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New Path for Raising Capital for Credit Unions – The NCUA's Final Rule on Subordinated Debt

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Introduction

On December 17, 2020, the National Credit Union Administration (the "NCUA") adopted a final rule (the "Final Rule") that (1) permits non-low-income designated credit unions with assets greater than $500 million and newly chartered credit unions to issue subordinated debt; and (2) modifies the NCUA's existing secondary capital rules for low-income designated credit unions. Most significantly, the Final Rule would, for the first time, provide federally insured credit unions (both federal and state-chartered) with more than $500 million in assets and without a low-income designation access to additional capital outside of retained earnings. Specifically, these credit unions would be permitted to sell subordinated debt to certain qualifying investors and use the proceeds to satisfy the NCUA's new risk-based capital ratio that will take effect on January 1, 2022 (the "Risk Based Capital Ratio"), which will require them to hold capital at least equal to 10% of their risk-weighted assets.

Beyond enhancing regulatory capital, the proceeds from a subordinated debt issuance can be utilized by issuing credit unions to finance strategic growth initiatives while mitigating capital dilution, reduce high member business lending concentrations and restore liquidity to desired levels due to unexpected losses.

Although low-income designated credit unions have had authority to issue secondary capital accounts (which are subordinated debt instruments) to non-natural person members and non-members and include the outstanding principal amount of these accounts as net worth and risk-based net worth for regulatory capital purposes, the Final Rule modifies the NCUA's existing secondary capital rules so that any new secondary capital issuance would be considered "subordinated debt" subject to the requirements of the Final Rule, while grandfathering any secondary capital issued before the effective date of the Final Rule.

Highlights of the Final Rule include:

- allowing federal and state-chartered complex credit unions (i.e., credit unions with assets greater than $500 million) without a low-income designation, low-income-designated credit unions and new credit unions to issue subordinated debt;

- permitting low-income designated credit unions to continue to include issued subordinated debt in their net worth and Risk-Based Capital Ratio calculations; while complex credit unions without a low-income designation would be eligible to include issued subordinated debt in their Risk-Based Capital Ratio calculation (but not in their net worth calculation);

- limiting eligible investors of subordinated debt to "accredited investors" as defined by the Securities and Exchange Commission (the "SEC"), which includes natural persons and entities;

- providing specific requirements for the subordinated debt instrument, such as having a maturity of at least five years but no more than 20 years, and being unsecured, issued pursuant to written contractual agreement(s) and subordinate to all other claims against the issuing credit union;

- prohibiting a credit union from being both an issuer and investor in subordinated debt; and

- providing specific application procedures for obtaining NCUA pre-approval to issue subordinated debt, as well as required disclosures that must be made to potential investors in the offering documents and the subordinated debt promissory note.

The Final Rule will be effective as of January 1, 2022. A detailed summary of the Final Rule is described below.

Planning and Key Considerations

The ability to raise capital through the issuance of subordinated debt, particularly in a low interest rate environment, could be attractive for many credit unions, as the proceeds can be utilized for growth and growth-related purposes – increasing scale through acquisitions of other banks, branches and fee-based businesses, reducing high member business lending concentrations and delivering improved services and technology to members and for more defensive capital and liquidity planning purposes – providing balance sheet protection and enhancing regulatory capital ratios and liquidity.

Given the unique issues of a subordinated debt offering, credit unions should consider the following:

Understand the Basics. It is important to have a firm understanding of the basics of a subordinated debt transaction, such as the terms of the instrument, including the offering size, maturity date and interest rate/pricing, the NCUA pre-approval process and regulatory capital implications. Other considerations would include the selection of a placement agent/underwriter to assist with the sale of the subordinated debt, the selection of a paying agent/trustee to provide on-going administrative services, whether to seek a credit rating of the subordinated debt, and the number and type of potential accredited investors, which may impact deal pricing. As part of the planning process, credit unions should develop projections showing the pro forma effects of the subordinated debt on net worth, earnings and future liquidity positions, and on-going debt servicing requirements to ensure the timely repayment of the subordinated debt to accredited investors.

Federal and State Securities Law Considerations. The NCUA has emphasized that any issuance of subordinated debt by a credit union must be done in accordance with the applicable federal and state securities laws and given the complexity of the securities law framework, qualified legal counsel should be engaged to ensure compliance with securities laws before, during and after any subordinated debt offering. Securities law compliance matters would include: (1) determining the appropriate exemption under the Securities Act of 1933, as amended, to be relied upon so that the subordinated debt offering does not require registration with the SEC; (2) certifying that potential investors are "accredited investors" as defined by the SEC; (3) complying with any state securities law requirements, such as applicable notice filings and filing fees that may be required for a particular state; and (4) ensuring that offering documents and disclosures made to potential investors comply with federal and state anti-fraud rules applicable to offers and sales of securities and the disclosure requirements required by the NCUA in the Final Rule. As a result of the foregoing, enhancing the credit union's director and officer liability insurance coverage may be warranted.

