

Notice to Members

OCTOBER 2002

SUGGESTED ROUTING

Executive Representatives
Legal & Compliance
Trading
Operations
Senior Management

KEY TOPICS

Certificates of Deposit

INFORMATIONAL

Certificates of Deposit

Clarification of Member Obligations Regarding Brokered
Certificates of Deposit **Effective Date: October 8, 2002**

Executive Summary

NASD is issuing this *Notice* to supersede *NASD Notice to Members 02-28 (Notice or Notice 02-28)* and replace the guidance offered in *Notice to Members 02-28*, which addressed issues applicable to members offering “brokered” certificates of deposit (CDs). Accordingly, this *Notice* repeats pertinent information from *Notice to Members 02-28*. However, it also provides additional guidance not included in *Notice to Members 02-28*. First, the *Notice* gives a more detailed description of the characteristics of brokered CDs, the mechanics of the brokered CD market, and the circumstances in which brokered CDs may be considered securities. Second, the *Notice* harmonizes NASD’s disclosure and sales practice requirements with the New York Stock Exchange’s (NYSE’s) disclosure and sales practice obligations applicable to its members offering brokered CDs. Finally, the *Notice* recommends the appropriate pricing that members should use in reporting the value of brokered CDs on customers’ account statements and the appropriate disclosures that should appear in customers’ account statements.

Questions/Further Information

Members may direct questions about this *Notice* to Patricia Albrecht, Assistant General Counsel, Office of General Counsel, NASD Regulatory Policy and Oversight, at (202) 728-8206.

02-69

Characteristics of Brokered CD and Brokered CD Market

CDs that typically are issued by a bank directly to a customer carry a fixed interest rate over a fixed duration of time and are insured by the Federal Deposit Insurance Corporation (FDIC) up to \$100,000 against insolvency by the depository institution. As such, they are generally considered by the investing public to be simple, conservative products that carry few risks.

However, some members have been soliciting customers with “brokered” CDs. As explained below, brokered CDs may have a longer holding period until maturity date, be more complex, and carry more risk than “traditional” CDs. Brokered CDs are CDs issued by banks via a “master CD” to deposit brokers, which in turn sell interests in the master certificate to individual retail investors. Any broker/dealer that sells brokered CDs is a deposit broker.

The master CD is a negotiable instrument that represents a certain number of individual CDs, each with the same denomination. FDIC insurance attaches to the individual CDs represented in the master CD.¹ The master CDs are held by a deposit broker as a custodian or by a sub-custodian appointed by the deposit broker. Either the deposit broker or the sub-custodian keeps the records of its customers’ ownership interests in the CDs.²

In general, brokered CDs have longer maturity dates (in some cases, 20 years from the date of issuance), than traditional CDs. The interest rate terms of brokered CDs can also differ significantly from the simple interest rate terms usually used by traditional CDs. For example, some brokered CDs have their

interest rates tied to a market index, such as the S&P 500. Brokered CDs also may have special call features that allow the issuing bank to terminate the CD after a specified period of time if interest rates drop. In this respect, the CD is similar to a callable, fixed-rate bond. To compensate for these additional features, brokered CDs frequently pay a higher interest rate than traditional CDs.

Because issuing banks may impose penalties on investors for withdrawing their funds before the maturity date of the CD or may not allow withdrawal prior to the maturity date, some deposit brokers (usually broker/dealers) may maintain a limited secondary market for customers who have purchased brokered CDs by buying back the CDs to resell to other customers. The deposit brokers maintain these markets to create some liquidity for the investment. However, the market conditions do not always favor the customer. For instance, if interest rates are high and a customer wants to trade in a low interest brokered CD for another CD with a higher interest rate, the customer might have to realize a loss on the principal of the CD in order to sell the CD. In addition, deposit brokers are not obligated to maintain a secondary market for brokered CDs sold to customers.

