October 17, 2022

Ms. Melane Conyers-Ausbrooks
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, Virginia 22314-3428

Re: Comments on Subordinated Debt Proposed Rule: RIN 3313-AF43

Dear Secretary Conyers-Ausbrooks,

We are pleased to offer this Comment Letter in support of the proposed changes to the National Credit Union Administration's ("NCUA") Subordinated Debt rule.

More specifically, we support the NCUA Board's efforts to amend the current Subordinated Debt rule (finalized in December 2020 and effective as of January 1, 2022) (1) to allow issuing credit unions to extend the maturity of their Notes to up to 30 years, upon a demonstration that the instrument would continue to qualify as "debt," and (2) to adopt four minor modifications to make the current Subordinated Debt rule "more user-friendly and flexible."[1] We agree with Chairman Harper that, together, these changes "would advance the statutory mission of federally insured credit unions to meet the credit and savings needs of their members, especially those of modest means."[2]

About Olden Lane

Olden Lane operates a SEC registered broker-dealer (Olden Lane Securities LLC) active in the share certificate market and the market for credit union subordinated debt. We also operate an SEC registered investment advisor (Olden Lane Advisors LLC) that assists credit unions with capital planning, balance sheet management, hedging and investments. We regularly help credit unions to properly identify appropriate objectives for capital and in connection with the proper maintenance of safety and soundness. As an advisor to many credit unions, including several participating in the U.S. Treasury's Emergency Capital Investment Program ("ECIP"), we offer this Comment Letter to provide additional

[1] *See Proposed Rule, Subordinated Debt*, National Credit Union Administration, (Sep. 22, 2022), available at https://www.ncua.gov/files/agenda-items/subordinated-debt-proposed-rule-20220922.pdf, at 2.
[2] *See* NCUA Chairman Todd M. Harper Statement on Amendments to the Subordinated Debt Rule, (Sep. 22, 2022), available at https://www.ncua.gov/newsroom/speech/2022/ncua-chairman-todd-m-harper-statement-amendments-subordinated-debt-rule

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context and to suggest certain considerations which might strengthen the Rule as proposed. Olden Lane's credibility on these issues is bolstered by the fact that, at the time of this letter, our firm has assisted 37 clients in gaining approval for subordinated debt applications with over $780 million since January 2019. This record includes 8 ECIP related applications approved for $295 and 29 traditional applications approved for over $485 million.

A Brief History of Credit Union Subordinated Debt

Since 1996, the NCUA has authorized Low-Income Credits Unions (LICUs) to raise uninsured secondary capital in the form of subordinated debt. For a LICU, the capital counts directly towards the PCA Net Worth ratio. This is a powerful form of regulatory relief, allowing LICUs to strengthen the institution in the face of adverse economic conditions and to invest in improvements to the member experience. Despite this significant regulatory relief, the mechanism was sparsely used during its first decade.

Prior to the 2008 Financial Crisis, when the U.S. Treasury invested directly in credit union secondary capital as part of its Troubled Asset Relief Program (TARP), total outstanding credit union secondary capital remained below $30 million. And, secondary capital was deployed primarily as a tool to aid struggling credit unions. The market for credit union secondary capital also suffered from a non-transparent and inconsistent application process which left many applicants confused and disappointed. This began to change in 2018, as financial service companies, like Olden Lane, focused attention on the underserved nature of the credit union market and set out to improve the application process for participating credit unions.

From 2018 to year-end 2021, LICUs added more than $700 million in secondary capital to their balance sheets, with the team at Olden Lane raising more for clients than any other advisors. This growth followed the NCUA's watershed release, Letter to Credit Unions 19-01. Across 23-pages, this letter articulated the requirements for approval of a secondary capital plan, offering welcomed guidance to the industry.

Letter to Credit Unions 19-01, combined with the maturation of the market and a diversification in the use of secondary capital, led to the aggressive growth of secondary capital. No longer limited to simply a lifeline for struggling credit unions, financially sound credit unions began issuing secondary capital to support organic and inorganic growth strategies.

The increased attention and accelerating market growth led the NCUA to adopt a new set of rules altogether in the beginning of 2022. The NCUA abandoned the term "secondary capital" and, as of January 1, 2022, all credit unions now issue subordinated debt.