While the Final Rule was adopted independent of federal securities laws and any available exemptions from the registration requirements thereof, the NCUA expects that credit unions issuing subordinated debt will work with experienced securities law counsel to help them consider the type and amount of disclosure (even if not expressly required by federal and state securities laws) that may be appropriate or necessary to adequately insulate the institution from risk and to complete the offering, as certain sophisticated investors,

rating agencies, placement agents/underwriters and trustees/paying agents may require more detailed disclosures and financial information about the credit union.

Subordinated Debt Policy. The NCUA requires, as part of its pre-approval process, that credit unions adopt and submit a written policy, in consultation with qualified legal counsel, governing the subordinated debt offering that addresses compliance with federal and state securities laws and investor relations matters. The policy must designate appropriate personnel who will be responsible and authorized to speak on the credit union's behalf and have procedures covering interactions with investors and disclosures of financial information about the credit union. In drafting the policy, the credit union will have to consider a variety of practical, disclosure-related issues, such as 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. From a securities law standpoint, this information must be materially correct and complete, and procedures must be implemented so that any non-public information is not disclosed on a selective basis.

Application Process and Timing. Given the scope of information that must be provided to the NCUA (as described below), the credit union should prepare the initial application for pre-approval in consultation with qualified legal and financial advisors. The credit union should also consider having pre-filing meetings with the NCUA and its state regulator (if applicable) to discuss the offering process and will likely need to explain how issuing subordinated debt is aligned with its strategic, business and capital plans and incorporated into its enterprise risk management framework.

The good news is that the Final Rule provides a two-year period to issue the subordinated debt after receipt of NCUA pre-approval, which enables a credit union to seek NCUA pre-approval well in advance of having to issue the subordinated debt, thereby mitigating the need for "just in-time capital." However, in considering capital needs and timing, credit unions should be cognizant that the subordinated debt offering process (including the planning phase) will likely take five-to-six months to complete and should consider engaging qualified legal and financial advisors well in advance of the offering process.

What to do Today. Although the Final Rule does not take effect until January 1, 2022, credit unions interested in raising capital through subordinated debt should begin the planning phase today, including board and management education, reviewing and updating business, strategic and capital plans and risk management policies, assessing regulatory capital and liquidity positions, considering the financial implications of an offering and on-going debt servicing requirements, and drafting the subordinated debt policy described above.

Sample Timeline – Subordinated Debt Offering Process

Time Frame:	Key Actions:
Month One	**Planning Phase**: • Board and management education. • Engage qualified legal counsel and begin assembling deal team, including placement agent (i.e., investment banker). • Determine potential offering size and number of accredited investors. • Develop projections for pro-forma effects of subordinated debt on net worth and risk-based capital, earnings, and liquidity. • Consider use of proceeds from subordinated debt (e.g., to support growth and/or restore regulatory capital and liquidity). • Update business, strategic and capital plans, as appropriate, and begin drafting subordinated debt policy.
Month Two/ Month Three	**NCUA Pre-Approval Process**: • Pre-filing meeting with the NCUA and state regulator (if applicable). • Preparation and filing of initial application, which must include: (1) a business plan; (2) an analysis of liquidity to repay the subordinated debt; (3) pro forma financial statements; and (4) the final subordinated debt policy. **Prepare Offering Documents**: (1) note purchase agreement and subordinated debt promissory note; (2) accredited investor certification; (3) offering memorandum that includes required disclosures of the Final Rule and other disclosures requested by placement agent; and (4) marketing materials.
Month Four	• **Receipt of NCUA Pre-Approval** (within 60 days after receipt of completed initial application). • **Finalize Offering Documents**. • **Finalize Other Matters (as appropriate):** (1) establishing a virtual data room for due diligence of the issuing credit union by potential investors (typically handled by placement agent); (2) requesting a credit rating of the subordinated debt from a rating agency; and (3) engagement of a trustee/paying agent.
Month Five	**Offering Phase:** • Identify and distribute offering documents to potential investors (typically managed by placement agent) and provide access to data room to potential investors. • Agree on pricing (i.e., interest rate) and allocation of subordinated debt to investors. • Circulating and finalizing note purchase agreement and promissory note with investors. • Closing and funding of the subordinated debt offering. • Submit all offering documents to the NCUA (within 10 business days).

Detailed Summary of the Final Rule

What is subordinated debt?

The Final Rule defines "subordinated debt" as a borrowing or series of borrowings issued by a credit union to certain qualifying investors that satisfies the requirements and restrictions of the Final Rule. It is typically evidenced by a note purchase agreement and promissory note setting forth its terms and conditions, such as the required interest paid thereon, the interest payment dates and the date on which the principal amount must be fully repaid (i.e., the maturity date).

Although subordinated debt is a "security" for purposes of federal and state securities laws, it has similar characteristics to a line of credit arrangement and ranks below other, more senior loans or securities with respect to claims on assets or earnings of the issuer. For U.S. GAAP purposes, the subordinated debt would be treated as a "borrowing" and presented as indebtedness on the credit union's balance sheet, and the interest paid thereon would be considered interest expense on the credit union's income statement.

