN LIQUIDATION.

1. § 709.5 Payout priorities in involuntary liquidation.

The Board is proposing to make conforming changes to the section of part 709 that addresses payout priorities in involuntary liquidations. Currently, § 709.5(b) lists secondary capital as the last priority for payout when a LICU is liquidated. In accordance with the FCU Act, secondary capital must be subordinate to all other claims against a LICU, including claims of other creditors, the NCUSIF, and shareholders.¹³⁷ Because this is a statutory provision, the Board is required to maintain Subordinated Debt issued by LICUs as the last in the list of payout priorities.

¹³⁷ 12 U.S.C. 1757a(c)(2)(B)(ii); 1790d(o)(2)(C)(ii).

Under the proposed rule, Subordinated Debt for LICUs, Complex Credit Unions, and New Credit Unions will be the same instrument and subject to the same regulation. Secondary capital and proposed Subordinated Debt also both function as capital that is subordinate to all claims, including those by the NCUSIF, general creditors, and shareholders. As such, the Board believes it is appropriate to include Subordinated Debt in the last payout priority when a natural person, federally insured credit union is liquidated. Further, to address Grandfathered Secondary Capital, discussed in section II. (C)(1) of this preamble, the last payout priority will clarify that such Grandfathered Secondary Capital continues to remain the last payout priority position.

E. PART 741—REQUIREMENTS FOR INSURANCE.

The Board is proposing to make several changes to part 741 to ensure consistency with the other proposed changes in this rule. Specifically, the Board is proposing to amend § 741.204 and add new §§ 741.226, and 741.227.

1. § 741.204 Maximum public unit and nonmember accounts, and low-income designation.

Currently, § 741.204 includes the rules and requirements for low-income FISCUs. Among these requirements is a discussion of how a low-income FISCU can apply for authority to issue secondary capital. Because secondary capital will, under the proposed rule, be included as part of Subordinated Debt and will no longer be included in § 701.34, the Board is proposing to make clarifying amendments to this section.

Specifically, the Board is proposing to change the cross reference in this section to proposed § 702.414 and clarify that this section only applies to secondary capital issued before the effective date of any final Subordinated Debt regulation. As discussed in the next section of this preamble, the Board is proposing to add a section to part 741 to address the requirements that apply to a FISCUS seeking approval to issue Subordinated Debt after the effective date of a final Subordinated Debt rule.

2. § 741.226 Subordinated Debt.

The Board is proposing to add a new section in subpart B of part 741 to instruct a FISCUS to comply with the requirements of subpart D of part 702 before it may issue Subordinated Debt. The new proposed section also clarifies that a FISCUS may only issue Subordinated Debt in accordance with subpart D of part 702 if such issuance complies with applicable state law and regulation. As discussed in section II. (C)(9) of this preamble, subpart D to part 702 includes application procedures specific to FISCUSs. This proposed new section is clarifying in nature and does not result in a substantive change for FISCUSs.

3. § 741.227 Loans to other credit unions.

The Board is proposing to include a new section in part 741 that would make the limitation on loans to credit unions included in proposed new § 701.25 applicable to all federally insured credit unions. As discussed in section II. (A)(1) of this preamble, the Board is proposing a new § 701.25 to address safety and soundness concerns with loans

between credit unions. Because the concerns discussed in relation to § 701.25 are not unique to FCUs, the Board believes it is prudent to extend the requirements of that section to all credit unions.

III. Regulatory Procedures

A. PAPERWORK REDUCTION ACT

The Paperwork Reduction Act of 1995 (PRA) applies to rulemakings in which an agency by rule creates a new paperwork burden on regulated entities or modifies an existing burden (44 U.S.C. 3507(d)). For purposes of the PRA, a paperwork burden may take the form of a reporting, recordkeeping, or a third-party disclosure requirement, referred to as an information collection.

NCUA is seeking comments on the information collection requirement of a proposed new subsection to part 702 that addresses requirements and regulatory capital treatment of subordinate debt. A request for a new OMB control number has been submitted to the Office of Management and Budget (OMB) for review and approval. The request contains information collection requirements associated with applying for authority to issue subordinated debt, credit union eligibility to issue subordinate debt, prepayments and disclosures. These information collection requirements apply to low-income credit unions (LICUs), complex and new credit unions.

The initial application requirement to issue subordinated debt can be found in §702.408(b) and is estimated to impact 25 credit unions annually and is estimated to take 100 hours per respondent. Following approval of the initial application, an issuing credit union must prepare and submit for each issuance of subordinated debt, an offering document for NCUA approval. This offering document is estimated to take each of the 25 issuing credit unions 40 hours to prepare. Additional reporting requirements covered under §§702.406, 702.408, 702.409, 702.411, and 702.414 involve requests for additional information, extensions, and prepayments. An issuing credit union must provide a copy of the approved offering document to each investor (§701.408(d)), and a FISCU must also provide a copy to its state supervisory authority (§702.409(a)); averaging an hour per respondent. Recordkeeping requirements to maintain records prescribed by this proposed rule is estimated to average 15 minutes per record. Proposed new §701.25(b) requires federally insured credit unions to establish a written policies for making loans to other credit unions. This recordkeeping requirement to retain this policy update is estimated to average 30 minutes and would impact 3,300 credit union

Information collection requirement reported under § 702.414 are currently cleared under OMB control number 3133-0140, Secondary Capital for Low-Income Designated Credit Unions. This burden will be consolidated under this request for a new OMB control number and 3133-0140 will be discontinued upon prolongation of this rule.

OMB Control Number: 3133-NEW.

Title of information collection: Subordinated Debt.

Estimated number of respondents: 3,300.

Estimated number of responses per respondent: 1.12.

Estimated total annual responses: 3,703.

Estimated burden per response: 1.53.

Estimated total annual burden: 5,662.

The NCUA invites comments on: (a) whether the proposed collection of information is necessary for the proper performance of the functions of the agency, including whether the information will have practical utility; (b) the accuracy of the agency's estimate of the burden of the proposed collection of information, including the validity of the methodology and assumptions used; (c) ways to enhance the quality, utility and clarity of the information to be collected; and (d) ways to minimize the burden of the collection of information on those who are to respond, including through the use of appropriate automated, electronic, mechanical, or other technological collection techniques or other forms of information technology.

All comments are a matter of public records. Comments submitted in response to this notice will be summarized and included in the request for OMB approval.

Comments regarding the information collection requirements of this rule should be sent to (1) Dawn Wolfgang, NCUA PRA Clearance Officer, 1775 Duke Street, Alexandria,

VA 22314, Suite 6032, or email at PRAComments@ncua.gov and the (1) Office of Information and Regulatory Affairs, Office of Management and Budget, Attention: Desk Officer for NCUA, New Executive Office Building, Room 10235, Washington, DC 20503, or email at OIRA_Submission@OMB.EOP.gov.

B. EXECUTIVE ORDER 13132

Executive Order 13132 encourages independent regulatory agencies to consider the impact of their actions on state and local interests. The NCUA, an independent regulatory agency as defined in 44 U.S.C. § 3502(5), voluntarily complies with the executive order to adhere to fundamental federalism principles.

This proposed rule does not have substantial direct effects on the states, on the relationship between the national government and the states, or on the distribution of power and responsibilities among the various levels of government. The NCUA has therefore determined that this final rule does not constitute a policy that has federalism implications for purposes of the executive order.

C. ASSESSMENT OF FEDERAL REGULATIONS AND POLICIES ON FAMILIES

The NCUA has determined that this rule will not affect family well-being within the meaning of § 654 of the Treasury and General Government Appropriations Act, 1999, Pub. L. 105-277, 112 Stat. 2681 (1998).

List of Subjects in 12 CFR Part 701

Advertising, Aged, Civil rights, Credit, Credit unions, Fair housing, Individuals with disabilities, Insurance, Marital status discrimination, Mortgages, Religious discrimination, Reporting and recordkeeping requirements, Sex discrimination, Signs and symbols, Surety bonds

List of Subjects in 12 CFR Part 702

Credit unions, Reporting and recordkeeping requirements

List of Subjects in 12 CFR Part 709

Claims, Credit unions

List of Subjects in 12 CFR Part 741

Bank deposit insurance, Credit unions, Reporting and recordkeeping requirements

By the NCUA Board on January 23, 2020.

Gerard Poliquin
Secretary of the Board

For the reasons discussed above, the NCUA is proposing to amend 12 CFR Parts 701, 702, 709, and 741 as follows:

PART 701—ORGANIZATION AND OPERATIONS OF FEDERAL CREDIT UNIONS

1. The authority citation for part 701 continues to read as follows:

Authority: 12 U.S.C. 1752(5), 1755, 1756, 1757, 1758, 1759, 1761a, 1761b, 1766, 1767, 1782, 1784, 1786, 1787, 1789. Section 701.6 is also authorized by 15 U.S.C. 3717. Section 701.31 is also authorized by 15 U.S.C. 1601 et seq.; 42 U.S.C. 1981 and 3601–3610. Section 701.35 is also authorized by 42 U.S.C. 4311–4312.

2. Revise § 701.25 to read as follows:

§ 701.25 Loans to credit unions.

(a) *Limits.* A federal credit union may make loans, including investments in Subordinated Debt, to other credit unions, including corporate credit unions and privately insured credit unions, subject to the following limits:

(1) *Aggregate Limit.* The aggregate principal amount of loans to other credit unions may not exceed 25 percent of the federal credit union's paid-in and unimpaired capital and surplus.

(2) *Single Borrower Limit.* The aggregate principal amount of loans made to any one credit union may not exceed the greater of 15 percent of the federal credit union's Net Worth, as defined in part 702 of this chapter, at the time of the closing of the loan or \$100,000, plus an additional 10 percent of the federal credit union's Net Worth if the amount that exceeds the federal credit union's 15 percent general limit is fully secured at all times with a perfected security interest by readily marketable collateral as defined in § 723.2 of this part.

(b) *Approval and Policies.* A federal credit union's board of directors must approve all loans to other credit unions and establish written policies for making such loans. The written policies must, at a minimum, include the following:

(1) how the federal credit union will manage the credit risk of loans to other credit unions; and

(2) the limits on the aggregate principal amount of loans the federal credit union can make to other credit unions. The policies must specify the limits on the aggregate principal amount of loans the federal credit union can make to all other credit unions and the aggregate principal amount of loans the federal credit union can make to any single credit union; provided that any limits included in such policies do not exceed the limits in this section.

(c) *Investment in Subordinated Debt.*

(1) *Eligibility.* A federal credit union may only invest, directly or indirectly, in the Subordinated Debt of federally insured, natural person credit unions, or in loans or obligations issued by a privately insured credit union that are subordinate to the private insurer; provided that the investing federal credit union:

(A) has at the time of the investment, a capital classification of “Well Capitalized,” as defined in part 702 of this chapter;

(B) does not have any outstanding Subordinated Debt or Grandfathered Secondary Capital, in each case with respect to which it was the Issuing Credit Union (as defined in part 702 of this chapter); and

(C) is not eligible to issue Subordinated Debt or Grandfathered Secondary Capital pursuant to an unexpired approval from the NCUA under subpart D of part 702 of this chapter.