With the transition to the new subordinated debt regime, the universe of credit unions capable of raising subordinated debt has increased dramatically. No longer limited to LICUs (who can still issue under the new rule, regardless of size), now all credit unions with greater than $500 million in assets ("complex credit unions") can raise subordinated debt following the approval of an application to the NCUA. For complex credit unions, the subordinated debt counts towards the numerator in the Risk Based Capital Ratio, as opposed to LICUs who see the debt count towards both their PCA and Risk Based Net Worth

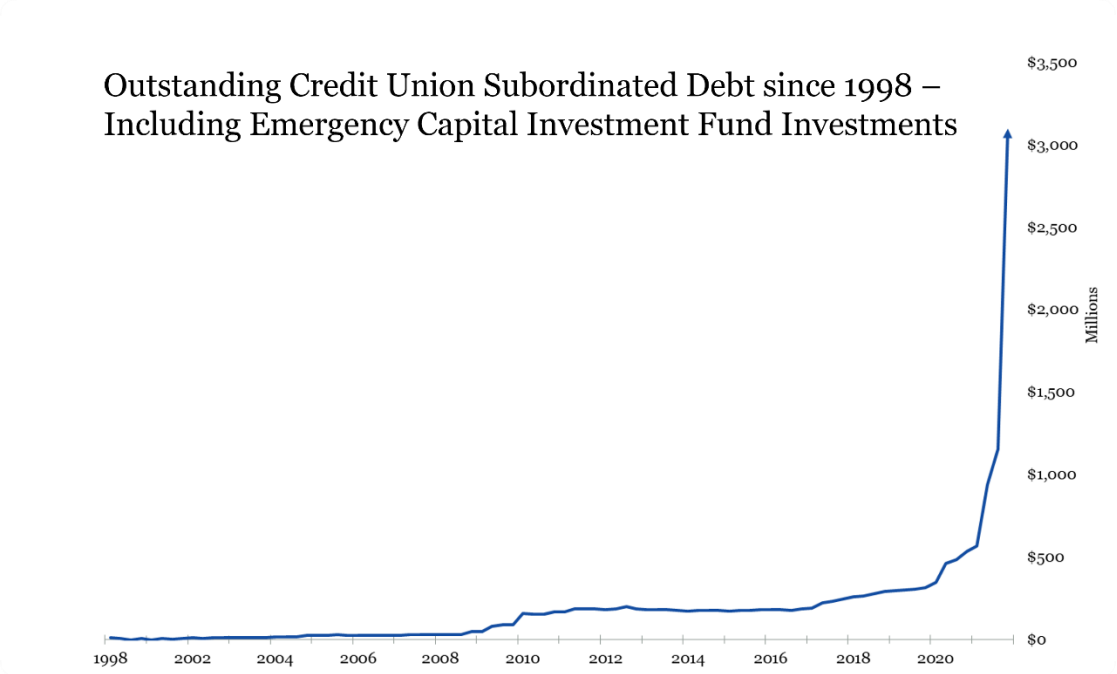
calculations. There were additional, nuanced changes to the Subordinated Debt Rule that affect how credit unions must approach the process of raising further capital.

As the market continues to grow, today's subordinated debt is most often deployed:

- **To support organic growth for a credit union** – If asset growth outpaces retained earnings, the dilution can be harmful to an otherwise thriving credit union. This dilution can be offset with subordinated debt.
- **To pursue an inorganic, acquisition-based growth strategy** – These strategies are typically dilutive to the capital ratios of the acquiring credit union. Subordinated debt can offset these negatives.
- **In preparation for economic headwinds** – Subordinated debt can bolster the balance sheet of a credit union, absorbing losses and helping the credit union through economically turbulent periods that would otherwise harm capital ratios.

Chart [1] below illustrates the rapid growth of the credit union subordinated debt over the last two decades.

Chart [1].



Classifying Credit Union Subordinated Debt as Debt or Equity

In October 2021, the NCUA issued a Letter to Credit Unions permitting LICUs participating in ECIP to issue 30-year subordinated debt instruments to take advantage of the most favorable terms offered by the U.S.

Treasury.[3] At the time, the NCUA expressed concern that the 30-year term was longer than the maximum term allowed on secondary capital under Section 701.34. Perhaps reading the political tea leaves, and because there was no reasonable position to oppose the extension of the duration, the NCUA allowed ECIP participants to extend the duration of the ECIP investment. After all, the programs monies from the U.S. Treasury were designed to allow MDIs and CDFIs on the front lines of meeting the financial needs of communities that are disproportionately underserved by traditional financial institutions and are primary lenders to LMI and communities of color, to recover from the COVID-19 pandemic and to assist their minority and low-income communities. Now, in considering extending the maximum available term for subordinated debt to 30 years more broadly, the agency is focused on ensuring that any such instrument so qualifying can properly support a characterization as debt.