Any secondary capital issued by a low-income designated credit union after January 1, 2022 would be considered "subordinated debt" (and no longer considered "secondary capital") and subject to the requirements of the Final Rule. In other words, there is not a separate class of security for subordinated debt issued by a low-income designated credit union as compared to a complex credit union or a new credit union without a low-income designation. As a result, secondary capital and subordinated debt are subject to nearly identical rules and, unless the context otherwise requires, the term "subordinated debt" refers to both types of debt instruments. Secondary capital that is currently outstanding or issued prior to January 1, 2022 is referred to by the Final Rule as "grandfathered secondary capital."

What credit unions are eligible to issue subordinated debt?

To issue subordinated debt, a credit union must satisfy the following eligibility criteria at the time of issuance: (1) it must be an "eligible credit union"; and (2) it may not be an "investor" in any subordinated debt. These credit unions are referred to by the Final Rule as "issuing credit unions."

Must be an Eligible Credit Union. To be an "eligible credit union," the credit union must either be a: (1) low-income designated credit union; (2) complex credit union (i.e., has an asset size that exceeds $500 million and a risk-based net worth that exceeds 6%, based on the credit union's most recent call report) with a capital classification of "undercapitalized" or better; (3) credit union that anticipates becoming a low-income designated credit union or a complex credit union with a capital classification of "undercapitalized" or better within 24 months after the planned issuance of the subordinated debt; or (4) new credit union with retained earnings equal to or greater than 1% of assets. Federally insured state-chartered credit unions that satisfy any of the above-mentioned criteria would be considered an "eligible credit union" for purposes of the Final Rule.

If the issuing credit union is a complex credit union that does not have a low-income designation, the aggregate amount of all subordinated debt issued may not exceed 100% of its net worth, as determined at the time of each issuance of subordinated debt. This limit is being imposed so that the regulatory capital of complex credit unions is not primarily composed of subordinated debt, viewed as a lower quality form of capital than retained earnings due to its finite duration.

May not be an Investor in 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 an issuing credit union acquires subordinated debt or grandfathered secondary capital in a merger or other consolidation, the credit union may still issue subordinated debt, but it may not

invest in the subordinated debt or grandfathered secondary capital of any other credit union while any subordinated debt issuance remains outstanding.

What is the regulatory capital treatment of subordinated debt?

If the subordinated debt satisfies the requirements and restrictions of the Final Rule, the regulatory capital treatment of the subordinated debt is treated as follows, depending on the type of eligible credit union issuer:

Type of Eligible Credit Union Issuer	Regulatory Capital Treatment of Subordinated Debt
Eligible Credit Union that is low-income designated and not a complex credit union (≤ $500 million in assets):	Outstanding principal amount of the subordinated debt will count as regulatory capital with respect to the credit union's "Net Worth Ratio."
Eligible Credit Union that is a complex credit union (> $500 million in assets) and not low-income designated:	Outstanding principal amount of subordinated debt will count as regulatory capital with respect to the credit union's "Risk-Based Capital Ratio."
Eligible Credit Union that is both a complex credit union (> $500 million in assets) and low-income designated:	Outstanding principal amount of subordinated debt will count as regulatory capital with respect to the credit union's "Risk-Based Capital Ratio" and "Net Worth Ratio."

Net Worth Ratio. Since 1998, the Net Worth Ratio has been utilized by the NCUA to assess a credit union's financial condition and capital adequacy. The "Net Worth Ratio" is the ratio of the credit union's net worth (which is primarily comprised of retained earnings) to total assets.

The outstanding principal amount of the subordinated debt and grandfathered secondary capital issued by a low-income designated credit union (including a complex credit union) would be treated as "net worth" for purposes of the Net Worth Ratio. Conversely, for complex credit unions without a low-income designation, the outstanding principal amount of the subordinated debt would not be treated as net worth for purposes of calculating their Net Worth Ratio.

Risk-Based Capital Ratio. Additionally, the NCUA has adopted a new risk-based capital calculation (the "Risk-Based Capital Ratio") that evaluates the capital adequacy of a credit union based on the risk level of each type of asset on its balance sheet to ensure the amount of capital is commensurate with the risk level of each type of asset. The Risk-Based Capital Ratio will replace the NCUA's current risk-based net worth requirement and will only apply to complex credit unions (>$500 million in assets) beginning on January 1, 2022. The Risk-Based Capital Ratio is the ratio of the complex credit union's "risk-based capital ratio numerator" to its "total risk-weighted assets."

The "risk-based capital ratio numerator" equals the difference between complex credit union's: (1) (i) undivided earnings; (ii) appropriation for non-conforming investments; (iii) other reserves; (iv) equity acquired in a merger; (v) net income; (vi) Allowance for Loan and Lease Losses, maintained in accordance with GAAP; (vii) grandfathered secondary capital/subordinated debt; and (viii) certain permissible assistance included in net worth, less; (2) (i) National Credit Union Share Insurance Fund ("NCUSIF") capitalization deposit; (ii) goodwill; (iii) other intangible assets; and (iv) identified losses not reflected in the risk-based capital ratio numerator.

