INFORMATIONAL

Certificates Of Deposit

Member Obligations Regarding Long-Term Or Brokered Certificates Of Deposit

SUGGESTED ROUTING

The Suggested Routing function is meant to aid the reader of this document. Each NASD member firm should consider the appropriate distribution in the context of its own organizational structure.

- Executive Representatives
- Legal & Compliance
- Trading
- Operations
- Senior Management

KEY TOPICS

- Long-Term or Brokered Certificates of Deposit

Executive Summary

Members increasingly have been offering to customers a number of non-traditional certificate of deposit (CD) products. Typically, these products are long-term CDs offered by "deposit brokers" that carry a maturity date of more than one year, are callable at the discretion of the issuer, and trade in a secondary market. In certain circumstances, these products are securities. Irrespective of whether a particular CD product is a security, members must ensure that their registered representatives are properly trained and informed about the products, and that customers receive adequate disclosure of risk factors. Members are advised to carry CD products at fair market value on customer account statements.

Questions/Further Information

Members may direct questions about this *Notice* to Philip Shaikun, Assistant General Counsel, Office of General Counsel, NASD Regulation, Inc., or Kosha Dalal, Assistant General Counsel, Office of General Counsel, NASD Regulation, Inc., at (202) 728-8071.

Background And Information

Traditional CDs 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 a simple and conservative product that carries few risks. Increasingly, members have been soliciting customers with more complex and risky products that are sometimes referred to as "long-term" CDs.[1] These CDs generally have a maturity of several years – in some cases, 20 years – and sometimes carry a higher yield. But they may also have any number of additional features that affect the rate of return and degree of risk for purchasers: for example, they may have variable interest rates, may be callable by the issuing bank, sometimes trade in a secondary market, and are subject to transaction costs not typically associated with a traditional CD. Importantly, these long-term CDs carry market risk to their principal value, unlike traditional bank CDs.

These products are sometimes sold by "deposit brokers" that may subdivide a bank-issued "master CD" and alter the terms before selling the new CDs to customers. Deposit brokers also may provide certain expertise and skills, such as marketing, the ability to identify attractive CDs, and maintenance of a secondary market, that may be important to the return and risk of the product. Since federal deposit insurance runs between the customer and the *issuing* institution, these unconventional CD products may not provide federal deposit insurance coverage for the investor. In particular, depending on the product's structure, the investor may only have an unsecured, uninsured claim against the deposit broker. Customers' entitlement to federal deposit insurance may also be dependent upon the deposit broker keeping adequate records of ownership.

Depending on various factors, these CD products can, as a legal matter, be securities. Regardless of whether a product is a security, members must ensure that their registered representatives understand the products and adequately disclose to customers the products' characteristics and risk factors. NASD Regulation advises members to account for these CD products at fair market value on customer account statements.

Risk Factors

Members must disclose to prospective purchasers all material risks associated with long-term CD products and should distinguish those risks from those that apply to traditional CDs. NASD Regulation has brought disciplinary actions against firm and individuals involving disclosure of risks in connection with the sale of these CD products.

1. Loss of Principal

Traditional CDs are purchased directly from the issuing bank. They come in fixed denominations for a fixed duration and pay a set interest rate at regular intervals. The issuing bank usually will impose a penalty if a purchaser redeems the CD before maturity. The terms of the CD make explicit the penalty, typically a loss of interest earned and/or a modest loss of principal.

By comparison, a customer who purchases a long-term CD from a brokerage firm or deposit broker could risk a greater loss of principal if the CD is sold before maturity. This is because the deposit broker is generally just a custodian of the CD on behalf of the issuing bank. As such, a customer cannot simply redeem the CD early and pay an early withdrawal penalty. Instead, the deposit broker must sell the CD in the secondary market. Two primary market factors may cause a significant loss of principal in these circumstances. First, fluctuations in interest rates may affect the value of the CD. Generally, as with other long-term fixed income investments, when interest rates rise, the market value of a long-term CD declines. In addition, changes in market interest rates will affect whether step-down or step-up features come into play, and whether a CD issuer will exercise its call option.[2] Second, there may be limited liquidity for these products due to the small size of the secondary market. Indeed, there is no guarantee of the continued existence of a secondary market for some of these products. When transactions do occur in the secondary market, sellers generally will incur a transaction cost, such as a commission to the broker/dealer.