(2) *Aggregate limit.*

(A) *Aggregate Limit.* A federal credit union's aggregate investment (direct or indirect) in the Subordinated Debt and Grandfathered Secondary Capital of any federally insured, natural person credit union, and in loans or obligations issued by a privately insured credit union that are subordinate to the private insurer, may not cause such aggregate investment to exceed, at the time of the investment, the lesser of:

(i) 25 percent of the investing federal credit union's Net Worth at the time of the investment; and

(ii) any amount of Net Worth in excess of seven percent (7%) of total assets.

(B) *Calculation of Aggregate Limit.* The amount subject to the limit in subsection (A) of this section is calculated at the time of investment, and is based on a federal credit union's aggregate outstanding:

(i) investment in Subordinated Debt;

(ii) investment in Grandfathered Secondary Capital;

(iii) investment in loans or obligations issued by a privately insured credit union that are subordinate to the private insurer; and

(iv) loans or portion of loans made by the credit union that is secured by any Subordinated Debt, Grandfathered Secondary Capital, or loans or obligations issued by a privately insured credit union that are subordinate to the private insurer.

(3) *Indirect investment.* A federal credit union must determine its indirect exposure by calculating its proportional ownership share of each exposure held in a fund, or similar indirect investment. The federal credit union's exposure to the fund is equal to the exposure held by the fund as if they were held directly by the federal credit union, multiplied by the federal credit union's proportional ownership share of the fund.

3. Revise the title of § 701.34 to read as follows:

§ 701.34 Designation of low income status.

3. Amend § 701.34 by deleting subsections (b), (c), and (d) and Appendix to § 701.34.

4. Amend § 701.38 to read as follows:

§ 701.38 Borrowed funds.

(a) Federal credit unions may borrow funds from any source; provided that:

(1) the borrowing is evidenced by a written contract, such as a signed promissory note, that sets forth the terms and conditions including, at a minimum, maturity, prepayment, interest rate, method of computation of interest, and method of payment;

(2) the written contract and any solicitation with respect to such borrowing contain clear and conspicuous language indicating that:

(A) the funds represent money borrowed by the federal credit union; and

(B) the funds do not represent shares and, therefore, are not insured by the National Credit Union Administration.

(b) A federal credit union is subject to the maximum borrowing authority of an aggregate amount not exceeding 50 percent of its paid-in and unimpaired capital and surplus. *Provided* that any federal credit union may discount with or sell to any federal intermediate credit bank any eligible obligations up to the amount of its paid-in and unimpaired capital (12 U.S.C. § 1757(9)).

PART 702—CAPITAL ADEQUACY

1. The authority citation for part 702 continues to read as follows:

Authority: 12 U.S.C. 1766(a), 1790d.

2. Add a phrase at the beginning of this section; amend the definition of “Net Worth;” add a new definition of “Grandfathered Secondary Capital” between the definitions of “Government-sponsored enterprise (GSE)” and “Guarantee;” add a new definition of “Secondary Capital” between the definitions of “Risk-weighted assets” and “Secured consumer loan;” and add a new definition of “Subordinated Debt” between “Subordinated” and “Supervisory merger or combination” in revised § 702.2, effective January 1, 2022, to read as follows:

§ 702.2 Definitions.

All accounting terms not otherwise defined herein have the meanings assigned to them in accordance with United States generally accepted accounting principles (U.S. GAAP).

* * * * *

Grandfathered Secondary Capital means any subordinated debt issued in accordance with § 701.34 (recodified as § 702.414 of subpart D of this part) or, in the case of a federally insured, state-chartered credit union, with § 741.204(c) before [INSERT THE EFFECTIVE DATE OF THIS REGULATION].

Net Worth means, with respect to any federally insured, natural person credit union, as of any date of determination:

(1) the retained earnings balance of the credit union at the most recent quarter end, as determined in accordance with U.S. GAAP, subject to paragraph (3) of this definition;

(2) with respect to a low-income designated credit union, the outstanding principal amount of Subordinated Debt treated as Regulatory Capital in accordance with § 702.407 of this part, and the outstanding

principal amount of Grandfathered Secondary Capital treated as
Regulatory Capital in accordance with § 702.414, in each case that is:

(A) uninsured; and

(B) subordinate to all other claims against
the credit union, including claims of creditors,
shareholders, and the National Credit Union Share
Insurance Fund; and

* * *

* * * * *

Subordinated Debt has the meaning as provided in subpart D of this part.

* * * * *

3. Amend revised § 702.104(b)(1)(vii), effective January 1, 2022, to read as
follows:

§ 702.104 Risk-based capital ratio.

* * * * *

(b) * * *

(1) * * *

(vii) The outstanding principal amount of Subordinated Debt treated as Regulatory Capital in accordance with § 702.407 of this part and the outstanding principal amount of Grandfathered Secondary Capital treated as Regulatory Capital in accordance with § 702.414 of this part; and

4. Amend revised § 702.104(c)(2), effective January 1, 2022, to add new subsection (v)(B)(9) to read as follows:

* * * * *

(c) * * *

(2) * * *

(v) * * *

(B) * * *

(9) Natural person credit union Subordinated Debt, Grandfathered Secondary Capital, and loans or obligations issued by a privately insured credit union that are subordinate to the private insurer.

5. Amend revised § 702.109, effective January 1, 2022, by redesignating existing paragraphs (a)(3) and (a)(4) as new paragraphs (a)(4) and (a)(5), respectively, and adding new paragraph (a)(3) to read as follows:

§ 702.109 Prompt corrective action for critically undercapitalized credit unions.

* * * * *

(a) * * *

(3) *Restrictions on payments on Subordinated Debt.* Beginning 60 days after the effective date of a federally insured, natural person credit union being classified by the NCUA as “Critically Undercapitalized”, that credit union shall not pay principal of or interest on its Subordinated Debt, except that unpaid interest shall continue to accrue under the terms of the related Subordinated Debt Note (as defined in subpart D of this part), to the extent permitted by law;

* * * * *

6. Revise § 702.109(b)(11), effective January 1, 2022, to read as follows:

(11) *Restrictions on payments on Grandfathered Secondary Capital.* Beginning 60 days after the effective date of classification of a

credit union as “Critically Undercapitalized”, prohibit payments of principal, dividends or interest on the credit union’s Grandfathered Secondary Capital (as defined in subpart D of this part), except that unpaid dividends or interest shall continue to accrue under the terms of the account to the extent permitted by law;

* * * * *

7. Revise § 702.205(d) to read as follows:

§ 702.205 Prompt corrective action for uncapitalized new credit unions.

* * * * *

(d) *Discretionary liquidation of an uncapitalized new credit union.* In lieu of paragraph (c) of this section, an uncapitalized new credit union may be placed into liquidation on grounds of insolvency pursuant to 12 U.S.C. 1787(a)(1)(A).

* * * * *

§ 702.206 Revised business plans (RBP) for new credit unions.

8. Revise § 702.206 by deleting subsection (d) and redesignating paragraphs (e) through (h) as (d) through (g).

9. Insert new § 702.207 to read as follows and renumber current §§ 702.207 through 702.210 as §§ 702.208 through 702.211:

§ 702.207 Consideration of Subordinated Debt and Grandfathered Secondary Capital for new credit unions.

(a) *Exception from prompt corrective action for new credit unions.* The requirements of §§ 702.204 and 702.205 do not apply to a new credit union if, as of the applicable date of determination, each of the following conditions is satisfied:

(1) the new credit union has outstanding Subordinated Debt or Grandfathered Secondary Capital;

(2) the Subordinated Debt or Grandfathered Secondary Capital would be treated as Regulatory Capital under subpart D of this part if the new credit union were a Complex Credit Union or a low income-designated credit union;

(3) the ratio of the new credit union's Net Worth (including the amount of its Subordinated Debt and Grandfathered Secondary Capital treated as Regulatory Capital (as defined in subpart D of this part)) to its total assets is at least seven percent (7%); and

(4) the new credit union's Net Worth is increasing in a manner consistent with the new credit union's approved initial business plan or RBP.

(b) *Consideration of Subordinated Debt and Grandfathered Secondary Capital in evaluating an RBP.* The NCUA shall, in evaluating an RBP under this subpart, consider a new credit union's aggregate outstanding principal amount of Subordinated Debt and Grandfathered Secondary Capital.

(c) *Prompt corrective action based on other supervisory criteria.*

(1) The NCUA Board may apply prompt corrective action to a new credit union that is otherwise exempt under subsection (a) of this section in the following circumstances:

(A) *unsafe or unsound condition.* The NCUA Board has determined, after providing the new credit union with written notice and opportunity for hearing pursuant to § 747.2003 of this chapter, that the new credit union is in an unsafe or unsound condition; or

(B) *unsafe or unsound practice.* The NCUA Board has determined, after providing the

new credit union with written notice and opportunity for hearing pursuant to § 747.2003 of this chapter, that the new credit union has not corrected a material unsafe or unsound practice of which it was, or should have been, aware.

(2) *Non-delegation.* The NCUA Board may not delegate its authority under this subsection.

(3) *Consultation with state officials.* The NCUA Board shall consult and seek to work cooperatively with the appropriate state official before taking action under this subsection and shall promptly notify the appropriate state official of its decision to take action under this subsection.

(d) *Discretionary Liquidation.* Notwithstanding paragraph (a) of this section, the NCUA may place a new credit union into liquidation pursuant to 12 U.S.C. 1787(a)(3)(A), provided that the new credit union's ratio under paragraph (a)(3) of this section is, as of the applicable date of determination, below six percent (6%) and the new credit union has no reasonable prospect of becoming "Adequately Capitalized" under § 702.202 of this subpart.

(e) *Restrictions on payments on Subordinated Debt.* Beginning 60 days after the effective date of a new credit union being classified by the NCUA as

“Uncapitalized”, the new credit union shall not pay principal of or interest on its Subordinated Debt, except that unpaid interest shall continue to accrue under the terms of the related Subordinated Debt Note, to the extent permitted by law.

10. Replace current subpart D with the following and redesignate current subparts D and E as subparts E and F, respectively:

SUBPART D—SUBORDINATED DEBT, GRANDFATHERED SECONDARY CAPITAL, AND REGULATORY CAPITAL

§ 702.401 Purpose and scope.

(a) *Subordinated Debt.* This subpart sets forth the requirements applicable to all Subordinated Debt issued by a federally insured, natural person credit union, including the NCUA’s review and approval of that credit union’s application to issue or prepay Subordinated Debt. This subpart shall apply to a federally insured, state-chartered credit union only to the extent that such federally insured, state-chartered credit union is permitted by applicable state law to issue debt instruments of the type described in this subpart. To the extent that such state law is more restrictive than this subpart with respect to the issuance of such debt instruments, that state law shall apply. Any secondary capital, as that term is used in the Federal Credit Union Act, issued after [INSERT THE EFFECTIVE DATE OF THIS REGULATION] is Subordinated Debt and subject to the requirements of this subpart.