"Total risk-weighted assets denominator" equals the complex credit union's risked-weighted on-balance and off-balance sheet assets, calculated based on the risk weights, ranging from 0% to 1,250%, assigned to various asset classes. There is a tiered risk-weight framework for high concentrations of residential real estate loans and commercial loans, such that as the complex credit union's concentration in these asset classes increases, incrementally higher levels of capital are required. The risk-weighted framework is not designed to limit lending activity, but rather requires the credit union to hold additional capital to account for elevated concentration risk.

For complex credit unions (both with and without low-income designations), the outstanding principal amount of the subordinated debt would be included in the risk-based capital ratio numerator in calculating their Risk-Based Capital Ratio. Similarly, for complex credit unions with low-income designations, their outstanding grandfathered secondary capital would also be included in the risk-based capital ratio numerator in calculating their Risk-Based Capital Ratio.

Prompt Corrective Action Framework. Effective January 1, 2022, the NCUA's prompt corrective action framework will be restructured to incorporate the Risk-Based Capital Ratio. Specifically, the following Risk-Based Capital Ratios levels (along with existing Net Worth Ratio levels) will be established for determining which NCUA prompt corrective action category would apply:

NCUA Capital Category	Net Worth Ratio	Risk-Based Capital Ratio(1)
Well Capitalized	7% or greater	10% or greater
Adequately Capitalized	6% or greater	8% or greater
Undercapitalized	4% or greater	Less than 8%
Significantly Undercapitalized	2% or greater (2)	n/a
Critically Undercapitalized	Less than 2%	n/a

(1) As described above, the Risk-Based Capital Ratio levels under the NCUA's prompt corrective action framework only applies to "complex credit unions" (i.e., >$500 million in assets). For all other credit unions, only the Net Worth Ratio levels would determine which prompt corrective action category would apply.

(2) Or less than a 5% Net Worth Ratio and (a) fails to timely submit, (b) fails to materially implement, or (c) receives notice of the rejection of a net worth restoration plan.

Discounting the Amount of Subordinated Debt Treated as Regulatory Capital. Once the remaining maturity of the subordinated debt is less than five years, the amount of subordinated debt that is treated as regulatory capital (i.e., included in the numerators of the issuing credit union's Net Worth Ratio and Risk-Based Capital Ratio, as applicable) would decline by 20% per year, as required by the following schedule:

Remaining Maturity of the Subordinated Debt	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%

What are the requirements and restrictions of the subordinated debt instrument?

Because credit unions do not have legal authority to issue equity instruments, the Final Rule imposes specific requirements and restrictions (including negative and default covenants), which would be reflected

in the note purchase agreement and promissory note evidencing the subordinated debt, to ensure that the subordinated debt is clearly issued as debt rather than equity, receives favorable regulatory capital treatment and acts as a buffer to protect depositors, as well as the NCUSIF. These specific requirements and restrictions also modify the current secondary capital rules, as described below.

General Requirements. The subordinated debt must satisfy the following general requirements: (1) be in the form of a written agreement (such as the note purchase agreement and promissory note); (2) have, at the time of issuance, a fixed stated maturity of at least five years but no more than 20 years (the current secondary capital rules require that a secondary capital account has a minimum maturity of five years, but does not have a maximum); (3) be subordinate to all other claims in a liquidation and have the same payout priority as all other subordinated debt, including grandfathered secondary capital, issued by the credit union; (4) be properly characterized as debt in accordance with U.S. GAAP; (5) be unsecured (this is not required by the current secondary capital rules); (6) except for prepayments approved by the NCUA, be repaid in full only at maturity; and (7) disclose any prepayment penalties or restrictions on prepayment (this not required by the current secondary capital rules).

The issuing credit union must also utilize 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. Although this requirement is reflected in the current secondary capital rules, the Final Rule specifically sets forth the frequency and timing of applying the subordinated debt to the issuing credit union's losses, which provides more transparency for investors.

General Restrictions. The subordinated debt must not: (1) be insured by the NCUA; (2) include any express or implied terms that that make it senior to any other subordinated debt or grandfathered secondary capital; (3) cause the issuing credit to exceed any applicable NCUA or state borrowing limits; (4) provide any investor with any management or voting rights in the issuing credit union; (5) be pledged by an investor as security for a loan to the issuing credit union; (6) include any term or condition that would require an issuing credit union to prepay or accelerate the payment of principal or interest or trigger an event of default based on its default on other debts; (7) include any condition, restriction or requirement based on the issuing credit union's credit quality; or (8) require the issuing credit union to make any form of payment with respect to the subordinated debt other than cash.

The issuing credit union is also prohibited from establishing a sinking fund (i.e., a fund formed by periodically setting aside money for the gradual repayment of the subordinated debt) or a compensating balance or any other funds or assets subject to a legal right of offset, as defined by applicable state law. These security arrangements could, in violation of the Final Rule, cause the subordinated debt to become senior in the right of payment to other creditors, thus limiting the issuing credit union from utilizing the proceeds of the subordinated debt to absorb losses and protect the NCUSIF.