Customers should also be informed whether the CDs are registered with the Depository Trust Corporation (DTC). Most CDs are registered with the DTC as "master CDs." The issuing bank, assisted by a member firm, registers the master CD with DTC and it is then assigned a CUSIP number. In general, the master CD is divided into units of $1,000 for sale to customers. After registration, the CDs are eligible for DTC's book-entry delivery and custody services, which enable clearing and settlement of CD transactions in customer accounts in the same manner as securities held by DTC. The CDs may also be transferred to accounts at other member firms. CDs that are not registered with DTC have additional risks since customers must depend upon the CD brokers to maintain accurate documentation of transactions, record ownership of the CDs in their books and with the issuing banks, make interest payments and collect their principal when the CDs reach maturity. If a CD broker becomes insolvent or cannot make good on its obligations for other reasons, customers may not be able to collect interest or principal payments and the CDs may be subjected to claims from the broker's creditors. The risk of owning non-DTC eligible CDs is significantly increased if the CD broker purchases CDs from banks and then fractionalizes them for sale to customers. These risks should be disclosed to customers.

For these reasons, long-term CDs generally are inappropriate products for customers who have a short-term investment horizon or who may need the principal before maturity. In any event, it is essential that customers be informed of the face maturity date of any CD, even where, as discussed below, the CD has call features that may effectively shorten that maturity period. All of these material risk factors, when present, must be disclosed to a prospective purchaser.

2. Call features

Long-term CDs often include a provision that allows the issuing bank to "call" the CD prior to maturity at a specified price. Members and their registered representatives must explain in detail any call features of the CD product, particularly where, as is often the case with long-term CDs, the call option is solely at the discretion of the issuer and the customer does not receive a corresponding option to "put" the CD back to the issuer at a set price. Purchasers should be told that under certain market conditions—*i.e.*, when falling interest rates would cause the CD to trade at a premium in the secondary market—the issuer likely will exercise its call option, as it can obtain deposits at lower interest rates.

Long-term CDs that contain step-down interest rates and call provisions are less favorable to investors than traditional CDs without those features. This fact also should be disclosed to investors.

3. Insurance

Federal deposit insurance generally covers deposits of up to $100,000 in the aggregate for each depositor in each bank, thrift, or credit union. Therefore, the purchaser of an insured CD is insured against insolvency of the *issuing* depository institution. In certain circumstances, deposit brokers may be considered the depositor for federal insurance purposes. Therefore, members that act as deposit brokers must keep adequate books and records to establish the chain of ownership of any brokered CD products. Failure to maintain such books and records may be a violation of SEC and NASD rules and regulations and can jeopardize the ability of a customer to establish entitlement to federal deposit insurance in the event of a depository institution's insolvency.

Also, federal deposit insurance does not protect purchasers against insolvency of deposit brokers. Consequently, if the long-term CD product being offered is dependent upon certain conduct by the deposit broker—*e.g.*, using expertise to locate attractive CDs, marketing, or maintaining a secondary trading market—purchasers incur additional risk with respect to the broker that must be disclosed. For example, if the deposit broker purchases the CD from the issuing depository institution and then sells portions of the CD to investors, the investor may have *no* insurance coverage at all. In addition, customers should be informed that should they choose to sell a long-term CD in the secondary market prior to its maturity date, there is no insurance coverage for any principal losses incurred.

Training

NASD Regulation expects registered persons to understand the characteristics and risk factors associated with all investment products, including unconventional CDs, before soliciting customers. NASD Regulation 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.

Account Statements

NASD Regulation advises firms to price CDs at fair market value on customer account statements. NASD Regulation has observed that some members continue to price long-term CDs at par value on account statements. While NASD Regulation recognizes that pricing data on these instruments sometimes can be difficult to obtain, members should diligently endeavor to accurately price the CDs on customer account statements. Carrying CDs at par could be materially misleading if values have significantly eroded. Members may include both par value and market value on account statements if an explanation of each is also provided.

There is no single method to determine the market value of long-term 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 to ascertain a theoretical market price. NASD Regulation recommends that members disclose to customers that the values of CDs on account statements are estimated and that their actual value may differ if customers elect to sell their CDs in the secondary market.

In the event that a member cannot obtain a reasonable market valuation for CDs in customer accounts, NASD Regulation recommends that the member segregate those CDs on the account statement and include a disclosure on the account statement covering the following points:

- the secondary market for CDs is generally illiquid;
- an accurate market value could not be determined by the member firm;
- the actual value of the CDs may be different from their purchase price; and
- a significant loss of principal could result if CDs are sold prior to maturity.

Endnotes

1 There also are available other non-traditional CDs, including those with returns that are linked to market indices or benchmark interest rates, such as the S&P 500 or LIBOR.

2 For example, if market interest rates decrease, the issuer typically exercises a call option, if available, and refunds the principal. Thus, the customer no longer obtains the higher rate of interest and may have to reinvest the principal at the now lower available interest rate. On the other hand, if the market interest rates increase, the customer will bear the risk of loss in selling the instrument in the secondary market. In a step-down CD, the interest rate will be lowered at stated intervals if market interest rates have fallen. If market interest rates rise, the customer again bears the risk of loss of principal value.