(b) *Grandfathered Secondary Capital.* Any secondary capital issued under § 701.34 before [INSERT THE EFFECTIVE DATE OF THIS REGULATION] is governed by § 702.414 of this subpart. Grandfathered Secondary Capital will no longer be treated as Regulatory Capital as of [INSERT 20 YEARS AFTER THE EFFECTIVE DATE OF THIS REGULATION].

§ 702.402 Definitions.

To the extent they differ, the definitions in this section apply only to Subordinated Debt and not to Grandfathered Secondary Capital. (Definitions applicable to Grandfathered Secondary Capital are in § 702.414 of this subpart.) All other terms in this subpart and not expressly defined herein have the meanings assigned to them elsewhere in this part. For ease of use, certain key terms are included below using cross citations to other sections of this part where those terms are defined.

Accredited Investor means a Natural Person Accredited Investor or an Entity Accredited Investor, as applicable.

Appropriate Supervision Office means, with respect to any credit union, the Regional Office or Office of National Examinations and Supervision that is responsible for supervision of that credit union.

Complex Credit Union has the same meaning as in subpart A of this part.

Entity Accredited Investor means an entity that, at the time of offering and closing of the issuance and sale of Subordinated Debt to that entity, meets the requirements of 17 CFR § 230.501(a)(1), (2), (3), (7), or (8).

Grandfathered Secondary Capital means any subordinated debt issued in accordance with § 701.34 (recodified as § 702.414 of subpart D of this part) or, in the case of a federally insured, state-chartered credit union, with § 741.204(c), before [INSERT THE EFFECTIVE DATE OF THIS REGULATION].

Immediate Family Member means spouse, child, sibling, parent, grandparent, or grandchild (including stepparents, stepchildren, stepsiblings, and adoptive relationships).

Issuing Credit Union means, for purposes of this subpart, a credit union that has issued, or is in the process of issuing, Subordinated Debt or Grandfathered Secondary Capital in accordance with the requirements of this subpart.

Low-Income designated Credit Union (LICU) is a credit union designated as having low-income status in accordance with § 701.34 of this chapter.

Natural Person Accredited Investor means a natural person who, at the time of offering and closing of the issuance and sale of Subordinated Debt to that person, meets the requirements of 17 CFR § 230.501(a)(5) or (6); *provided* that, for purposes of purchasing or holding any Subordinated Debt Note, this term shall not include any board member or Senior Executive Officer of the Issuing Credit Union or any Immediate

Family Member of any board member or Senior Executive Officer of the Issuing Credit Union.

Net Worth has the same meaning as in § 702.2 of this chapter.

Net Worth Ratio has the same meaning as in § 702.2 of this chapter.

New Credit Union has the same meaning as in § 702.201 of this chapter.

Offering Document means the document(s) required by § 702.408, including any term sheet, offering memorandum, private placement memorandum, offering circular, or other similar document used to offer and sell Subordinated Debt Notes.

Pro Forma Financial Statements means projected financial statements that show the effects of proposed transactions as if they actually occurred in a variety of plausible scenarios, including both optimistic and pessimistic assumptions, over measurement horizons that align with the credit union's expected activities.

Qualified Counsel means an attorney licensed to practice law in the relevant jurisdiction(s) who has expertise in the areas of federal and state securities laws and debt transactions similar to those described in this subpart.

Regulatory Capital means (i) with respect to an Issuing Credit Union that is a LICU and not a Complex Credit Union, the aggregate outstanding principal amount of

Subordinated Debt and, until [20 YEARS AFTER THE EFFECTIVE DATE OF THIS REGULATION], Grandfathered Secondary Capital that is included in the credit union's Net Worth Ratio; (ii) with respect to an Issuing Credit Union that is a Complex Credit Union and not a LICU, the aggregate outstanding principal amount of Subordinated Debt that is included in the credit union's RBC Ratio; (iii) with respect to an Issuing Credit Union that is both a LICU and a Complex Credit Union, the aggregate outstanding principal amount of Subordinated Debt and, until [INSERT 20 YEARS AFTER THE EFFECTIVE DATE OF THIS REGULATION], Grandfathered Secondary Capital that is included in its Net Worth Ratio and in its RBC Ratio; and (iv) with respect to a New Credit Union, the aggregate outstanding principal amount of Subordinated Debt and, until [INSERT 20 YEARS AFTER THE EFFECTIVE DATE OF THIS REGULATION], Grandfathered Secondary Capital that is considered pursuant to § 702.207 of this part.

Retained Earnings has the same meaning as in United States GAAP.

RBC Ratio has the same meaning as in § 702.2 of this part.

Senior Executive Officer means a credit union's chief executive officer (for example, president or treasurer/manager), any assistant chief executive officer (e.g., any assistant president, any vice president or any assistant treasurer/manager) and the chief financial officer (controller). The term "Senior Executive Officer" also includes employees and contractors of an entity, such as a consulting firm, hired to perform the functions of positions covered by the term Senior Executive Officer.

Subordinated Debt means an Issuing Credit Union's borrowing that meets the requirements of this subpart, including all obligations and contracts related to such borrowing.

Subordinated Debt Note means the written contract(s) evidencing the Subordinated Debt.

§ 702.403 Eligibility.

(a) Subject to receiving approval under §§ 702.408 or 702.409 of this subpart, a credit union may issue Subordinated Debt only if, at the time of such issuance, the credit union is:

(1) a Complex Credit Union with a capital classification of at least "Undercapitalized," as defined in § 702.102 this part;

(2) a LICU;

(3) able to demonstrate to the satisfaction of the NCUA that it reasonably anticipates becoming either a Complex Credit Union meeting the requirements of paragraph (a)(1) of this section or a LICU within 24 months after issuance of the Subordinated Debt Notes; or

(4) a new credit union with Retained Earnings equal to or greater than one percent (1%) of assets.

(b) At the time of issuance of any Subordinated Debt, an Issuing Credit Union may not have any investments, direct or indirect, in Subordinated Debt or Grandfathered Secondary Capital (or any interest therein) of another credit union. If a credit union acquires Subordinated Debt or Grandfathered Secondary Capital in a merger or other consolidation, the Issuing Credit Union may still issue Subordinated Debt, but it may not invest (directly or indirectly) in the Subordinated Debt or Grandfathered Secondary Capital of any other credit union while any Subordinated Debt Notes issued by the Issuing Credit Union remain outstanding.

(c) If the Issuing Credit Union is a Complex Credit Union that is not also a LICU, the aggregate outstanding principal amount of all Subordinated Debt issued by that Issuing Credit Union may not exceed 100 percent of its Net Worth, as determined at the time of each issuance of Subordinated Debt.

§ 702.404 Requirements of the Subordinated Debt and Subordinated Debt Note.

(a) *Requirements.* At a minimum, the Subordinated Debt or the Subordinated Debt Note, as applicable, must:

(1) be in the form of a written, unconditional promise to pay on a specified date a sum certain in money in return for adequate consideration in money;

(2) have, at the time of issuance, a fixed stated maturity of at least five years and not more than 20 years from issuance. The stated maturity of the Subordinated Debt Note may not reset and may not contain an option to extend the maturity;

(3) be subordinate to all other claims in liquidation under § 709.5(b) of this chapter, and have the same payout priority as all other outstanding Subordinated Debt and Grandfathered Secondary Capital;

(4) be properly characterized as debt in accordance with U.S. GAAP;

(5) be unsecured, including, without limitation, prohibiting the establishment of any legally enforceable claim against funds earmarked for payment of the Subordinated Debt through:

(A) a compensating balance or any other funds or assets subject to a legal right of offset, as defined by applicable state law; or

(B) a sinking fund, such as a fund formed by periodically setting aside money for the gradual repayment of the Subordinated Debt.

(6) be applied by the Issuing Credit Union at the end of each of its fiscal years (or more frequently as determined by the Issuing Credit Union) in which the Subordinated Debt remains outstanding to cover any deficit in Retained Earnings on a pro rata basis among all holders of the Subordinated Debt and Grandfathered Secondary Capital of the Issuing Credit Union; it being understood that any amounts applied to cover a deficit in Retained Earnings shall no longer be considered due and payable to the holder(s) of the Subordinated Debt or Grandfathered Secondary Capital;

(7) except as provided in §§ 702.411 and 702.412(c) of this subpart, be payable in full by the Issuing Credit Union or its successor or assignee only at maturity;

(8) disclose any prepayment penalties or restrictions on prepayment;

(9) be offered, issued, and sold only to Entity Accredited Investors or Natural Person Accredited Investors, in accordance § 702.406 of this subpart; and

(10) be re-offered, reissued, and resold only to an Entity Accredited Investor (if the initial offering, issuance, and sale was solely made to Entity Accredited Investors) or any Accredited Investor (if the initial offering, issuance, and sale involved one or more Natural Person Accredited Investors).

(b) *Restrictions.* The Subordinated Debt or the Subordinated Debt Note, as applicable, must not:

(1) be structured or identified as a share, share account, or any other instrument in the Issuing Credit Union that is insured by the National Credit Union Administration;

(2) include any express or implied terms that make it senior to any other Subordinated Debt issued under this subpart or Grandfathered Secondary Capital;

(3) cause the Issuing Credit Union to exceed the borrowing limit in § 741.2 of this chapter or, for federally insured, state-chartered credit unions, any more restrictive state borrowing limit;

(4) provide the holder thereof with any management or voting rights in the Issuing Credit Union;

(5) be eligible to be pledged or provided by the investor as security for a loan from, or other obligation owing to, the Issuing Credit Union;

(6) include any express or implied term, condition, or agreement that would require the Issuing Credit Union to prepay or accelerate payment of principal of or interest on the Subordinated Debt prior to maturity, including investor put options;

(7) include an express or implied term, condition, or agreement that would trigger an event of default based on the Issuing Credit Union's default on other debts;

(8) include any condition, restriction, or requirement based on the Issuing Credit Union's credit quality or other credit-sensitive feature; or

(9) require the Issuing Credit Union to make any form of payment other than in cash.

(c) *Negative Covenants.* A Subordinated Debt Note must not include any provision or covenant that unduly restricts or otherwise acts to unduly limit the authority of the Issuing Credit Union or interferes with the NCUA's supervision of the Issuing Credit Union. This includes, but is not limited to, a provision or covenant that:

(1) requires the Issuing Credit Union to maintain a minimum amount of Retained Earnings or other metric, such as a minimum Net Worth Ratio or minimum asset, liquidity, or loan ratios;

(2) unreasonably restricts the Issuing Credit Union's ability to raise capital through the issuance of additional Subordinated Debt;

(3) provides for default of the Subordinated Debt as a result of the Issuing Credit Union's compliance with any law, regulation, or supervisory directive from the NCUA or, if applicable, the state supervisory authority;

(4) provides for default of the Subordinated Debt as the result of a change in the ownership, management, or organizational structure or charter of the Issuing Credit Union; provided that, following such change, the Issuing Credit Union or the resulting institution, as applicable:

(A) agrees to perform all of the obligations, terms, and conditions of the Subordinated Debt; and

(B) at the time of such change, is not in material default of any provision of the Subordinated Debt Note, after giving effect to the

applicable cure period described in subsection (d) of this section.