Negative Covenants. Neither the note purchase agreement nor the promissory note evidencing the subordinated debt may include any provision or covenant that restricts or limits the authority of the issuing credit union or interfere with the NCUA's supervision of a credit union. Specifically, the note purchase agreement or promissory note may not: (1) contain covenants requiring 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 restrict the issuing credit union's ability to raise capital through the issuance of additional subordinated debt; (3) provide for default of the subordinated debt as a result of the issuing credit union's compliance with any regulation or supervisory directive from the NCUA or, if applicable, the state supervisory authority; or (4) provide for default of the subordinated debt due to any changes in management, organizational structure or charter of the issuing credit union, or as a result of an act or omission of any third party, including a credit union service organization.

Cure Period for Event of Default. The note purchase agreement and/or promissory note must provide the issuing credit union with a reasonable cure period of not less than 30 days in the event of default of any provision of the subordinated debt.

Must a federally insured state-chartered credit unions comply with the Final Rule with respect to issuing subordinated debt?

A federally insured state-chartered credit union's legal authority to issue subordinated debt is derived from state law and regulation and, thus, must confirm that such an issuance is permitted thereunder. However, subordinated debt issued by federally insured state-chartered credit union must comply with the requirements and restrictions of the Final Rule to receive favorable regulatory capital treatment by the NCUA. This ensures that federally insured stated-chartered credit unions are subject to the same subordinated debt framework as federal credit unions.

Who can be an eligible investor in subordinated debt issued by a credit union?

Subordinated debt may only be issued by an issuing credit union to entities or natural persons (which may be members or non-members) that are "accredited investors" as defined in Rule 501(a) of Regulation D under the Securities Act of 1933, as amended, with respect to the SEC's exempt offering framework, whereby an offer or sale of a security (such as subordinated debt) is not required to be registered with the SEC.

An "accredited investor" refers to investors who are financially sophisticated, able to assess the risks of an investment and have a reduced need for protections that come from a registered public offering of securities. Accredited investor status is determined based on certain factors, such as income, net worth or professional experience for qualifying natural persons and asset size and entity type for eligible entities. The Final Rule distinguishes between "natural person accredited investors" and "entity accredited investors," which is relevant with respect to certain requirements of the Final Rule, including minimum denomination requirements (noted below), the offering document approval processes and resale provisions. Common accredited investors include high net worth individuals, banks, insurance companies, broker dealers and trusts. Although not specifically identified as an accredited investor under Regulation D, the SEC has issued interpretative guidance clarifying that credit unions whose accounts are insured by the NCUA are considered "accredited investors."

Regardless of accredited investor status, subordinated debt may <u>not</u> be issued by an issuing credit union to any of its board members or senior executive officers, including any immediate family members of such board members or senior executive officers.

Minimum Denominations for Natural Person Accredited Investors. To ensure that natural person accredited investors are financially sophisticated and have substantial net worth, subordinated debt sold or issued to a natural person accredited investor must be made in denominations of at least $100,000. In addition, natural person accredited investors cannot exchange such subordinated debt for newly-issued subordinated debt of the issuing credit union in denominations of less than $10,000. There are, however, no minimum denomination requirements for subordinated debt sold or issued to an entity accredited investor, as the NCUA believes that having a large minimum denomination for entity accredited investors is not necessary.

What are the required disclosures that must be made to accredited investors related to the subordinated debt?

Contrary to federal securities laws and related SEC rules, which do not mandate a particular level of disclosure to potential investors that are offered securities pursuant to the SEC's exempt offering framework, the Final Rule requires issuing credit unions to deliver offering document(s) to potential accredited investors of the subordinated debt and provide specific disclosures in the offering document(s) and the subordinated debt promissory note. Although an exempt offering for federal securities law purposes, any disclosures related to the subordinated debt made by an issuing credit union to an accredited investor remains subject to federal and state anti-fraud rules applicable to offers and sales of securities.

Disclosures in the Offering Documents. Each purchaser of subordinated debt must receive offering document(s) that satisfy the minimum disclosure requirements of the Final Rule. Offering documents would include any term sheet, offering memorandum, private placement memorandum, offering circular or any other similar document used to offer and sell subordinated debt by an issuing credit union. The required disclosures require basic information about the issuing credit union, the subordinated debt instrument, and any placement agent. A placement agent is an agent (such as an investment banker) hired to connect the issuing credit union to potential accredited investors of the subordinated debt. A placement agent may also provide other services related to the offering, such as providing advice about the financial implications of the offering, including ongoing debt servicing requirements, preparing marketing materials and establishing a virtual data room to facilitate due diligence of the issuing credit union.