Circumstances that May Make a Brokered CD a Security

Although brokered CDs may have certain features that traditional CDs do not have, it is important to remember that, as long as a banking institution issues the brokered CDs, sets all of their features, and FDIC insurance applies to them, brokered CDs are generally considered bank products, not securities. However, there are several circumstances under

which a brokered CD may be considered a security. For example, if a deposit broker materially alters the terms and features of a brokered CD (e.g., offering a different interest rate than the interest rate set by the issuing depository institution), the brokered CD is arguably a different investment vehicle that could be considered a security. Additionally, if a deposit broker buys for itself a large-denomination CD, fractionalizes it, and sells the fractions to investors, these actions could make the fractionalized CDs securities. Also, if a deposit broker affirmatively offers to customers certain expertise and skills that go beyond the sale of brokered CDs as incentives to purchase the brokered CDs, such as marketing and the ability to identify attractive CDs, these features may make the brokered CDs securities.³ As noted above, some deposit brokers maintain a limited secondary market for customers who have bought brokered CDs. If a deposit broker, as an incentive to purchase brokered CDs, offers and/or maintains a secondary market for customers to rely upon to provide additional liquidity to their brokered CDs, this feature may make brokered CDs securities.

Training

NASD expects registered persons to understand the characteristics and risk factors associated with all investment products, including each type of brokered CD offered by the member with which the registered persons are associated, before soliciting customers. NASD recommends that firms review their compliance programs, supervisory procedures, and continuing education offerings to ensure that registered persons are properly trained and educated about these products. Audits,

compliance meetings, and continuing education programs should include a discussion of these products.

Appropriate Disclosures and Sales Practices

The NYSE has also provided guidance on the appropriate disclosures and sales practices for members selling brokered CDs to customers.⁴ As noted above, this *Notice* serves in part to harmonize NASD's disclosure and sales practice requirements applicable to members offering brokered CDs with those of the NYSE. Accordingly, the *Notice* recommends amended disclosure and sales practice requirements in the following areas: (1) loss of principal; (2) secondary market; (3) call features; and (4) "step-rate" CDs. The following disclosures should be provided sufficiently in advance of the transaction date in any brokered CD in order to provide customers with meaningful notice of the terms, conditions, and risks in connection with such a transaction.

1. Loss of Principal

If a member buys a brokered CD from a customer prior to the CD's maturity date, the member should disclose to the customer that, if the customer chooses to sell the CD prior to the maturity date, the pre-maturity sales price of the brokered CD may be less than its original purchase price. This will be particularly true if interest rates have risen since the time of the original sale. Buyers, including members, will not generally be interested in buying a lower interest rate CD in the secondary market if they can purchase a higher rate CD in the primary market. In addition, a member should not use the term "no penalty for early withdrawal" unless the issuer guarantees redemption

of the full face value of the brokered CD in the event the owner decides to sell before the maturity date.

2. Secondary Market

Members should inform customers that the secondary market for brokered CDs may be limited. The following types of disclosures may be used to describe an organization's post-distribution intentions:

"Upon completion of the distribution, the firm may not make a market in this CD."

or

"Upon completion of the distribution the firm may, as an accommodation to customers, make a market in this CD."

or

"The firm, though not obligated to do so, may maintain a secondary market in this CD upon completion of the distribution."

3. Call Features

Brokered CDs may include a provision that allows the issuing bank or other depository institution to "call" or redeem the CD prior to maturity at a given price. Call features typically are exercised when a brokered CD is trading at a premium to its call price in the secondary market. The call option is solely at the discretion of the issuer. Members should inform customers that the brokered CD they are purchasing is callable at the sole discretion of the issuing depository institution and that if the CD is "called," investors seeking to reinvest their

redeemed funds will be subject to reinvestment risk because interest rates may have fallen since the time they first purchased the brokered CD. Also, in marketing callable brokered CDs, members should be careful not to predict the likelihood that the CDs will be called.