(5) provides for default of the Subordinated Debt as the result of an act or omission of any third party, including but not limited to a credit union service organization, as defined in § 712.1(d) of this chapter.

(d) *Default covenants.* A Subordinated Debt Note that includes default covenants must provide the Issuing Credit Union with a reasonable cure period of not less than 30 calendar days.

(e) *Minimum denominations of issuances to Natural Person Accredited Investors.* An Issuing Credit Union may only issue Subordinated Debt Notes to Natural Person Accredited Investors in minimum denominations of \$100,000, and cannot exchange any such Subordinated Debt Notes after the initial issuance or any subsequent resale for Subordinated Debt Notes of the Issuing Credit Union in denominations less than \$10,000. Each such Subordinated Debt Note, if issued in certificate form, must include a legend disclosing that it cannot be exchanged for Subordinated Debt Notes of the Issuing Credit Union in denominations less than \$100,000, and Subordinated Debt Notes issued in book-entry or other uncertificated form shall include appropriate instructions prohibiting the exchange of such Subordinated Debt Notes for Subordinated Debt Notes of the Issuing Credit Union in denominations that would violate the foregoing restrictions.

§ 702.405 Disclosures.

(a) An Issuing Credit Union must disclose the following language clearly, in all capital letters, on the face of a Subordinated Debt Note:

- THIS OBLIGATION IS NOT A SHARE IN THE ISSUING CREDIT UNION AND IS NOT INSURED BY THE NATIONAL CREDIT UNION ADMINISTRATION.
- THIS OBLIGATION IS UNSECURED AND SUBORDINATE TO ALL CLAIMS AGAINST THE ISSUING CREDIT UNION AND IS INELIGIBLE AS COLLATERAL FOR A LOAN BY THE ISSUING CREDIT UNION.
- AMOUNTS OTHERWISE PAYABLE HEREUNDER MAY BE REDUCED IN ORDER TO COVER ANY DEFICIT IN RETAINED EARNINGS OF THE ISSUING CREDIT UNION. AMOUNTS APPLIED TO COVER ANY SUCH DEFICIT WILL RESULT IN A CORRESPONDING REDUCTION OF THE PRINCIPAL AMOUNT OF ALL OUTSTANDING SUBORDINATED DEBT ISSUED BY THE ISSUING CREDIT UNION, AND WILL NO LONGER BE DUE AND PAYABLE TO THE HOLDERS OF SUCH SUBORDINATED DEBT. AMOUNTS APPLIED TO COVER ANY SUCH DEFICIT MUST BE APPLIED AMONG ALL HOLDERS OF SUCH SUBORDINATED DEBT PRO RATA BASED ON THE AGGREGATE AMOUNT OF

SUBORDINATED DEBT OWED BY THE ISSUING CREDIT UNION TO EACH SUCH HOLDER AT THE TIME OF APPLICATION.

- THIS OBLIGATION CAN ONLY BE REPAYED AT MATURITY OR IN ACCORDANCE WITH 12 C.F.R. § 702.411. THIS OBLIGATION MAY ALSO BE REPAYED IN ACCORDANCE WITH 12 C.F.R. PART 710 IF THE ISSUING CREDIT UNION VOLUNTARILY LIQUIDATES.
- THE NOTE EVIDENCING THIS OBLIGATION HAS NOT BEEN AND WILL NOT BE REGISTERED UNDER THE SECURITIES ACT OF 1933, AS AMENDED (THE “SECURITIES ACT”), OR THE SECURITIES LAWS OF ANY STATE OF THE UNITED STATES OR ANY OTHER JURISDICTION, AND MAY BE ISSUED, SOLD, PLEDGED, OR OTHERWISE TRANSFERRED ONLY (A) AS PERMITTED IN THE NOTE AND TO A PERSON WHOM THE ISSUER OR SELLER REASONABLY BELIEVES IS [AN “ACCREDITED INVESTOR” (AS DEFINED IN 12 C.F.R. § 702.402)] [AN “ENTITY ACCREDITED INVESTOR” (AS DEFINED IN 12 C.F.R. § 702.402)] (THAT IS NOT A MEMBER OF THE ISSUING CREDIT UNION’S BOARD, A SENIOR EXECUTIVE OFFICER OF THE ISSUING CREDIT UNION (AS THAT TERM IS DEFINED IN 12 C.F.R. § 702.402), OR ANY IMMEDIATE FAMILY MEMBER OF ANY SUCH BOARD MEMBER OR SENIOR EXECUTIVE OFFICER), PURCHASING FOR ITS OWN ACCOUNT, (1) TO WHOM NOTICE IS

GIVEN THAT THE SALE, PLEDGE, OR OTHER TRANSFER IS BEING MADE IN RELIANCE ON THE EXEMPTION FROM SECURITIES ACT REGISTRATION PROVIDED BY SECTION 3(a)(5) OF THE SECURITIES ACT, OR (2) IN ACCORDANCE WITH ANOTHER EXEMPTION FROM THE REGISTRATION REQUIREMENTS OF THE SECURITIES ACT (SUBJECT TO THE DELIVERY OF SUCH CERTIFICATIONS, LEGAL OPINIONS, OR OTHER INFORMATION AS THE ISSUING CREDIT UNION MAY REASONABLY REQUIRE TO CONFIRM THAT SUCH SALE, PLEDGE, OR TRANSFER IS BEING MADE PURSUANT TO AN EXEMPTION FROM, OR IN A TRANSACTION NOT SUBJECT TO, THE REGISTRATION REQUIREMENTS OF THE SECURITIES ACT), (B) IN COMPLIANCE WITH THE CERTIFICATION AND OTHER REQUIREMENTS SPECIFIED IN THE [INDENTURE OR OTHER DOCUMENT PURSUANT TO WHICH THE SUBORDINATED DEBT NOTE IS ISSUED] REFERRED TO HEREIN, AND (C) IN ACCORDANCE WITH ANY APPLICABLE SECURITIES LAWS OF ANY STATE OF THE UNITED STATES AND ANY OTHER APPLICATION JURISDICTION.

(b) An Issuing Credit Union must also clearly and accurately disclose in the Subordinated Debt Note:

(1) the payout priority and level of subordination, as described in § 709.5(b) of this chapter, that would apply in the event of the involuntary liquidation of the Issuing Credit Union;

(2) a general description of the NCUA's regulatory authority that includes, at a minimum:

(A) if the Issuing Credit Union is "Undercapitalized" or, if the Issuing Credit Union is a New Credit Union, "Moderately Capitalized" (each as defined in this part), and fails to submit an acceptable Net Worth restoration plan, capital restoration plan, or revised business plan, as applicable, or materially fails to implement such a plan that was approved by the NCUA, the Issuing Credit Union may be subject to all of the additional restrictions and requirements applicable to a "Significantly Undercapitalized" credit union or, if the Issuing Credit Union is a New Credit Union, a "Marginally Capitalized" New Credit Union;

(B) beginning 60 days after the effective date of an Issuing Credit Union being classified as "Critically Undercapitalized" or, in the case of a

New Credit Union, “Uncapitalized,” the Issuing Credit Union shall not pay principal of or interest on its Subordinated Debt, until reauthorized to do so by the NCUA; provided, however, that unpaid interest shall continue to accrue under the terms of the Subordinated Debt Note, to the extent permitted by law.

(3) the risk factors associated with the NCUA’s or, if applicable, the state supervisory authority’s, authority to conserve or liquidate a credit union under the Federal Credit Union Act (FCU Act) or applicable state law.

§ 702.406 Requirements related to the offer, sale, and issuance of Subordinated Debt Notes.

(a) *Offering Document.* An Issuing Credit Union or person acting on behalf of or at the direction of any Issuing Credit Union may only issue and sell Subordinated Debt Notes if, a reasonable time prior to the issuance and sale of any Subordinated Debt Notes, each purchaser of a Subordinated Debt Note receives an Offering Document that meets the requirements of § 702.408(e) of this subpart and such further material information, if any, as may be necessary to make the required disclosures in that Offering Document, in the light of the circumstances under which they are made, not misleading.

(b) *Territorial limitations.* An Issuing Credit Union may only offer, issue, and sell Subordinated Debt Notes in the United States of America (including any one of the states thereof and the District of Columbia), its territories, and its possessions.

(c) *Accredited Investors.* An Issuing Credit Union may only offer, issue, and sell Subordinated Debt to Accredited Investors, and the terms of any Subordinated Debt Note must include the restrictions in § 702.404(a)(10) of this subpart; provided that no Subordinated Debt Note may be issued, sold, resold, pledged, or otherwise transferred to a member of the board of the Issuing Credit Union, any Senior Executive Officer of the Issuing Credit Union, or any Immediate Family Member of any such board member or Senior Executive Officer. Prior to the offer of any Subordinated Debt Note, the Issuing Credit Union must receive a signed, one-page, unambiguous certification from any potential investor of a Subordinated Debt Note. The certification must be in substantially the following form:

CERTIFICATE OF ACCREDITED INVESTOR STATUS

Except as may be indicated by the undersigned below, the undersigned is an accredited investor, as that term is defined in Regulation D under the Securities Act of 1933, as amended (the “Act”). In order to demonstrate the basis on which it is representing its status as an accredited investor, the undersigned has checked one of the boxes

below indicating that the undersigned is:

A bank as defined in Section 3(a)(2) of the Act, or any savings and loan association or other institution as defined in Section 3(a)(5)(A) of the Act whether acting in its individual or fiduciary capacity; a broker or dealer registered pursuant to Section 15 of the Securities Exchange Act of 1934; an insurance company as defined in Section 2(a)(13) of the Act; an investment company registered under the Investment Company Act of 1940 or a business development company as defined in Section 2(a)(48) of that act; a small business investment company licensed by the U.S. Small Business Administration under Section 301(c) or (d) of the Small Business Investment Act of 1958; a plan established and maintained by a state, its political subdivisions, or any agency or instrumentality of a state or its political subdivisions, for the benefit of its employees, if such plan has total assets in excess of \$5,000,000; an employee benefit plan within the meaning of the Employee Retirement Income Security Act of 1974, if the investment decision is made by a plan fiduciary, as defined in Section 3(21) of such act, which is either a bank, savings and loan association, insurance company, or registered investment adviser, or if the employee benefit plan has total assets in excess of \$5,000,000 or, if a self-directed plan, with investment decisions made solely by persons that are accredited investors;

A private business development company as defined in Section 202(a)(22) of the Investment Advisers Act of 1940;

An organization described in Section 501(c)(3) of the Internal Revenue Code; a corporation; a Massachusetts or similar business trust; or a partnership, not formed for the specific purpose of acquiring the securities offered, with total assets in excess of \$5,000,000;

A natural person whose individual net worth, or joint net worth with the undersigned's spouse, at the time of this purchase exceeds \$1,000,000 (excluding the value of the person's primary residence);

A natural person who had individual income in excess of \$200,000 in each of the two most recent years or joint income with the undersigned's spouse in excess of \$300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year;

A trust with total assets in excess of \$5,000,000, not formed for the specific purpose of acquiring the securities offered, whose purchase is directed by a person who has such knowledge and experience in financial and business matters that he or she is capable of evaluating the merits and risks of the prospective

investment; or

An entity in which all of the equity holders are accredited investors by virtue of their meeting one or more of the above standards.