In performing our own review of the guidance on the classification of an instrument as debt or equity, we can identify several factors that courts have regularly employed to inform such a decision. Most experts agree that no single factor should be dispositive.[4] Nonetheless, an examination of those factors in this context is enlightening – especially because most favor an interpretation that would allow credit union subordinated debt instruments to be debt. In fact, our analysis suggests that, for the typical credit union subordinated debt transaction, a demonstration that the subordinated debt is intended to be debt should not be a high bar at all.

In *Estate of Mixon*, for example, the Fifth Circuit summarized one of the most obvious factors in determining the character of an instrument, observing that "[t]he issuance of a stock certificate indicates an equity contribution; the issuance of a bond, debenture, or note is indicative of a bona fide indebtedness."[5] In the case of the typical issuance of credit union subordinated debt, for example, there is very little to suggest that any part involved expects anything other than a debt instrument. A Promissory Note is often the most important part of a closing package, typically accompanied by a Note Purchase Agreement. In the case of those credit unions participating in ECIP, the title of the term sheet makes the intent of the U.S. Department of Treasury very clear: "Emergency Capital Investment Program Credit Union Subordinated Debt Term Sheet" (emphasis ours).[6]

Aside from the plain terms of the instrument, there are several additional attributes of the typical credit union subordinated debt arrangement (ECIP, or otherwise) which favor a debt characterization, despite a proposed term of up to 30 years. These include the following:

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[3] Letter to Credit Unions 21-CU-22, National Credit Union Administration, (Oct. 2021) available at https://www.ncua.gov/regulation-supervision/letters-credit-unions-other-guidance/emergency-capital-investment-program-participation.

[4] *See, e.g.* Letter to Credit Unions 21-CU-11, Emergency Capital Investment Program Participation and enclosed Supervisory Letter No. 21-02 (Oct. 20, 2021). ("The agency has always recognized that no one term or factor of an ECIP instrument is dispositive in characterizing the nature of the instrument. As such, the agency is satisfied that the close collaboration between the NCUA and Treasury, the unique status of the ECIP, and the terms of the instrument have resulted in an instrument that complies with the Federal Credit Union Act, even with a 30-year term.").

[5] *See Estate of Mixon,* 464 F.2d 394 (5th Cir. 1972).

[6] *Emergency Capital Investment Program Credit Union Subordinated Debt Term Sheet*, United States Department of Treasury, (Aug. 11, 2021), available at https://home.treasury.gov/system/files/136/Subordinated_Debt_Term_Sheet_for_Credit_Unions.pdf.

- **Fixed maturity date:** "The presence of a fixed maturity date indicates a fixed obligation to repay, a characteristic of a debt obligation. The absence of the same on the other hand would indicate that repayment was in some way tied to the fortunes of the business, indicative of an equity advance."[7] In any case, each credit union subordinated debt transaction we have seen or expect to see will have a stated maturity date. In fact, the Subordinated Debt rule requires it.[8]

- **Payments not dependent upon earnings:** A bona fide debt is one that arises from "a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money."[9] By contrast, "where repayments depend on future corporate success, an equity investment may be indicated,"[10] and "where prospects for repayment are questionable because of persistent corporate losses, an equity investment may be indicated."[11] With respect to credit union subordinated debt, each issuing credit union has prepared an Application to Issue Subordinated Debt to the satisfaction of its Regional Director. Moreover, each ECIP participant has satisfied a significant process of application and investigation by both the U.S. Department of Treasury and the NCUA. Moreover, any state-chartered credit unions participating in a subordinated debt offering will have also satisfied any requirements of its state regulator. Subject to such a regime of pre-clearance which expressly considers a prospective issuing credit union's ability to repay and its overall safety and soundness, it seems unlikely that repayments can be deemed to be questionable.

- **No management participation:** While increased management rights typically support an equity characterization,[12] such a scenario is specifically prohibited in the credit union subordinated debt context, as 12 CFR 702.402(b)(4) provides, in pertinent part, that "[t]he Subordinated Debt or Subordinated Debt Note, as applicable, must not [p]rovide the holder thereof with any management or voting rights in the Issuing Credit Union."[13]

  In the ECIP context, it seems even more unlikely that ECIP investments will fall anywhere close to the line here. In addition to having to abide by the prohibition described above, the program's term sheet goes to great lengths to avoid any creditor rights whatsoever that could be characterized as exerting influence over a borrowing credit union's management. For example, only upon a credit union's failure to make five quarterly interest payments in full will the U.S.