The offering documents must also include a risk factors section that describes the material risks associated with purchasing subordinated debt. These risk factors must be tailored to address any distinctive characteristics of the issuing credit union's business, field of membership or geographic location that are likely to have a material impact on the issuing credit union's future financial performance. Further, the offering documents must disclose the particular provisions of the subordinated being offered and sold, including: (1) the principal amount, interest rate, payment terms, maturity date and any provisions relating to prepayment of the subordinated debt; (2) all material covenants that govern the subordinated debt; (3) any legends required by applicable state law; (4) that securities regulators, including the SEC, have not approved the offering or any of the terms of, or disclosures related to, the subordinated debt; and (5) that the subordinated debt to be issued has not been registered with the SEC under the Securities Act and that it will be issued pursuant to exemptions from those requirements.

Finally, the offering documents must contain disclosures that cover the same items that are required to be disclosed in the subordinated promissory note as described below.

Disclosures in the Subordinated Debt Promissory Note. Specific disclosure legends set forth in the Final Rule must be displayed on the face of the subordinated debt promissory note. Several of these legends identify specific restrictions associated with investing in subordinated debt of an issuing credit union, including: (1) the subordinated debt holder being prohibited from using the note as collateral for a loan from the issuing credit union; (2) the possibility that principal amount of the note may be reduced to cover any deficit in retained earnings of the issuing credit union; (3) the prohibition of redemption or prepayment of the outstanding principal balance of the subordinated debt prior to maturity, except in limited circumstances; and (4) the subordinated debt being prohibited from being sold or resold to members of the issuing credit union's board, senior executive officers and/or immediate family members of board members or senior officers. Other legends must be displayed on the face of the subordinated debt promissory note to inform investors of the risks associated with investing in subordinated debt, such as that the subordinated debt is not insured by the NCUA, not registered with the SEC and is not a liquid investment supported by an active secondary trading market.

There are also other disclosures that must be disclosed in the body of the subordinated debt promissory note that are intended to specify the consequences if the issuing credit union is subject to an involuntary termination or is undercapitalized or critically undercapitalized pursuant to the NCUA's prompt corrective action framework.

Lastly, the issuing credit union must disclose the risks associated with the NCUA's or applicable state regulator's authority to conserve or liquidate an issuing credit union under federal or state law.

What is the required regulatory framework regarding the offering process for issuing subordinated debt?

In addition to the required disclosures be provided to potential accredited investors of the subordinated debt, the Final Rule provides a regulatory framework for the offering process of issuing subordinated debt. Its key components are as follows:

- ***Offering Document.*** An issuing credit union must deliver offering document(s) to each purchaser of subordinated debt that satisfies the minimum disclosure requirements above and provides any additional information necessary to provide potential investors with material information relevant to investing in subordinated debt.

- ***Territorial Limitations.*** Subordinated debt may only be issued or sold in the United States.

- ***Verification of Accredited Investors.*** As described above, an issuing credit union may only offer and sell subordinated debt to accredited investors, excluding the issuing credit union's senior executive officers, directors and their immediate family. Prior to any offering, the issuing credit union must verify the accredited investor status of potential purchasers, which would require obtaining a written certification of accredited investor status from each potential purchaser, and verifying the potential purchaser's accredited investor status by reviewing specific financial information or by receiving a certification of potential purchaser's status as an accredited investor from a broker-dealer, investment advisor, attorney or certified public accountant.

- ***Use of Trustees.*** An issuing credit union is not required to engage a trustee in connection with the subordinated debt offering. However, if a trustee is engaged, the trustee must meet the qualification requirements of the Trust Indenture Act of 1939, as amended (the "Trust Indenture Act").

  The Trust Indenture Act requires all SEC-registered debt securities offerings, such as subordinated debt, to be issued pursuant to a formal agreement, or indenture, between the debt issuer and a "qualified trustee" that satisfies the requirements of the Trust Indenture Act. A "qualified trustee" is an institutional trustee that: (1) is a corporation doing business under the laws of the United States or a corporation or other person permitted to act as trustee by the SEC; and (2) at all times has capital and surplus of at least $150,000. Pursuant to the indenture, the qualified trustee is required to protect and enforce the rights, and represent the interests, of investors. Debt securities offerings not registered with the SEC are generally exempt from the Trust Indenture Act and, thus, the appointment of a qualified trustee is not required.

  Because the subordinated debt offering of an issuing credit union will not be registered with the SEC and will qualify for exemption from the Trust Indenture Act, it will likely not be necessary or practical for an issuing credit union to appoint a qualified trustee. However, a paying agent is commonly used in non-registered subordinated debt offerings to perform administrative functions,

such as acting as an agent to the issuer in making interest and principal payments to the subordinated debt holders.

- ***Sales Practices.*** Consistent with the general industry norms for the sale of securities, the Final Rule prohibits or places certain restrictions on certain sales practices related to the subordinated debt issuance. Particularly, the issuing credit union is prohibited from paying commissions or bonuses to any of its employees (or employees of a CUSO) who assist in the marketing and sale of the subordinated debt. This restriction does not apply to payments made to registered broker-dealers who may be engaged as placement agents. Further, no offers or sales of the subordinated debt may be made by tellers (or comparable persons) at the teller counters of the issuing credit union. Marketing activities may only be undertaken by full-time employees of the issuing credit union and/or securities personnel who are subject to supervision by a registered broker-dealer.