The undersigned understands that [NAME OF ISSUING CREDIT UNION] (the “Credit Union”) is required to verify the undersigned’s accredited investor status AND ELECTS TO DO ONE OF THE FOLLOWING:

Allow the Credit Union’s representative to review the undersigned’s tax returns for the two most recently completed years and provide a written representation of the undersigned’s reasonable expectation of reaching the income level necessary to qualify as an accredited investor during the current year;

Allow the Credit Union’s representative to: (1) obtain a written representation from the undersigned that states that all liabilities necessary to make a determination of net worth have been disclosed; and (2) review one or more of the following types of documentation dated within the past three months: bank statements, brokerage statements, tax assessments, appraisal reports as to assets, or a consumer report from a nationwide consumer reporting agency;

[] Provide the Credit Union with a written confirmation from one of the following persons or entities that such person or entity has taken reasonable steps to verify that the undersigned is an accredited investor within the prior three months and has determined that the undersigned is an accredited investor:

- A registered broker-dealer;
- An investment adviser registered with the Securities Exchange Commission;
- A licensed attorney who is in good standing under the laws of the jurisdictions in which such attorney is admitted to practice law; or
- A certified public accountant who is duly registered and in good standing under the laws of the place of such accountant's residence or principal office.

IN WITNESS WHEREOF, the undersigned has executed this Certificate of Accredited Investor Status effective as of _____, 20

_____.

Name of Investor

[Name of Authorized Representative

Title of Authorized Representative]

Signature

Address

Address

Phone Number

Email Address

(d) *Use of trustees.* If using a trustee in connection with the offer, issuance, and sale of Subordinated Debt Notes, the trustee must meet the requirements set forth in the Trust Indenture Act of 1939, as amended, and any rules promulgated thereunder, including requirements for qualification set forth in § 310 thereof, and any applicable state law.

(e) *Offers, issuances, and sales of Subordinated Debt Notes.* Offers, issuances, and sales of Subordinated Debt Notes are required to be made in accordance with the following requirements:

(1) *Application to offer, issue, and sell at offices of Issuing Credit Union.* If the Issuing Credit Union intends to offer and sell Subordinated Debt Notes at one or more of its offices, the Issuing Credit Union must first apply in writing to the Appropriate Supervision Office indicating that it intends to offer, issue, and sell Subordinated Debt Notes at one or more of its offices. The application must include, at a minimum, the physical locations of such offices and a description of how the Issuing Credit Union will comply with the requirements of this subsection;

(2) *Decision on application.* Within 60 calendar days (which may be extended by the Appropriate Supervision Office) after the date of receipt of a complete application described in paragraph (e)(1) above, the Appropriate Supervision Office will provide the Issuing Credit Union with a written determination on its application to conduct offering and sales activity from its office(s). Any denial of an Issuing Credit Union's application under this section will include the reasons for such denial;

(3) in connection with any offering and sale of Subordinated Debt Notes (whether or not conducted at offices of the Issuing Credit Union), an Issuing Credit Union shall not pay, directly or indirectly, any commissions, bonuses, or comparable payments to any employee of the Issuing Credit Union or any affiliated Credit Union Service Organizations (CUSOs) assisting with the offer, issuance, and sale of such Subordinated Debt Notes, or to any other person in connection with the offer, issuance,

and sale of Subordinated Debt Notes; except that compensation and commissions consistent with industry norms may be paid to securities personnel of registered broker-dealers as otherwise permitted by applicable law;

(4) no offers or sales may be made by tellers at the teller counter of any Issuing Credit Union, or by comparable persons at comparable locations;

(5) in connection with an offering or sale of Subordinated Debt Notes (whether or not conducted at offices of the Issuing Credit Union), such activity may be conducted only by regular, full-time employees of the Issuing Credit Union or by securities personnel who are subject to supervision by a registered broker-dealer, which securities personnel may be employees of the Issuing Credit Union's affiliated CUSO that is assisting the Issuing Credit Union with the offer, issuance, and sale of the Subordinated Debt Notes;

(6) in connection with an offering or sale of Subordinated Debt Notes (whether or not conducted at offices of the Issuing Credit Union), issuance practices, advertisements, and other issuance literature used in connection with offers and issuances of Subordinated Debt Notes by Issuing Credit Unions or any affiliated CUSOs assisting with the offer and

issuance of such Subordinated Debt Notes shall be subject to the requirements of this subpart; and

(7) for purposes of this subsection, an “office” of an Issuing Credit Union means any premises used by the Issuing Credit Union that is identified to the public through advertising or signage using the Issuing Credit Union’s name, trade name, or logo.

(f) *Securities laws.* An Issuing Credit Union must comply with all applicable federal and state securities laws.

(g) *Resales.* All resales of Subordinated Debt Notes issued by an Issuing Credit Union by holders of such Subordinated Debt Notes must be made pursuant to Rule 144 under the Securities Act of 1933, as amended (17 CFR 230.144) (other than paragraphs (c), (e), (f), (g) and (h) of such Rule), Rule 144A under the Securities Act of 1933, as amended (17 CFR 230.144A), or another exemption from registration under the Securities Act of 1933, as amended. Subordinated Debt Notes must include the restrictions on resales in § 702.404(a)(10) of this subpart.

§ 702.407 Discounting of amount treated as Regulatory Capital.

The amount of outstanding Subordinated Debt that may be treated as Regulatory Capital shall reduce by 20 percent per annum of the initial aggregate principal amount of

the applicable Subordinated Debt (as reduced by prepayments or amounts extinguished to cover a deficit under § 702.404(a)(6) of this subpart), as required by the following schedule:

Remaining maturity	Balance treated as Regulatory Capital
Four to less than five years	80 %
Three to less than four years	60 %
Two to less than three years	40 %
One to less than two years	20 %
Less than one year	0 %

§ 702.408 Preapproval to issue Subordinated Debt.

(a) *Scope.* This section requires all credit unions to receive written preapproval from the NCUA before issuing Subordinated Debt. Procedures related specifically to applications from federally insured, state-chartered credit unions are contained in § 702.409 of this subpart. A credit union seeking approval to offer and sell Subordinated Debt at one or more of its offices must also follow the application procedures in § 702.406(e) of this subpart. All approvals under this section are subject to the expiration limits specified in subsection (k) of this section.

(b) *Initial application to issue Subordinated Debt.* A credit union requesting approval to issue Subordinated Debt must first submit an application to the Appropriate Supervision Office that, at a minimum, includes:

(1) a statement indicating how the credit union qualifies to issue Subordinated Debt given the eligibility requirements of § 702.403 with additional supporting analysis if anticipating to meet the requirements of a LICU or Complex Credit Union within 24 months after issuance of the Subordinated Debt;

(2) the maximum aggregate principal amount of Subordinated Debt Notes and the maximum number of discrete issuances of Subordinated Debt Notes that the credit union is proposing to issue within the period allowed under subsection (k) of this section;

(3) the estimated number of investors and the status of such investors (Natural Person Accredited Investors and/or Entity Accredited Investors) to whom the credit union intends to offer and sell the Subordinated Debt Notes;

(4) a statement identifying any outstanding Subordinated Debt or Grandfathered Secondary Capital previously issued by the credit union;

(5) a copy of the credit union's strategic plan, business plan, and budget, and an explanation of how the credit union intends to use the Subordinated Debt in conformity with those plans;

(6) an analysis of how the credit union will provide for liquidity to repay the Subordinated Debt upon maturity of the Subordinated Debt;

(7) Pro Forma Financial Statements (balance sheet, income statement, and statement of cash flows), including any off-balance sheet items, covering at least five years. Analytical support for key assumptions and key assumption changes must be included in the application. Key assumptions include, but are not limited to, interest rate, liquidity, and credit loss scenarios;

(8) a statement indicating how the credit union will use the proceeds from the issuance and sale of the Subordinated Debt;

(9) a statement identifying the governing law specified in the Subordinated Debt Notes and the documents pursuant to which the Subordinated Debt Notes will be issued;

(10) a draft written policy governing the offer, and issuance, and sale of the Subordinated Debt, developed in consultation with Qualified Counsel, which, at a minimum, addresses:

(A) compliance with all applicable federal and state securities laws and regulations;

(B) compliance with applicable securities laws related to communications with investors and potential investors, including, but not limited to: who may communicate with investors and potential investors; what information may be provided to investors and potential investors; ongoing disclosures to investors; who will review and ensure the accuracy of the information provided to investors and potential investors; and to whom information will be provided;

(C) compliance with any laws that may require registration of credit union employees as broker-dealers; and

(D) any use of outside agents, including broker-dealers, to assist in the marketing and issuance of Subordinated Debt, and any limitations on such use.

(11) a schedule that provides an itemized statement of all expenses incurred or expected to be incurred by the credit union in connection with the offer, issuance, and sale of the Subordinated Debt Notes to which the initial application relates, other than underwriting discounts and commissions or similar compensation payable to broker-dealers acting as placement agents. The schedule must include, as applicable, fees and expenses of counsel, auditors, any trustee or issuing and paying agent or any transfer agent, and printing and engraving expenses. If the amounts of any items are not known at the time of filing of the initial application, the credit union must provide estimates, clearly identified as such;

(12) in the case of a New Credit Union, a statement that it is subject to either an approved initial business plan or revised business plan, as required by this part, and how the proposed Subordinated Debt would conform with the approved plan. Unless the New Credit Union has a LICU designation pursuant to § 701.34, it must also include a plan for replacing the Subordinated Debt with Retained Earnings before the credit union ceases to meet the definition of New Credit Union in § 702.2 of this part;

(13) a statement describing any investments the credit union has in the Subordinated Debt of any other credit union, and the manner in which the credit union acquired such Subordinated Debt, including through a merger or other consolidation;

(14) a signature page signed by the credit union's principal executive officer, principal financial officer or principal accounting officer, and a majority of the members of its board of directors. Amendments to an initial application must be signed and filed with the NCUA in the same manner as the initial application; and

(15) any additional information requested in writing by the Appropriate Supervision Office.

(c) *Decision on initial application.* Upon receiving an initial application submitted under this subsection and any additional information requested in writing by the Appropriate Supervision Office, the Appropriate Supervision Office will evaluate, at a minimum, the credit union's compliance with this subpart and all other NCUA regulations, the credit union's ability to manage and safely offer, issue, and sell the proposed Subordinated Debt, the safety and soundness of the proposed use of the Subordinated Debt, the overall condition of the credit union, and any other factors the Appropriate Supervision Office determines are relevant.

(1) *Written determination.* Within 60 calendar days (which may be extended by the Appropriate Supervision Office) after the date of receipt of a complete application, the Appropriate Supervision Office will provide the credit union with a written determination on its application. In the case of a full or partial denial, or conditional approval under

subsection (c)(2) of this section, the written decision will state the reasons for the denial or conditional approval.