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[7] Estate v. Mixon, *supra* note 4, at 404. *See also Debt vs. Equity: Form & Substance Matter,* Farrell Fritz P.C. (Sep. 25, 2017) ("A fixed maturity date is indicative of an obligation to repay, which supports characterizing an advance of funds as debt."), available at https://www.taxlawforchb.com/2017/09/debt-vs-equity-form-substance-matter/.

[8] *See Final Rule, Subordinated Debt*, National Credit Union Administration, (Dec. 17, 2020), available at https://www.ncua.gov/files/agenda-items/AG20201217Item5b.pdf, at 83 (citing §702.404) ("At a minimum, the Subordinated Debt or the Subordinated Debt Note, as applicable, must: . . . (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").

[9] *See generally Debt vs. Equity: Form & Substance Matter,* Farrell Fritz P.C., *supra* note 6.

[10] *Id.*

[11] *Id.*

[12] *See, e.g.* Jeff Borghino, *Debt v. Equity in the Tax Court,* The Tax Adviser (Feb. 1, 2013), available at https://www.thetaxadviser.com/issues/2013/feb/clinic-story-01.html.

[13] *See* Final Rule, Subordinated Debt, National Credit Union Administration, (Dec. 17, 2020), available at https://www.ncua.gov/files/agenda-items/AG20201217Item5b.pdf, at 85.

Treasury gain "the right, but not the obligation, to appoint a representative to serve as an observer on the issuer's board of directors." And, in any case, the term sheet qualifies that such an observer "will not have any rights granted to board members under the Federal Credit Union Act and/or the NCUA's regulations or the Credit Union's bylaws." In the aggregate, these rights steer well clear of anything that exerts any participation rights in the management of the credit union. Again, an equity characterization seems wholly inapplicable.

- **Use of proceeds:** The Subordinated Debt rule requires an issuing credit union to satisfy the agency that the additional capital will be deployed in a manner consistent with the credit union's strategic plan, business plan and budget and that such uses can reasonably support the liquidity to make repayment upon maturity.[14] In addition, significant financial modeling must be prepared by applicants – including the analytical support for the key assumptions – before an application is approved by the agency.[15] Finally, Section 702.408(b)(8) requires that an issuing credit union include, as part of its application "[a] statement indicating how the credit union will use the proceeds from the issuance and sale of the subordinated debt."[16]

  For ECIP participants, the proceeds of the Treasury's investment are required to be used to "provide loans, grants, and forbearance for small businesses, minority-owned businesses, and consumers, especially in low-income and underserved communities, that may be disproportionately impacted by the economic effects of the COVID-19 pandemic."[17] In other words, the funds are intended to allow the credit union to do more of the business of the credit union. As one court observed, when "[I]t appears that the advances were used to meet the daily operating needs of [the company]," a "bona fide indebtedness" is indicated.[18]

- **Reasonable expectation of repayment:** In a recent case, the Tax Court expounded that "[w]hether an advance gives rise to a bona fide debt for Federal tax purposes is determined from all the facts and circumstances," adding that "[t]o constitute a bona fide debt, at the time of the transfer there must be a real expectation of repayment and an intent on the part of the purported creditor to secure repayment."[19] Here, such an expectation of repayment must be assumed. First, there would be no reason for the requirement of an NCUA approval of subordinated debt applications otherwise.[20] Secondly, each subordinated debt investor certainly extends funds with a real expectation of repayment and an intent to secure repayment.

As we consider the primary factors described in the relevant case law, we suspect that it will not be difficult for credit union issuers to meet the NCUA's requirement that they satisfy a "debt"

[14] 12 CFR 702.408(b)(5), (6).
[15] 12 CFR 702.408(b)(7).
[16] 12 CFR 702.408(b)(8).
[17] *See generally,* Emergency Capital Investment Program Website, available at https://home.treasury.gov/policy-issues/coronavirus/assistance-for-small-businesses/emergency-capital-investment-program.
[18] *Stinnett's Pontiac Serv., Inc.*, 730 F.2d 634, 640 (11th Cir. 1984).
[19] *See 2590 Assocs., LLC v. Commissioner,* T.C. Memo. 2019-3, at *21.
[20] *See, e.g.,* 12 CFR 701.34(b)(1)(iii), (requiring that, before accepting secondary capital, a qualifying low-income credit union "[e]xplains how the LICU will provide for liquidity to repay secondary capital upon maturity of the accounts").

