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# Certificate of Deposit Programs and Brokered Deposits

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# Part I: Certificate of Deposit Programs

# Types of CDs

- “Plain vanilla”
  - Fixed rate, floating rate
  - Akin to a traditional CD, but held through a brokerage account
- Structured or market-linked CDs, referencing the performance of an underlying asset
- “Lightly structured”
  - Fixed to floating rate CDs and step up callables

# Structured CDs

- Reference assets that are similar to those referenced in registered structured notes: indices, ETFs, single stocks, currencies, interest rates
- Possible to link to a broader range of assets, since the SEC's "Morgan Stanley" letter doesn't apply to certificates of deposit
  - Small cap stocks
  - Non-U.S. stocks that are not registered in the U.S.
  - Credit-linked instruments
- Investor suitability still needs to be considered
- Interest bearing or non-interest bearing
- Fixed, floating or indexed interest payments

# Structured CDs *(cont'd)*

- Callable versus non-callable
- Participation rate – greater than, equal to, or less than, any increase in the underlying asset
- Survivor's option: upon death (or incompetency) of investor, estate can obtain deposit amount prior to maturity
  - Feature is associated with some structured notes
  - Typically subject to aggregate limits in the course of a year
- Key difference from structured notes: may not pay less than principal at maturity. So, no non-principal protected market-linked CDs. Otherwise, the FDIC would take the position that these were not “deposits”, and not subject to FDIC insurance
  - But may be sold for less than principal if sold prior to maturity
  - “Principal protection” applies only at maturity

# Securities law considerations

- “Certificates of deposit” are included in the 1933 Act’s definition of a “security”
- However, under relevant case law (*Marine v Weaver*), FDIC insured CDs are typically not treated as a “security”
  - Guaranteed payment of principal
  - Other regulatory protections provided to holders under applicable banking laws
  - Similar concept of exemption from OCC registration for national banks
- When is a certificate of deposit a security?
  - See “Gary Plastics,”
  - Bad facts:
    - Broker marketed CDs that it had obtained from other banks
    - Broker promised to maintain a secondary market in order to guarantee liquidity
    - Broker represented to investors that it had reviewed the financial soundness of the issuing banks.

# Securities law considerations (*cont'd*)

- Today's structured CD offering documents are drafted with these concerns in mind.
- Given that CDs generally are not considered "securities," the state blue sky laws would not apply to CDs
- However, even if the CDs were thought to be considered securities, the blue sky laws would exempt them as "covered securities"
  - Covered securities include securities that are issued or guaranteed by a bank, such as securities exempt under Section 3(a)(2) of the 1933 Act

# FDIC Deposit Insurance

- Current limit is \$250,000 per depositor, per ownership category
  - Must be a deposit issued by an insured bank
- Application may vary, depending upon type of investment account
  - Guidance is available to the public on the FDIC's website
- Not all payments are guaranteed:
  - Principal and accrued interest payments are covered by FDIC insurance
  - The FDIC has taken the position that contingent payments at maturity and any indexed interest payments are not insured until determined
    - Impact: if bank fails before a "determination date," that payment will not be covered by FDIC insurance
  - FDIC insurance *will not* cover any amount paid in excess of principal, such as the payment of a premium in a secondary market transaction
    - *E.g.*, investor pays \$1,001 for a CD with a face amount of \$1,000. That additional dollar is not insured
  - FDIC insurance *will* cover the accrued portion of original issued discount
    - *E.g.*, investor pays \$900 for a CD with a face amount of \$1,000. The accrued portion of the \$100 discount is insured



# FDIC Insurance and Recordkeeping

- FDIC determines deposit insurance coverage based on the deposit account records of the bank
  - Deposit account records for CDs may not disclose the name of the beneficial owner because they are held through intermediaries (*e.g.*, DTCC, broker-dealer)
  - To pass-through deposit insurance to the owner, FDIC rules generally require bank to title the account in a manner that discloses the existence of the intermediary relationship. Can be highly prescriptive
  - Banks do not need to retain beneficial ownership information for negotiable CDs
    - But, owner must prove to the FDIC that they acquired the CD prior to the bank's failure
  - Beneficial owner's interest in a CD will be combined with any other accounts they hold at the bank when calculating coverage limit (*i.e.*, \$250,000 limit)