(2) *Conditions of approval.* Any approval granted by an Appropriate Supervision Office under this section may include one or more of the following conditions:

(A) approval of an aggregate principal amount of Subordinated Debt that is lower than what the credit union requested;

(B) any applicable minimum level of Net Worth that the credit union must maintain while the Subordinated Debt Notes are outstanding;

(C) approved uses of the Subordinated Debt; and

(D) any other limitations or conditions the Appropriate Supervision Office deems necessary to protect the NCUSIF.

(d) *Offering Document.* Following receipt of written approval of its initial application, an Issuing Credit Union must prepare an Offering Document

for each issuance of Subordinated Debt Notes. In addition, as required in subsection (f) of this section, an Issuing Credit Union that intends to offer Subordinated Debt Notes to any Natural Person Accredited Investors must have the related Offering Document declared “approved for use” by the NCUA before its first use. At a reasonable time prior to any issuance and sale of Subordinated Debt Notes, the Issuing Credit Union must provide each investor with an Offering Document as described in this section. All Offering Documents must be filed with the NCUA within two business days after their respective first use.

(e) Requirements for all Offering Documents.

(1) An Offering Document must, at a minimum, include the following information:

(A) the name of the Issuing Credit Union and the address of its principal executive office;

(B) the initial principal amount of the Subordinated Debt being issued;

(C) the name(s) of any underwriter(s) or placement agents being used for the issuance;

(D) a description of the material risk factors associated with the purchase of the Subordinated Debt Notes, including any special or distinctive characteristics of the Issuing Credit Union's business, field of membership, or geographic location that are reasonably likely to have a material impact on the Issuing Credit Union's future financial performance;

(E) the disclosures described in § 702.405 of this subpart and such additional material information, if any, as may be necessary to make the required disclosures, in the light of the circumstances under which they are made, not misleading;

(F) provisions related to the interest, principal, payment, maturity, and prepayment of the Subordinated Debt Notes;

(G) all material affirmative and negative covenants that may or will be included in the Subordinated Debt Note, including, but not limited to, the covenants discussed in this subpart;

(H) any legends required by applicable state law; and

(I) the following legend, displayed on the cover page in prominent type or in another manner:

None of the Securities and Exchange Commission (the “SEC”), any state securities commission or the National Credit Union Administration has passed upon the merits of, or given its approval of, the purchase of any Subordinated Debt Notes offered or the terms of the offering, or passed on the accuracy or completeness of any Offering Document or other materials used in connection with the offer, issuance, and sale of the Subordinated Debt Notes. Any representation to the contrary is unlawful. These Subordinated Debt Notes have not been registered under the Securities Act of 1933, as amended (the “Act”) and are being offered and sold to [an Entity Accredited Investor][an Accredited Investor] (as defined in 12 C.F.R. § 702.402) pursuant to an exemption from registration under the Act; however, neither the SEC nor the NCUA has made an independent determination that the offer and issuance of the Subordinated Debt Notes are exempt from registration.

(2) *Legibility requirements.* An Issuing Credit Union’s Offering Document must comply with the following legibility requirements:

(A) information in the Offering Document must be presented in a clear, concise, and understandable manner, incorporating plain English principles. The body of all printed Offering Documents shall be in type at least as large and as legible as 10-point type. To the extent necessary for convenient presentation, however, financial statements and other tabular data, including tabular data in notes, may be in type at least as large and as legible as 8-point type. Repetition of information should be avoided. Cross-referencing of information within the document is permitted; and

(B) where an Offering Document is distributed through an electronic medium, the Issuing Credit Union may satisfy legibility requirements applicable to printed documents, such as paper size, type size and font, bold-face type, italics and red ink, by presenting all required information in a format readily communicated to offerees and, where indicated, in a manner reasonably calculated to draw the attention of offerees to specific information.

(f) *Offering Documents approved for use in offerings of Subordinated Debt to any Natural Person Accredited Investors.*

(1) *Filing of a Draft Offering Document.* An Issuing Credit Union that intends to offer Subordinated Debt Notes to any Natural Person Accredited Investors must file a draft Offering Document with the NCUA and have such draft Offering Document declared “approved for use” by the NCUA before its first use.

(A) *Request for additional information, clarifications, or amendments.* Prior to declaring any Offering Document “approved for use,” the NCUA may ask questions, request clarifications, or direct the Issuing Credit Union to amend certain sections of the draft Offering Document. The NCUA will make any such requests in writing.

(B) *Written determination.* Within 60 calendar days (which may be extended by the NCUA) after the date of receipt of each of the initial filing and each filing of additional information, clarifications, or amendments requested by the NCUA under subsection (f)(1)(A) of this section, the NCUA will provide the Issuing Credit Union

with a written determination on the applicable filing. The written determination will include any requests for additional information, clarifications, or amendments, or a statement that the Offering Document is “approved for use.”

(2) *Filing of a final Offering Document.* At such time as the NCUA declares an Offering Document “approved for use” in accordance with subsection (f)(1)(B) of this section, the Issuing Credit Union may then use that Offering Document in the offer and sale of the Subordinated Debt Notes. The Issuing Credit Union must file a copy of each of its Offering Documents with the NCUA within two business days after their respective first use.

(g) *Filing of an Offering Document for offerings of Subordinated Debt exclusively to Entity Accredited Investors.* An Issuing Credit Union that is offering Subordinated Debt exclusively to Entity Accredited Investors is not required to have its Offering Document “approved for use” by the NCUA under subsection (f) of this section before using it to offer and sell the Subordinated Debt Notes. As described in this section, however, the Issuing Credit Union must file a copy of each of its Offering Documents with the NCUA within two business days after their respective first use.

(h) *Material changes to any initial application or Offering Document.*

(1) *Reapproval of initial application.* If any material event arises or material change in fact occurs after the approval of the initial application by the NCUA, but prior to the completion of the offer and sale of the related Subordinated Debt Notes, then no person shall offer or sell Subordinated Debt Notes to any other person until an amendment to the Offering Document reflecting the event or change has been filed with and approved by the NCUA.

(2) *Reapproval of Offering Document.* If an Offering Document must be approved for use under subsection (f) of this section, and any event arises or change in fact occurs after the approval for use of any Offering Document, and that event or change in fact, individually or in the aggregate, results in the Offering Document containing any untrue statement of material fact, or omitting to state a material fact necessary in order to make statements made in the Offering Document not misleading in light of the circumstances under which they were made, then no person shall offer or sell Subordinated Debt Notes to any other person until an amendment reflecting the event or change has been filed with and “approved for use” by the NCUA.

(3) *Failure to request reapproval.* If an Issuing Credit Union fails to comply with subsection (h)(1) or (h)(2) of this section, the NCUA may, at its discretion, exercise the full range of administrative remedies available under the FCU Act, including:

(A) prohibiting the Issuing Credit Union from issuing any additional Subordinated Debt for a specified period; and/or

(B) determining not to treat the Subordinated Debt as Regulatory Capital.

(i) *Notification.* Not later than 10 business days after the closing of a Subordinated Debt Note issuance and sale, the Issuing Credit Union must submit to the Appropriate Supervision Office:

(1) a copy of each executed Subordinated Debt Note;

(2) a copy of each executed purchase agreement, if any;

(3) any indenture or other transaction document used to issue the Subordinated Debt Notes;

(4) copies of signed certificates of Accredited Investor status, in a form similar to that in § 702.406(c), from all investors;

(5) all documentation provided to investors related to the offer and sale of the Subordinated Debt Note (other than any Offering Document that was previously filed with the NCUA); and

(6) any other material documents governing the issuance, sale or administration of the Subordinated Debt Notes.

(j) *Resubmissions.* An Issuing Credit Union that receives any adverse written determination from the Appropriate Supervision Office with respect to the approval of its initial application or any amendment thereto or, if applicable, the approval for use of an Offering Document or any amendment thereto, may cure any reasons noted in the written determination and refile under the requirements of this section. This subsection does not prohibit an Issuing Credit Union from appealing an Appropriate Supervision Office's decision under subpart A of part 746 of this chapter.

(k) *Expiration of authority to issue Subordinated Debt.*

(1) Any approvals to issue Subordinated Debt Notes under this section expire one year from the later of the date the Issuing Credit Union receives:

(A) approval of its initial application, if the Issuing Credit Union is offering Subordinated Notes exclusively to Entity Accredited Investors; or

(B) the initial approval for use of its Offering Document, if the Issuing Credit Union is

offering Subordinated Debt Notes to any Natural Person Accredited Investors.

(2) Failure to issue all or part of the maximum aggregate principal amount of Subordinated Debt Notes approved in the initial application process within the applicable period specified in subsection (k) of this section will result in the expiration of the NCUA's approval. An Issuing Credit Union may file a written extension request with the Appropriate Supervision Office. The Issuing Credit Union must demonstrate good cause for any extension(s), and must file the request at least 30 calendar days before the expiration of the applicable period specified in subsection (k) of this section or any extensions granted under this subsection. In any such written application, the Issuing Credit Union must address whether any such extension poses any material securities law implications.

(1) *Filing requirements and inspection of documents.*

(1) Except as otherwise provided in this section, all initial applications, Offering Documents, amendments, notices, or other documents must be filed with the NCUA electronically at [http://www.\[_____\] .gov/](http://www.[_____] .gov/). Documents may be signed electronically using the signature provision in Rule 402 under the Securities Act of 1933, as amended (17 CFR 230.402).

(2) Provided the Issuing Credit Union filing the document has complied with all requirements regarding the filing, the date of filing of the document is the date the NCUA receives the filing. An electronic filing that is submitted on a business day by direct transmission commencing on or before 5:30 p.m. Eastern Standard or Daylight Savings Time, whichever is then currently in effect, would be deemed received by the NCUA on the same business day. An electronic filing that is submitted by direct transmission commencing after 5:30 p.m. Eastern Standard or Daylight Savings Time, whichever is then currently in effect, or on a Saturday, Sunday, or Federal holiday, would be deemed received by the NCUA on the next business day. If an electronic filer in good faith attempts to file a document with the NCUA in a timely manner, but the filing is delayed due to technical difficulties beyond the electronic filer's control, the electronic filer may request that the NCUA adjust the filing date of such document. The NCUA may grant the request if it appears that such adjustment is appropriate and consistent with the public interest and the protection of investors.

(3) If an Issuing Credit Union experiences unanticipated technical difficulties preventing the timely preparation and submission of an electronic filing, the Issuing Credit Union may, upon notice to the Appropriate Supervision Office, file the subject filing in paper format no later than one business day after the date on which the filing was to be made.

(4) Any filing of amendments or supplements to an Offering Document must include two copies, one of which must be marked to indicate clearly and precisely, by underlining or in some other conspicuous manner, the changes made from the previously filed Offering Document.

(m) *Filing fees.*

(1) The NCUA may require filing fees to accompany certain filings made under this subpart before it will accept those filings. The NCUA provides an applicable fee schedule on its website at www.NCUA.gov.