characterization to overcome the 20-year limitation. We applaud the NCUA, because an insistence on a 20-year maximum would have material consequence for impacted credit unions and their members. If credit union issuers can uncover investors willing to invest in subordinated debt for longer than 20 years, an artificial NCUA maturity limit would certainly be frustrating. While we suspect that investors with an appetite for that duration might be few and far between, we certainly support the NCUA's willingness to be flexible. With respect to ECIP, the extension has already proven advantageous to the credit unions that took part in that program. As a result, the related credit union lending growth among LMI, minority and other historical disadvantaged borrowers can be expected to be more than would have otherwise been achieved had the NCUA prohibited the 30-year investment for those ECIP participants. Harmonizing the rule now to allow such a term for others who may find a willing lender makes great sense.

Again, we caution the NCUA against adding unnecessary costs to an offering of subordinated debt longer than 20 years. In this regard, the Proposed Rule does well to concede that "the Board does not anticipate that a legal or CPA opinion would be necessary for issuances that have fixed stated maturities that are not significantly longer than 20 years and do not contain any other features or terms that could be viewed as akin to an equity issuance."[21] However, we do worry that regulatory creep might make legal opinions or CPA analysis a requirement over time. For that reason, we would favor rewriting the proposed language for 702.408(b)(14). Currently, the Proposed Rule provides that credit union issuers seeking to issue Notes with a maturity greater than 20 years submit, at the discretion of the Appropriate Supervision Office

> "one or more of the following:
> 1. A written legal opinion from a Qualified Counsel;
> 2. A written opinion from a licensed CPA; and
> 3. An analysis conducted by the credit union or independent third-party."[22]

We note that the third category above includes the first two categories. As such, we would suggest revising the language to state simply "[t]he Appropriate Supervision Office may require such analysis conducted by the credit union or an independent third party as is reasonable to support the characterization of the Notes as debt."

The Four Proposed Minor Modifications

1. Qualified Counsel

We support the Board's proposed amendments to the definition of "Qualified Counsel" to clarify where such person(s) must be licensed to practice law. As described, it was never the Board's intention to mandate that "Qualified Counsel" be licensed to practice law in every jurisdiction that may be relevant to an issuance of subordinated debt. Instead, the requirement of qualified counsel was meant to specify that an issuing credit union be afforded the counsel of someone (1) licensed to practice law; (2) with an expertise in the areas of Federal and state securities laws and debt transactions; and (3) qualified to

[21] *Proposed Rule, Subordinated Debt*, National Credit Union Administration, (Sep. 22, 2022), available at https://www.ncua.gov/files/agenda-items/subordinated-debt-proposed-rule-20220922.pdf, at 13.
[22] *Id*.

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provide sufficient advice to an issuing credit union to comply with the requirement in § 702.406(f) and all applicable Federal and state securities laws.

2. Statement of Cash Flows

The Board is proposing to amend §§ 702.408(b)(7) and 702.409(b)(2) to remove the statement of cash flow from the Pro Forma Financial Statements requirement and replace it with the requirement for cash flow projections. We agree with the Board's position that a cash flow projection should be sufficient to allow the Appropriate Supervision Office enough information to properly evaluate the viability of an issuance.

3. Filing requirements and inspection of documents

We support the ministerial change to remove "inspection of documents" from the title of the referenced paragraph and the replacement of the current requirement that a credit union submit all applicable documents via the NCUA's website with a requirement that a credit union make all submissions directly to the Appropriate Supervision Office.

4. Categorization of Grandfathered Secondary Capital that no longer counts as Regulatory Capital

We also support the proposed change to § 702.414(c). We agree that the removal of "("discounted secondary capital" recategorized as Subordinated Debt)" aligns the section to the current treatment of Grandfathered Secondary Capital on the most recent Call Report.

Additional Technical Improvements to Consider

We are aware of the targeted scope of the Proposed Rule. However, while not part of a Proposed Rule at this time, we wish to highlight a few additional technical improvements that the NCUA might consider:

1. Recoupment of Losses

NCUA Regulation § 702.404(a)(6) requires that subordinated debt must:

> "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"

We are curious as to whether it was truly intended that an accounting deficit in retained earnings would extinguish the subordinated creditors claim in respect of such deficit. There have certainly been experiences where creditors were able to improve their recovery in previous cases of liquidation with

failed banks. And, bank subordinated debt transactions are typically not subject to a similar provision. The inclusion of this provision in the credit union subordinated debt context puts the asset class at a distinct disadvantage as compared with comparable bank subordinated debt transactions. And, it seems to do so with no apparent benefit. In fact, this provision strikes us as rather novel for debt securities. We expect that this provision will likely exclude discerning institutional investors and may impact pricing relative to bank subordinated debt. We would encourage the NCUA to consider whether it might be removed via a technical improvement that makes credit union subordinated debt "more user-friendly and flexible."[23]