# FDIC Insurance and Recordkeeping *(cont'd)*

- For larger banks, FDIC has detailed rules relating to account identification, in order to determine who is entitled to FDIC insurance payments, if needed (12 C.F.R. § 360.9)
  - In the case of brokered deposits, the broker is usually obligated by contract to maintain this information
- For the largest banks (those 2 million or more deposit accounts), there are even more detailed rules regarding recordkeeping (12 C.F.R. pt. 370)
  - Recordkeeping requirements intended to facilitate prompt payment of FDIC – insured deposits if a bank fails
  - The rules require the banks to maintain complete data on each depositor’s ownership interest by right and capacity for all of its deposit accounts

# FDIC Insurance and Recordkeeping *(cont'd)*

- Under the Part 370 rules, a bank should:
  - Collect the information needed to allow the FDIC to determine promptly the deposit insurance coverage for each owner of funds on deposit at the covered institutions; and
  - Ensure that its IT system is capable of calculating the deposit insurance available to each owner of funds on deposit in accordance with the FDIC's deposit insurance rules
- A covered institution could use alternative recordkeeping requirements that:
  - Provide a unique identifier for the account holder of each such account
  - A pending reason code would indicate to the FDIC that additional information would be needed to complete the deposit insurance calculation
- None of these rules require the bank to possess the name of the beneficial owner prior to failure

# Truth-in-Savings Act

- CFPB Regulation DD implements the Truth-in-Savings Act
- Provisions are applicable to the issuing banks, as well as to deposit brokers
- Banks may not advertise deposits in any way that is inaccurate or misleading, and the regulation provides examples
- Required disclosure of “annual percentage yield,” “penalty fees” that may be imposed for early withdrawals, and any other fees
- In addition, the Federal Trade Commission Act prohibits unfair or deceptive acts or practices
  - Applies to all aspects of a depository institution’s consumer products and services, including advertisements
  - Enforced against depository institutions by the banking regulators

# “Yankee CDs”

- Typically do not have the benefit of FDIC insurance, but are designed to have the preferences for deposits that apply under applicable banking laws
  - Are they securities? Answer depends upon, in part, the terms of the instrument and how they are marketed
    - OCC stated in 1994 that it did not intend for the definition of security to cover deposits or other traditional bank products
    - Are the CDs transferable?
    - How does the issuer record them on its own books and records? As a deposit?
  - However, even if they are securities, an exemption from SEC registration (and OCC registration) can typically be found
    - Federal branches: Part 16.6 – non-convertible debt securities
  - Typically offered in large denominations, in transactions that are privately negotiated with sophisticated investors
  - Consider appropriate level of disclosures about the issuer, the instrument, and the relevant risk factors

# FINRA

- Because structured CDs are (usually) not “securities,” a variety of FINRA rules do not technically apply
  - *e.g.*, Corporate Financing Rule
  - Most broker-dealers apply a comparable degree of compliance procedures to these instruments as they do in the case of securities
- Key areas of FINRA regulation implicated by structured CDs:
  - Retail communication – accuracy and completeness
  - FINRA has made substantive comments to broker-dealer marketing materials for these instruments
- Training
- New product approvals

# Third party distribution and KYD

- Many structured CDs are distributed through third party distributors
- Often subject to a dealer agreement between (a) the dealer that is in privity with the bank and (b) downstream distributors
  - A separate form of agreement is typically needed that differs from the type used for securities
    - Different regulatory regime
    - FDIC record-keeping requirements
    - Covenant that distributor will sell certificates of deposit only to retail (individual) investors
    - All communications about the CDs will be delivered to holders
    - Acknowledges that holders may enforce their rights directly against bank
  - Concern that “bad acts” by downstream distributor could result in liability or reputational risk for issuer or primary distributor
    - Agreements are filled with negotiated representations and warranties, covenants and indemnification, usually for the benefit of the primary distributor

# Third party distribution and KYD (*cont'd*)

- To date, FINRA's proceedings with respect to structured products have generally imposed liability on the responsible entity
- FINRA's 2013 Report re: Conflicts of Interest
  - Recommends know-your-dealer diligence procedures



# Disclosure documents for CDs

- No specific form requirements. (In contrast, registered securities are subject to the form requirements of S-3/F-3 and Regulation S-K)
- Truth-in-Savings Act, FINRA communication rules, and “best practices” require full and accurate disclosure
- Usually a disclosure statement
  - The CD disclosure statement will contain general disclosure regarding the bank and the features of the CDs
- Estimated Initial Value Disclosures:
  - CDs are not subject to the 2012 SEC “sweep letter”
  - However, many regard it as a good disclosure, and many distributors request its disclosure