(2) Filing fees must be paid to the NCUA by electronic transfer.

§ 702.409 Preapproval for federally insured, state-chartered credit unions to issue Subordinated Debt.

(a) A federally insured, state-chartered credit union is required to submit the information required under § 702.408 of this subpart and, if applicable, subsection (b) of this section to both the Appropriate Supervision Office and its state supervisory authority. The Appropriate Supervision Office will issue decisions approving a federally insured, state-chartered credit union's application only after obtaining the concurrence of the federally insured, state-chartered credit

union's state supervisory authority. The NCUA will notify a federally insured, state-chartered credit union's state supervisory authority before issuing a decision to "approve for use" a federally insured, state-chartered credit union's Offering Document and any amendments thereto, under § 702.408, if applicable.

(b) If the Appropriate Supervision Office has reason to believe that an issuance by a federally insured, state-chartered credit union under this subpart could subject that federally insured, state-chartered credit union to federal income taxation, the Appropriate Supervision Office may require the federally insured, state-chartered credit union to provide:

(1) a written legal opinion, satisfactory to the NCUA, from nationally recognized tax counsel or letter from the Internal Revenue Service indicating whether the proposed Subordinated Debt would be classified as capital stock for federal income tax purposes and, if so, describing any material impact of federal income taxes on the federally insured, state-chartered credit union's financial condition; or

(2) a Pro Forma Financial Statement (balance sheet, income statement, and statement of cash flows), covering a minimum of five years, that shows the impact of the federally insured, state-chartered credit union being subject to federal income tax.

(c) If the Appropriate Supervision Office requires additional information from a federally insured, state-chartered credit union under subsection (b) of this section, the federally insured, state-chartered credit union may determine, in its sole discretion, whether the information it provides is in the form described in (b)(1) or (b)(2) above.

§ 702.410 Interest payments on Subordinated Debt.

(a) *Requirements for interest payments.* An Issuing Credit Union is prohibited from paying interest on Subordinated Debt in accordance with § 702.109.

(b) Notwithstanding nonpayment pursuant to subsection (a) of this section, interest on the Subordinated Debt may continue to accrue according to terms provided for in the Subordinated Debt Note and as otherwise permitted in this subpart.

(c) *Interest safe harbor.* Except as otherwise provided in this section, the NCUA shall not impose a discretionary supervisory action that requires the Issuing Credit Union to suspend interest with respect to the Subordinated Debt if:

(1) the issuance and sale of the Subordinated Debt complies with all requirements of this subpart;

(2) the Subordinated Debt is issued and sold in an arms-length, bona fide transaction;

(3) the Subordinated Debt was issued and sold in the ordinary course of business, with no intent to hinder, delay or defraud the Issuing Credit Union or its creditors; and

(4) the Subordinated Debt was issued and sold for adequate consideration in U.S. dollars.

(d) This section does not waive, limit, or otherwise affect the authority, rights, or powers of the NCUA or the NCUA Board in any capacity, including the NCUA Board as conservator or liquidating agent, to take any action or to exercise any power not specifically mentioned, including but not limited to any rights, powers or remedies of the NCUA Board as conservator or liquidating agent regarding transfers or other conveyances taken in contemplation of the Issuing Credit Union's insolvency or with the intent to hinder, delay or defraud the Issuing Credit Union or the creditors of such Issuing Credit Union, or that is fraudulent under applicable law.

§ 702.411 Prior written approval to prepay Subordinated Debt.

(a) *Requirements.*

(1) *Prepayment option.* An Issuing Credit Union may include in the terms of its Subordinated Debt an option that allows the Issuing Credit Union to prepay the Subordinated Debt in whole or in part prior to maturity, provided, however, that the Issuing Credit Union is required to:

(A) clearly disclose the requirements of this section in the Subordinated Debt Note; and

(B) obtain approval under subsection (b) of this section before exercising a prepayment option.

(b) *Prepayment application.* Before an Issuing Credit Union can, in whole or in part, prepay Subordinated Debt prior to maturity, the Issuing Credit Union must first submit to the Appropriate Supervision Office an application that must include, at a minimum, the information required in this subsection (d) of this section.

(c) *federally insured, state-chartered credit union prepayment applications.* Before a federally insured, state-chartered credit union may submit an application for prepayment to the Appropriate Supervision Office, it must obtain written approval from its state supervisory authority to prepay the Subordinated Debt it is proposing to prepay. A federally insured, state-chartered credit union must provide evidence of such approval as part of its application to the Appropriate Supervision Office.

(d) *Application contents.* An Issuing Credit Union's application to prepay Subordinated Debt must include, at a minimum, the following:

(1) a copy of the Subordinated Debt Note and any agreement(s) reflecting the terms and conditions of the Subordinated Debt the Issuing Credit Union is proposing to prepay;

(2) an explanation why the Issuing Credit Union believes it still would hold an amount of capital commensurate with its risk exposure notwithstanding the proposed prepayment or a description of the replacement Subordinated Debt, including the amount of such instrument, and the time frame for issuance, the Issuing Credit Union is proposing to use to replace the prepaid Subordinated Debt; and

(3) any additional information the Appropriate Supervision Office requests.

(e) *Decision on application to prepay.*

(1) Within 45 calendar days (which may be extended by the Appropriate Supervision Office) after the date of receipt of a complete application, the Appropriate Supervision Office will provide the Issuing Credit Union with a written determination on its application. In the case of a full or partial denial, including a conditional approval under

subsection (e)(2) of this section, the written decision will state the reasons for the denial or conditional approval.

(2) The written determination from the Appropriate Supervision Office may approve the Issuing Credit Union's request, approve the Issuing Credit Union's request with conditions, or deny the Issuing Credit Union's request. In the case of a denial or conditional approval, the Appropriate Supervision Office will provide the Issuing Credit Union with a description of why it denied the Issuing Credit Union's request or imposed conditions on the approval of such request.

(3) If the Issuing Credit Union proposes or the NCUA requires the Issuing Credit Union to replace the Subordinated Debt, the Issuing Credit Union must receive affirmative approval under this subpart and must issue and sell the replacement instrument prior to or concurrently with prepaying the Subordinated Debt.

(f) *Resubmissions.* An Issuing Credit Union that receives an adverse written determination on its application to prepay, in whole or in part, may cure any deficiencies noted in the Appropriate Supervision Office's written determination and reapply under the requirements of this section. This subsection does not prohibit an Issuing Credit Union from appealing the Appropriate Supervision Office's adverse decision under subpart A of part 746 of this chapter.

§ 702.412 Effect of a merger or dissolution on the treatment of Subordinated Debt as Regulatory Capital.

(a) In the event of a merger of an Issuing Credit Union into or the assumption of its Subordinated Debt by another federally insured credit union, the Subordinated Debt will be treated as Regulatory Capital only to the extent that the resulting credit union is either a LICU, a Complex Credit Union, and/or a New Credit Union.

(b) In the event the resulting credit union is not a LICU, a Complex Credit Union, or a New Credit Union, the Subordinated Debt of the merging credit union can either be:

(1) if permitted by the terms of the Subordinated Debt Note, repaid by the resulting credit union upon approval by the NCUA under § 702.411 of this subsection; or

(2) continue to be held by the resulting credit union as Subordinated Debt, but will not be classified as Regulatory Capital under this subpart, unless the resulting credit union meets the eligibility requirements of § 702.403 of this subpart.

(c) *Voluntary liquidation.* In the event of a voluntary dissolution of an Issuing Credit Union that has outstanding Subordinated Debt, the Subordinated

Debt may be repaid in full according to 12 C.F.R. part 710, subject to the requirements in § 702.411 of this subpart.

§ 702.413 Repudiation safe harbor.

(a) The NCUA Board as conservator for a federally insured credit union, or its lawfully appointed designee, shall not exercise its repudiation authorities under 12 U.S.C. § 1787(c) with respect to Subordinated Debt if:

(1) the issuance and sale of the Subordinated Debt complies with all requirements of this subpart;

(2) the Subordinated Debt was issued and sold in an arms-length, bona fide transaction;

(3) the Subordinated Debt was issued and sold in the ordinary course of business, with no intent to hinder, delay or defraud the Issuing Credit Union or its creditors; and

(4) the Subordinated Debt was issued and sold for adequate consideration in U.S. dollars.

(b) This section does not authorize the attachment of any involuntary lien upon the property of either the NCUA Board as conservator or liquidating agent

or its lawfully appointed designee. Nor does this section waive, limit, or otherwise affect the authority, rights, or powers of the NCUA or the NCUA Board in any capacity to take any action or to exercise any power not specifically mentioned, including but not limited to any rights, powers or remedies of the NCUA Board as conservator or liquidating agent (or its lawfully appointed designee) regarding transfers or other conveyances taken in contemplation of the Issuing Credit Union's insolvency or with the intent to hinder, delay or defraud the Issuing Credit Union or the creditors of such Issuing Credit Union, or that is fraudulent under applicable law.

§ 702.414 Regulations governing Grandfathered Secondary Capital.

This section codifies the requirements of §§ 701.34(b), (c), and (d) in subpart D, with minor modifications, in effect before [INSERT EFFECTIVE DATE OF THIS RULE].

The terminology used in this section is specific to this section. All secondary capital issued before the effective date of this rule that was issued in accordance with §§ 701.34(b), (c), and (d) in subpart D or, in the case of a federally insured, state-chartered credit union, § 741.204(c), that is referred to elsewhere in this subpart as “Grandfathered Secondary Capital,” is subject to the requirements set forth below.

- (a) Secondary capital is subject to the following conditions:

(1) *Secondary capital plan.* A credit union that has Grandfathered Secondary Capital under this subsection must have a written, NCUA-approved “Secondary Capital Plan” that, at a minimum:

(A) states the maximum aggregate amount of uninsured secondary capital the LICU plans to accept;

(B) identifies the purpose for which the aggregate secondary capital will be used, and how it will be repaid;

(C) explains how the LICU will provide for liquidity to repay secondary capital upon maturity of the accounts;

(D) demonstrates that the planned uses of secondary capital conform to the LICU’s strategic plan, business plan and budget; and

(E) includes supporting pro forma financial statements, including any off-balance sheet items, covering a minimum of the next two years.

(2) *Issuances not completed before [INSERT EFFECTIVE DATE OF THIS RULE]*. Any issuances of secondary capital not completed by the effective date of this subpart are, as of the effective date of this subpart, subject to the requirements applicable to Subordinated Debt discussed elsewhere in this subpart.

(3) *Nonshare account*. The secondary capital account is established as an uninsured secondary capital account or other form of non-share account.

(4) *Minimum maturity*. The maturity of the secondary capital account is a minimum of five years.

(5) *Uninsured account*. The secondary capital account is not insured by the National Credit Union Share Insurance Fund or any governmental or private entity.

(6) *Subordination of claim*. The secondary capital account investor's claim against the LICU is subordinate to all other claims including those of shareholders, creditors and the National Credit Union Share Insurance Fund.