2. Securities Offering Status Making Subordinated Debt Inaccessible for Smaller Credit Unions

As part of the Subordinated Debt rule, the NCUA required issuing credit unions to prepare an offering document and retain securities counsel. While the Final Rule was being considered, we cautioned the agency that these requirements would make issuances of subordinated debt cost-prohibitive for many smaller credit unions. In our comment letter, we highlighted the bilateral nature of the then current market for credit union secondary capital and encouraged the agency to refrain from implementing a blanket approach to securities law compliance.[24] The NCUA considered this position yet adopted a regime that required (1) strict adherence to securities laws and (2) an Offering Document that is "independent of and, in some cases, additive to any requirements imposed by applicable securities laws."[25] At the time, the NCUA commented:

> "As a prudential regulator, it is incumbent upon the NCUA to include in a rulemaking of this complexity provisions to help ensure credit unions comply with regulatory or statutory requirements, and to help credit unions avoid legal challenges from investors."[26]

Unfortunately, we have already seen evidence of smaller credit unions deeming this market inaccessible based on cost. Again, we encourage the NCUA to consider a simple exemption for small offerings of $10 million or less sold to no more than five (5) institutional accredited investors. The burdens of the full application of the current set of Subordinated Debt rules in such circumstances far outweigh any benefits. We note that, even after incorporating such an exemption, the scope of exemptive relief in the NCUA debt offering framework would be much more limited than either of the related OCC or SEC frameworks.

3. Amortization

[23] *Id.*, at 2.

[24] *See Letter to Gerard Poliquin,* Comments on Subordinated Debt, Olden Lane (Jul. 7, 2020), available at file:///C:/Users/olden/Downloads/NCUA-2020-0016-0133_attachment_1.pdf ("Such regulatory burdens are unnecessary based on the composition of the current secondary capital market where practically none of the credit unions are engaged in broadly distributed securities offerings or issue subordinated debt to more than a few investors... While we certainly understand the desire of the NCUA to encourage a regime that protects lenders, we are concerned that this proposal seeks to achieve those protections by imposing cumbersome costs on the credit union borrowers.")

[25] Final Rule, Subordinated Debt, National Credit Union Administration, (Dec. 17, 2020), available at https://www.ncua.gov/files/agenda-items/AG20201217Item5b.pdf, at 20.

[26] *Id.*

We have noticed that there are still credit union subordinated debt transactions in the market structured with the 5-year amortization schedule that is a vestige of the old secondary capital regime. Prior to the current Subordinated Debt rule, the secondary capital rules under 701.34 only permitted repayment of principal amount prior to maturity up to the amount of the debt that was discounted for purposes of regulatory capital treatment (*i.e.* 20% a year beginning 5 years prior to maturity). In the typical structure of that era, investors and issuers generally agreed that the issuer would seek permission to make such prepayments on an annual basis.

Under the new Subordinated Debt rule, however, we observe explicit restrictions on prepayments that are not strictly at issuer election. Specifically, Section 702.404(b)(6) provides:

> "The Subordinated Debt or the Subordinated Debt Note, as applicable, must not… 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."

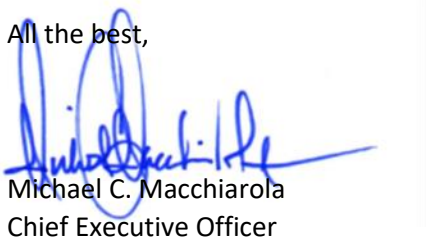
As such, we believe that transactions structured with 20% mandatory prepayment per year beginning five years from maturity are no longer permissible. We believe that the market would benefit from the NCUA clarifying that this is, in fact, the case.

Conclusion

We thank the NCUA Board and Staff for the consideration of this Comment Letter. And, we are grateful for the opportunity to share our views on the proposed amendments. While we look forward to the adoption of the Proposed Rule, we respectfully request that the NCUA give serious thought to the additional improvements we have summarized above.

Should you have any questions regarding our comments, please feel free to contact the undersigned at 908 432-6819 or mmacchiarola@oldenlane.com.

All the best,



Michael C. Macchiarola
Chief Executive Officer
Olden Lane Inc.