# Disclosure documents for CDs (*cont'd*)

- The SEC has published guidance on some disclosure issues related to CDs on its site (see, “Equity-Linked CDs” at <https://www.sec.gov/fast-answers/answersequitylinkedcdshtm.html>)

# Additional documentation for CD programs

- Program or similar agreement with distributors
  - Similar in some respects to agreements used for registered notes, but tailored for the bank regulatory structure
- If applicable, paying agency agreement with third party paying agent although the bank may be its own paying agent
- Forms of master certificates representing the CDs
- DTC Letter of Representations, with CD rider (each CD is still an individual obligation of the bank)
- Agreements with hedging counterparties

# Part II: Brokered Deposits

# Brokered deposits

- Following the savings and loan crisis, in 1989, Congress enacted Section 29 of the Federal Deposit Insurance Act relating to brokered deposits
- The action was premised on a belief by the banking agencies that brokered deposits are risky
  - Brokered deposits are not “sticky,” and are “hot money”
  - Deposits will get pulled or will not be rolled at maturity if another bank offers better rates
  - Reliance on brokered deposits and other similar funding would prompt concerns in a downturn
  - Retail deposits thought to be “stickier”

# Brokered deposits (cont'd)

- Because of this perception of brokered deposits, historically there have been some constraints on brokered deposits
  - FDIC 337.6 restricts the use of brokered deposits and limits rates paid on interest-bearing deposits that are solicited by banks that are less than “well capitalized”
  - If an institution is less than well capitalized, it must seek a waiver to accept new brokered deposits
  - Some banks may be subject to limits on the rates
  - The amount of brokered deposits can affect a bank’s deposit insurance assessment rate by affecting components of the rate:
    - For a large or complex institution, it would affect the core deposits ratio
    - For a small institution that has experienced a more than 40% growth in assets over the past four years

# Brokered deposits (cont'd)

- For any institution that is either not well capitalized or that has a composite CAMELS rating below a 2, and that has a ratio of brokered deposits to domestic deposits greater than 10%, subjecting the institution to an additional brokered deposit adjustment
- For banks subject to the liquidity coverage ratio, brokered deposits are treated more punitively
  - A bank subject to the LCR must maintain high quality liquid assets (HQLA) not less than 100% of its projected net cash outflows, over a hypothetical 30-day period
  - The outflow rate used in calculating the LCR depends on whether a deposit is considered retail or wholesale and then whether the deposit is brokered and if so whether it is a reciprocal brokered deposit, brokered sweep deposit or other type of brokered deposit

## Brokered deposits (*cont'd*)

- Brokered deposits that are not reciprocal brokered or brokered sweep deposits are assigned a 100% outflow rate if they have no maturity or mature within the LCR's 30-day window
- By contrast, reciprocal brokered and brokered sweep deposits are assigned outflow rates of 10%, 25% and 40%
- Retail deposits that are not brokered deposits are assigned outflow rates of 3% or 10%
- The Dodd-Frank Act directed the FDIC to conduct a study of core deposits and brokered deposits
  - The FDIC completed the study in 2011 and updated the statistics in 2017



# Brokered deposits (*cont'd*)

- The study found higher use of brokered deposits is associated with heightened probability of bank failure
- Banks with higher levels of brokered deposits are generally more costly to the Deposit Insurance Fund
- On average, brokered deposits are correlated with higher levels of asset growth and nonperforming loans
- Brokered deposits that have posed risk to the DIF are characterized by rapid growth, volatility and lower value to purchasers of failed banks

# Identifying a brokered deposit

- What is a brokered deposit?
  - Defined by reference to a *deposit broker*
  - Any deposit that is obtained, directly or indirectly, from or through the mediation or assistance of a deposit broker
  - Over time, the FDIC issued guidance that provides some interpretation regarding what constitutes a deposit broker, and, in turn, what constitutes a brokered deposit
  - The definitions were criticized as being too expansive, and quite fact-specific
  - In 2020, the FDIC revised its rules and guidance for brokered deposits