- ***Securities laws.*** All sales and resales of the subordinated debt must comply with all applicable federal and state securities laws.

What is the NCUA's required pre-approval process for issuing subordinated debt?

Initial Application. Eligible credit unions must apply and receive written pre-approval from the NCUA before issuing subordinated debt. The initial application must provide or address the following:

- ***Eligibility and Applicable Law.*** The credit union must demonstrate how it satisfies the eligibility requirements to issue subordinated debt under the Final Rule, as described above, and disclose any investments it has in the subordinated debt of any other credit union. The credit union must also identify the applicable federal and state law and the legal documents pursuant to which the subordinated debt will be issued.

- ***Principal Amount of the Subordinated Debt and Accredited Investor Information.*** The credit union must provide the maximum principal amount of the subordinated debt issuance that may be issued during the allowable period (as described below) and the estimated number of accredited investors, including their classification (i.e., natural person and/or entity), to whom the subordinated debt will be offered.

- ***Outstanding Grandfathered Secondary Capital or Subordinated Debt.*** So that the NCUA can evaluate the credit union's prior experience with subordinated debt instruments, the credit union must disclose the amount, if any, of its outstanding subordinated debt and/or grandfathered secondary capital previously issued.

- ***Business Plan.*** A copy of the credit union's strategic/business plan must be included, along with an explanation (if necessary) of how its strategic/business plan will need to be updated if the application to issue subordinated debt is approved. The NCUA expects the credit union to have a clear business objective for offering subordinated debt and the necessary expertise to safely manage the planned use of the subordinated debt.

- ***Analysis of Ability to Repay the Subordinated Debt.*** An analysis of how the credit union will provide liquidity to repay the subordinated debt to accredited investors upon maturity is required. In the analysis, the credit union must also reasonably estimate its liquidity needs and changes in its liquidity positions over a multi-year period, which must include reasonable and supportable projections of its future liquidity positions and earnings using both optimistic and pessimistic

assumptions (such as asset quality deterioration and changes in interest rates) that are aligned with the credit union's expected activities.

- ***Pro Forma Financial Statements.*** Pro forma financial statements (i.e., balance sheet, income statement and statement of cash flows and any off-balance sheet items) covering at least two years must be provided by the credit union. The financial statements must also include: (1) the impact of the subordinated debt on the credit union's earnings, net worth and expenses; and (2) analytical support for the assumptions used in preparing the pro forma financial statements, such as expected earnings, net worth, interest rate, liquidity, and credit loss assumptions under reasonable scenarios.

- ***Use of Proceeds.*** A credit union must disclose how it will use the proceeds from the subordinated debt issuance, such as using the subordinated debt to restore its regulatory capital to a desired level due to unexpected losses or asset growth that outpaced its ability to enhance its net worth through retained earnings to support future growth initiatives (organically or through acquisitions) or to comply with the member business lending limit.

- ***Subordinated Debt Policy.*** A draft written policy governing the subordinated debt offering must be adopted by the credit union and submitted as part of the application. The NCUA expects that the policy will be developed in consultation with qualified legal counsel with expertise in subordinated debt securities offerings. The policy must address: (1) compliance with federal and state securities laws; (2) the use of investment advisors in assisting with the marketing and issuing of subordinated debt; and (3) investor relations matters, such as on-going disclosures about the financial information of the credit union and interactions with investors. For example, the personnel who will be responsible for answering questions and having discussions with investors.

- ***Schedule of Fees and Expenses.*** The application must include a schedule of all estimated expenses to be incurred by the credit union in connection with the subordinated debt offering, such as fees and expenses of legal counsel, auditors, investment bankers, any trustee or paying agent, and printing expenses.

NCUA's Decision on the Initial Application. The NCUA's review time of the initial application is 60 days after its receipt. Thereafter the NCUA will provide a written determination of approval, denial, or conditional approval. Examples of conditional approval include approving a subordinated debt amount that is lower than the principal amount requested by the credit union or requiring that a minimum level of net worth that must be maintained by the credit union while the subordinated debt is outstanding.

In considering whether to approve the initial application, the NCUA will evaluate the credit union's compliance with the requirements of the Final Rule, ability to manage and safely issue subordinated debt, and financial condition and risk management practices.

For federally insured state-chartered credit unions, the NCUA will not approve the initial application until concurrence of the credit union's state regulator is obtained.

Offering Document Distribution. Following NCUA pre-approval of the initial application, the issuing credit union may proceed with the subordinated debt offering so long as the credit union has provided, at a reasonable time in advance of the issuance, offering documents to each potential accredited investor that contain the required disclosures described above. If the credit union intends to offer the subordinated debt solely to entity accredited investors, the offering documents do not need NCUA pre-approval prior to their distribution; however, they must be filed with the NCUA within two business days after their first use.

Conversely, if potential accredited investors will include one or more natural persons, the offering documents may only be distributed after they are approved for use by the NCUA.