(7) *Availability to cover losses*. Funds deposited into a secondary capital account, including interest accrued and paid into the secondary

capital account, are available to cover operating losses realized by the LICU that exceed its net available reserves (exclusive of secondary capital and allowance accounts for loan and lease losses), and to the extent funds are so used, the LICU must not restore or replenish the account under any circumstances. The LICU may, in lieu of paying interest into the secondary capital account, pay accrued interest directly to the investor or into a separate account from which the secondary capital investor may make withdrawals. Losses must be distributed pro-rata among all secondary capital accounts held by the LICU at the time the losses are realized. In instances where a LICU accepted secondary capital from the United States Government or any of its subdivisions under the Community Development Capital Initiative of 2010 (“CDCI secondary capital”) and matching funds were required under the Initiative and are on deposit in the form of secondary capital at the time a loss is realized, a LICU must apply either of the following pro-rata loss distribution procedures to its secondary capital accounts with respect to the loss:

(A) if not inconsistent with any agreements governing other secondary capital on deposit at the time a loss is realized, the CDCI secondary capital may be excluded from the calculation of the pro-rata loss distribution until all of its matching secondary capital has been depleted, thereby causing the CDCI secondary capital to be held as

senior to all other secondary capital until its matching secondary capital is exhausted. The CDCI secondary capital should be included in the calculation of the pro-rata loss distribution and is available to cover the loss only after all of its matching secondary capital has been depleted.

(B) regardless of any agreements applicable to other secondary capital, the CDCI secondary capital and its matching secondary capital may be considered a single account for purposes of determining a pro-rata share of the loss and the amount determined as the pro-rata share for the combined account must first be applied to the matching secondary capital account, thereby causing the CDCI secondary capital to be held as senior to its matching secondary capital. The CDCI secondary capital is available to cover the loss only after all of its matching secondary capital has been depleted.

(8) *Security.* The secondary capital account may not be pledged or provided by the account investor as security on a loan or other obligation with the LICU or any other party.

(9) *Merger or dissolution.* In the event of merger or other voluntary dissolution of the LICU, other than merger into another LICU, the secondary capital accounts will be closed and paid out to the account investor to the extent they are not needed to cover losses at the time of merger or dissolution.

(10) *Contract agreement.* A secondary capital account contract agreement must have been executed by an authorized representative of the account investor and of the LICU reflecting the terms and conditions mandated by this section and any other terms and conditions not inconsistent with this section.

(11) *Disclosure and acknowledgement.* An authorized representative of the LICU and of the secondary capital account investor each must have executed a “Disclosure and Acknowledgment” as set forth in the appendix to this section at the time of entering into the account agreement. The LICU must retain an original of the account agreement and the “Disclosure and Acknowledgment” for the term of the agreement, and a copy must be provided to the account investor.

(12) *Prompt corrective action.* As provided in part 702 of this chapter, the NCUA may prohibit a LICU as classified “critically undercapitalized” or, if “new,” as “moderately capitalized”, “marginally capitalized”, “minimally capitalized” or “uncapitalized,” as the case may

be, from paying principal, dividends or interest on its uninsured secondary capital accounts established after August 7, 2000, `except that unpaid dividends or interest will continue to accrue under the terms of the account to the extent permitted by law.

(b) *Accounting treatment; Recognition of net worth value of accounts.*

(1) *Debt.* A LICU that issued secondary capital accounts pursuant to paragraph (a) of this section must record the funds on its balance sheet as a debt titled “uninsured secondary capital account.”

(2) *Schedule for recognizing net worth value.* The LICU’s reflection of the net worth value of the accounts in its financial statement may never exceed the full balance of the secondary capital on deposit after any early redemptions and losses. For accounts with remaining maturities of less than five years, the LICU must reflect the net worth value of the accounts in its financial statement in accordance with the lesser of:

(A) the remaining balance of the accounts after any redemptions and losses; or

(B) the amounts calculated based on the following schedule:

Remaining maturity	Net worth value of original balance (percent)
Four to less than five years	80 %
Three to less than four years	60 %
Two to less than three years	40 %
One to less than two years	20 %
Less than one year	0 %

(3) *Financial statement.* The LICU must reflect the full amount of the secondary capital on deposit in a footnote to its financial statement.

(c) *Redemption of secondary capital.* With the written approval of NCUA, secondary capital that is not recognized as net worth under paragraph (b)(2) of this section (“discounted secondary capital” re-categorized as Subordinated Debt) may be redeemed according to the remaining maturity schedule in paragraph (c)(3) of this section.

(1) *Request to redeem secondary capital.* A request for approval to redeem discounted secondary capital may be submitted in writing at any time, must specify the increment(s) to be redeemed and the schedule for redeeming all or any part of each eligible increment, and must demonstrate to the satisfaction of NCUA that:

(A) the LICU will have a post-redemption net worth classification of at least “adequately capitalized” under part 702 of this chapter;

(B) the discounted secondary capital has been on deposit at least two years;

(C) the discounted secondary capital will not be needed to cover losses prior to final maturity of the account;

(D) the LICU’s books and records are current and reconciled;

(E) the proposed redemption will not jeopardize other current sources of funding, if any, to the LICU; and

(F) the request to redeem is authorized by resolution of the LICU’s board of directors.

(2) *Decision on request.* A request to redeem discounted secondary capital may be granted in whole or in part. If a LICU is not notified within 45 days of receipt of a request for approval to redeem

secondary capital that its request is either granted or denied, the LICU may proceed to redeem secondary capital accounts as proposed.

(3) *Schedule for redeeming secondary capital.*

Remaining maturity	Redemption limit as percent of original balance
Four to less than five years	20 %
Three to less than four years	40 %
Two to less than three years	60 %
One to less than two years	80 %

(4) *Early redemption exception.* Subject to the written approval of NCUA obtained pursuant to the requirements of paragraphs (c)(1) and (2) of this section, a LICU can redeem all or part of secondary capital accepted from the United States Government or any of its subdivisions at any time after the secondary capital has been on deposit for two years. If the secondary capital was accepted under conditions that required matching secondary capital from a source other than the Federal Government, the matching secondary capital may also be redeemed in the manner set forth in the preceding sentence. For purposes of obtaining NCUA's approval, all secondary capital a LICU accepts from the United States Government or any of its subdivisions, as well as its matching secondary capital, if any, is eligible for early redemption regardless of

whether any part of the secondary capital has been discounted pursuant to paragraph (b)(2) of this section.

Appendix to § 702.414

A LICU that is authorized to accept uninsured secondary capital accounts and each investor in such an account must have executed and dated the following “Disclosure and Acknowledgment” form, a signed original of which must be retained by the credit union:

Disclosure and Acknowledgment

[Name of CU] and [Name of investor] hereby acknowledge and agree that [Name of investor] has committed [amount of funds] to a secondary capital account with [name of credit union] under the following terms and conditions:

1. *Term.* The funds committed to the secondary capital account are committed for a period of ___ years.

2. *Redemption prior to maturity.* Subject to the conditions set forth in 12 CFR § 702.414, the funds committed to the secondary capital account are redeemable prior to maturity only at the option of the LICU and only with the prior written approval of NCUA.

3. *Uninsured, non-share account.* The secondary capital account is not a share account and the funds committed to the secondary capital account are not insured by the National Credit Union Share Insurance Fund or any other governmental or private entity.

4. *Prepayment risk.* Redemption of U.S.C. prior to the account's original maturity date may expose the account investor to the risk of being unable to reinvest the repaid funds at the same rate of interest for the balance of the period remaining until the original maturity date. The investor acknowledges that it understands and assumes responsibility for prepayment risk associated with the [name of credit union]'s redemption of the investor's U.S.C. account prior to the original maturity date.

5. *Availability to cover losses.* The funds committed to the secondary capital account and any interest paid into the account may be used by [name of credit union] to cover any and all operating losses that exceed the credit union's net worth exclusive of allowance accounts for loan losses, and in the event the funds are so used, (name of credit union) will under no circumstances restore or replenish those funds to [name of institutional investor]. Dividends are not considered operating losses and are not eligible to be paid out of secondary capital.

6. *Accrued interest.* By initialing below, [name of credit union] and [name of institutional investor] agree that accrued interest will be:

___Paid into and become part of the secondary capital account;

__Paid directly to the investor;

__Paid into a separate account from which the investor may make withdrawals; or

__Any combination of the above provided the details are specified and agreed to in writing.

7. *Subordination of claims.* In the event of liquidation of [name of credit union], the funds committed to the secondary capital account will be subordinate to all other claims on the assets of the credit union, including claims of member shareholders, creditors and the National Credit Union Share Insurance Fund.

8. *Prompt Corrective Action.* Under certain net worth classifications (see 12 CFR 702.204(b)(11), 702.304(b) and 702.305(b), as the case may be), the NCUA may prohibit [name of credit union] from paying principal, dividends or interest on its uninsured secondary capital accounts established after August 7, 2000, except that unpaid dividends or interest will continue to accrue under the terms of the account to the extent permitted by law.

ACKNOWLEDGED AND AGREED TO this __ day of [month and year] by:

[name of investor's official]

[title of official]

[name of investor]

[address and phone number of investor]

[investor's tax identification number]

[name of credit union official]

[title of official]

**PART 709—INVOLUNTARY LIQUIDATION OF FEDERAL CREDIT UNIONS
AND ADJUDICATION OF CREDITOR CLAIMS INVOLVING FEDERALLY
INSURED CREDIT UNIONS IN LIQUIDATION.**

1. The authority citation for part 709 continues to read as follows:

Authority: 12 U.S.C. 1757, 1766, 1767, 1786(h), 1786(t), and 1787(b)(4), 1788, 1789, 1789a.

2. Amend § 709.5(b) by revising section (8) to read as follows:

§ 709.5 Payout priorities in involuntary liquidation.

* * * * *

(b) * * *

(8) Outstanding Subordinated Debt (as defined in part 702 of this chapter) or outstanding Grandfathered Secondary Capital (as defined in part 702 of this chapter); and

* * * * *

PART 741—REQUIREMENTS OF INSURANCE.

1. The authority citation for part 741 continues to read as follows:

Authority: 12 U.S.C. 1757, 1766(a), 1781-1790, and 1790d; 31 U.S.C. 3717.

2. Revise §§ 741.204 by revising subsection (c) to read as follows and deleting subsection (d):

§ 741.204 Maximum public unit and nonmember accounts, and low-income designation.

* * * * *

(c) Follow the requirements of § 702.414 for any Grandfathered Secondary Capital (as defined in part 702 of this chapter) issued before [INSERT EFFECTIVE DATE OF THIS REGULATION].

3. Add new subsections 741.226 and 741.227 after subsection 741.225 to read as follows:

§ 741.226 Subordinated Debt

Any credit union that is insured, or that makes application for insurance, pursuant to title II of the Act must follow the requirements of subpart D of part 702 of this chapter before it may issue Subordinated Debt, as that term is defined in § 702.402 of this chapter, and to the extent not inconsistent with applicable state law and regulation; and

§ 741.227 Loans to credit unions.

Any credit union that is insured pursuant to Title II of the Act must adhere to the requirements in § 701.25 of this chapter.