# Definition of deposit broker

- What is a deposit broker?
  - Section 29 of the FDI Act defines a deposit broker as “any person engaged in the business of placing deposits, or facilitating the placement of deposits, of third parties with insured depository institutions or the business of placing deposits with insured depository institutions for the purpose of selling interests in those deposits to third parties...”
  - There are nine exclusions from the definition, including:
    - An insured depository institution, with respect to funds placed with that depository institution;
    - An employee of an insured depository institution, with respect to funds placed with that depository institution
    - A trust department of an insured depository institution, if the trust in question has not been established for the primary purpose of placing funds with insured depository institutions

# Definition of deposit broker (*cont'd*)

- The trustee of a pension or other employee benefit plan, with respect to the funds of the plan;
  - A person acting as a plan administrator or an investment adviser in connection with a pension plan or other employee benefit plan provided that that person is performing managerial functions with respect to the plan
  - The trustee of a testamentary account
  - The trustee of an irrevocable trust as long as the trust in question has not been established for the primary purpose of placing funds with insured depository institutions
  - A trustee or custodian of a pension or profit sharing plan qualified under the Internal Revenue Code
  - An agent or nominee whose primary purpose is not the placement of funds with the depository institution
- Historically, the last exclusion was the focus of industry efforts for relief because “primary purpose” can have multiple interpretations

# 2020 Rulemaking

- Extensively interprets and narrows the definition of “deposit broker”
  - Four-prong definition that is effectively limited to situations in which a person (i) acts with respect to more than one depository institution and (ii) has a business relationship with the depositor on whose behalf the deposit is being placed
  - Facilitation of deposit placement is limited to circumstances in which the putative broker takes an active role in opening the account or maintains a level of influence or control over the account after it is open
- Expands the statutory primary purpose exception to explicitly be available to an agent or nominee that is engaged in one or more of 14 designated businesses
  - Largely tracks existing FDIC staff interpretations
  - Eligibility for the designated business exclusions is assessed on a business line basis
  - Some designated business exclusions require a person to notify the FDIC and provide quarterly reporting
  - FDIC expects depository institutions to have an awareness of whether persons are deposit brokers or qualify for an exception
    - Recent criticism of banks that did not consider whether third-party vendors were deposit brokers because a broker-dealer sweeping deposits qualified for an exception
  - Brokered CDs cannot qualify for an exception

# FDIC Advertising Requirements

- FDIC revised its advertising rules in 2022 to address misrepresentations regarding deposit insurance
  - Applies to banks and third-parties (e.g., broker-dealers selling CDs)
- Rules generally prohibit a person from making knowing misrepresentations about deposit insurance, including misrepresentations through material omission
- Material omissions includes a statement about deposit insurance if a person other than a bank represents or implies that an advertised product is insured or guaranteed by the FDIC and does not identify the banks with which the person has a direct or indirect business relationship for the placement of deposits and may place deposits

# FINRA and brokered certificates of deposit

- FINRA Notice to Members 2-69 sets forth issues applicable to FINRA members offering brokered CDs
- The NTM sets out the criteria to consider in assessing whether a brokered CD should be considered a security rather than a deposit
- Sets out training obligation for registered persons
- Discusses appropriate disclosures and sales practices
- Members should provide customers with written materials that describe the characteristics and risks of purchasing brokered CDs
- Suggests disclosures for account statements

# Additional Resources

- Read more:
  - [What's The Deal – Structured CDs](#)



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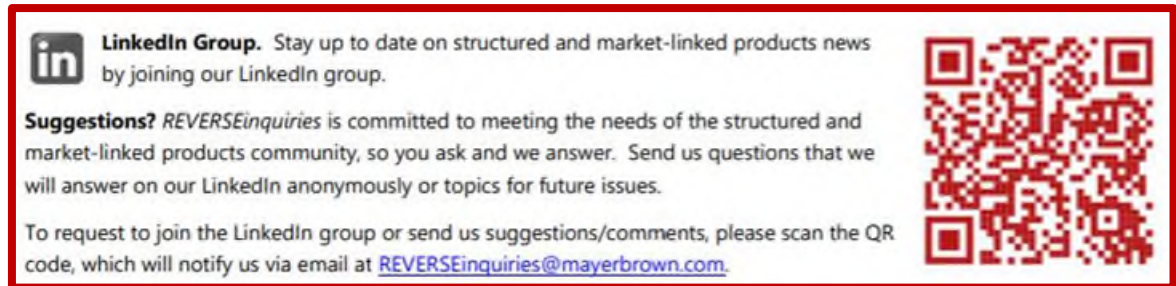
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