Notification of Subordinated Debt Issuance. Within 10 business days following the closing of the subordinated debt offering, the issuing credit union must submit all documents related to the offering to the NCUA, which would include: (1) a copy of each executed note purchase agreement and subordinated debt promissory note with accredited investors; (2) any indenture or paying agent agreement; (3) copies of signed accredited investor certificates; and (4) copies of any marketing materials and other documents provided to accredited investors.

When does the credit union's authority to issue subordinated debt expire after NCUA pre-approval?

NCUA pre-approval to issue subordinated debt will expire two years from the later of the date on which the issuing credit union receives: (1) NCUA approval of its initial application if the potential investors are exclusively entity accredited investors; or (2) NCUA approval of the offering documents if the potential investors include at least one natural person accredited investor (the "applicable period").

At least 30 days prior to the expiration of the applicable period, the issuing credit union may request an extension of the applicable period so long as good cause is demonstrated and the extension will not present any material securities law implications.

Are there any additional restrictions with respect to interest payments on subordinated debt?

An issuing credit union is prohibited from paying interest on any issued subordinated debt if it is critically undercapitalized. If the issuing credit union's net worth category is more favorable than "critically undercapitalized," the NCUA will generally not impose any suspension of interest payments so long as certain qualifying criteria is satisfied, such as the subordinated debt was issued to accredited investors in an arms-length transaction, in the ordinary course of business, and for adequate consideration.

Is pre-approval from the NCUA necessary to prepay the subordinated debt?

An issuing credit union is permitted to prepay any portion of the subordinated debt prior to maturity so long as (1) the right to prepay is clearly disclosed to accredited investors in the subordinated debt promissory note; and (2) approval to prepay is obtained from the NCUA (and any applicable state regulator).

To obtain approval to prepay, the issuing credit union must submit an application to the NCUA that includes the subordinated debt promissory note (and any other agreements reflecting the terms and conditions of prepaying), and demonstrate that, after prepayment, the credit union will have sufficient capital commensurate with its risk profile. The NCUA will have a 45-day period to review and respond to the prepayment request.

What is the effect of a merger or liquidation of the issuing credit union on the treatment of the subordinated debt?

Effect of a Merger. If the issuing credit union merges with another credit union, the resulting credit union may assume the subordinated debt and the subordinated debt will continue to receive favorable regulatory capital treatment so long as the resulting credit union is either a low-income designated credit union, complex credit union or new credit union. However, if the resulting credit union is not a low-income designated credit union, complex credit union or new credit union, the resulting credit union may still assume the subordinated debt following the merger, but the subordinated debt will not receive favorable regulatory capital treatment until the resulting credit union becomes one of the aforementioned types of credit unions.

Effect of a Voluntary Liquidation. In the event of a voluntary liquidation of an issuing credit union, the outstanding subordinated debt may be repaid in full, subject to NCUA approval as described above with respect to prepayments.

Conclusion

In addition to increasing regulatory capital, subordinated debt is an attractive capital raising tool for credit unions outside of retained earnings for growth and balance sheet management purposes. Given the novelty of a subordinated debt offering, including the NCUA's pre-approval process, credit unions considering raising capital through a subordinated debt issuance should work with legal and financial advisors that have a strong understanding of the offering process, as well as its legal and regulatory framework. Understanding the unique processes and issues involved and using that understanding to conduct advance planning is critical to executing a successful subordinated debt issuance and ensuring it is done in accordance with applicable federal and state securities laws.

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About Luse Gorman, PC

Luse Gorman, PC is a Washington, DC-based law firm that specializes in representing credit unions, cooperative and mutual savings institutions, publicly-held and privately-held financial institutions in mergers and acquisitions, acquisitions and sales of branches and fee-based businesses, capital raising transactions and securities offerings, regulatory and enforcement matters before the federal and state regulatory banking agencies, including the National Credit Union Administration, the Federal Deposit Insurance Corporation, the Federal Reserve Board, the Securities and Exchange Commission ("SEC") and state securities, credit union and banking departments, and employee benefits and executive compensation matters. With 21 attorneys, including 18 partners, focused exclusively on financial institution matters, Luse Gorman, PC is one of the largest financial institution legal practices in the United States. Our attorneys have served at many of the federal banking agencies, as well as the SEC.

Luse Gorman, PC is the leading law firm nationally with respect to mergers and acquisition transactions involving financial institutions, as we have been the number one ranked law firm in total number of transactions for the last six consecutive years and have completed over 100 merger and acquisition transactions during such time frame. We have also acted as legal counsel on the first acquisition of a stock bank by a credit union through a purchase and assumption transaction in a landmark acquisition, which has created new expansion opportunities for credit unions and a broader range of acquirers for banks.

Luse Gorman, PC is also one of the leading law firms nationally with respect public and private securities offerings for financial institutions, including subordinated debt securities offerings. We routinely deal with complex issues arising under the registration and exemptive provisions of the Securities Act of 1933 and related to applicable disclosure requirements under federal and state securities laws.

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