4. "Step Rate" CDs

Brokered CDs may also have "step-up" or "step-down" features. A "step-down" CD will pay an above-market interest rate for a defined period of time but will then "step-down" to a lower, predetermined rate that will be paid until maturity. Similarly, a "step-up" CD will generally pay a below market interest rate for a defined period of time and will "step-up" to a higher, predetermined rate that will be paid until maturity. Members should inform customers that the "step rate" on a brokered CD may be below or above then-prevailing market rates and that the CDs are also subject to secondary market risk and often will include a call provision by the issuing depository institution that would likewise subject them to reinvestment risk. Members should also remind customers that the initial rate cannot be used to calculate the yield to maturity.

Written Communications

Members should provide customers with written materials that describe the characteristics and risks of purchasing brokered CDs or prepare such material for distribution if not made available by the issuer. Any such written materials must also comply with Rule 2210 ("Communications With The Public").

Account Statements

NASD has observed that some members continue to price brokered CDs at par value on account statements. Carrying CDs at par value could be materially misleading if values have significantly eroded, and members are advised to diligently endeavor to price accurately the brokered CDs on customer account statements.

There is no single method to determine the market value of brokered CDs. Members can obtain estimated values from several sources, including commercial pricing services. Some members rely on their fixed-income trading desks to determine a market value, while others have developed computerized valuation models or matrices to ascertain a theoretical market price. NASD recommends that when disclosing in account statements the more accurate values of brokered CDs held by customers, members should also disclose to customers that the value of brokered CDs on account statements are estimated and that their actual value may differ if customers elect to sell their brokered CDs in the secondary market. In addition, NASD recommends that members disclose the pricing method used to determine the market value of the brokered CDs. If market value is not provided as described above, NASD recommends that brokered CDs be reflected on customer statements as unpriced.

The *Notice* also recommends including other disclosures on the account statement, covering the following points:

- (1) the secondary market for CDs is generally illiquid;
- (2) an accurate market value could not be determined by the member firm;
- (3) the actual value of the CDs may be different from their purchase price; and
- (4) a significant loss of principal could result if brokered CDs are sold prior to maturity. If the disclosure documents initially provided to customers purchasing brokered CDs provides information on these points, NASD does not believe that the disclosures, while preferable, need to appear in customers' account statements.

Endnotes

- 1 Federal deposit insurance generally covers deposits of up to \$100,000 in the aggregate for each depositor in each bank, thrift, or credit union. A customer should ensure that purchasing any insured CD will not bring his or her aggregate deposit over the \$100,000 FDIC insurance limit.
 - 2 For FDIC insurance protection to apply to the owner of the brokered CD, it is important that deposit brokers keep accurate records of the ownership interest in the brokered CD. However, the FDIC does not have to rely solely upon the records of the bank and/or the deposit broker to establish ownership. Under the FDIC's rules, if the brokered CDs are being held by a custodian, which is usually the case in sales by broker/dealers, the FDIC may also look to the records of a custodian to establish a relationship that permits deposit insurance to pass through the custodian to the purchaser. In addition, if the FDIC has reason to believe that the insured depository institution's deposit account records misrepresent the actual ownership of deposited funds and such misrepresentation would increase deposit insurance coverage, the FDIC may consider other available evidence of ownership and pay claims for insured deposits on the basis of the actual rather than the misrepresented ownership. See 12 C.F.R. § 330.5. Accordingly, firms should suggest to their customers that the customers keep records of their brokered CDs in the event the FDIC needs to look beyond the custodian's or deposit institution's records to establish ownership.
 - 3 See *Gary Plastic v. Merrill Lynch, Pierce, Fenner & Smith*, 756 F.2d 230 (2d Cir. 1985).
 - 4 See NYSE Information Memo No. 01-5 (March 7, 2001) and NYSE Information Memo No. 01-19 (July 20, 2001).
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