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# Final Rule on Deposit and Sweep Accounts for Depository Institutions

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Effective July 1, 2009, insured depository institutions must inform their sweep account customers of the nature of their swept funds and how those funds would be treated if the institution failed. Although this sounds simple in theory, in practice, ascertaining how funds are swept and the classification of these funds upon the bank's receivership are both quite difficult.

New treatment of swept funds upon receivership depends on many characteristics of the sweep transaction, including, but not limited to, the type of sweep, timing, underlying securities and other involved parties. Many banks are finding that certain investment vehicles they labeled and sold as sweep accounts are not what they appear; as such, the classification of these investments and the underlying funds in the event of bank failure may come as a surprise to banks and customers. Because of this uncertainty, institutions are now required to inform customers what type of investment vehicles they are participating in and what will happen to such customers' funds should the bank be placed into receivership by the Federal Deposit Insurance Corporation ("FDIC").

The FDIC's final rule, titled *Processing of Deposit Accounts in the Event of an Insured Depository Institution Failure*, clarifies the method for determining the value and nature of claims against a failed insured depository institution, and imposes disclosure requirements in connection with sweep accounts, both of which are important new provisions for banks to understand and satisfy.

## Determining Claims Against Failed Depository Institution

The Final Rule establishes practices for determining deposit and other liability account balances on the day an insured depository institution is placed into receivership by the FDIC.

### *A. End-of-Day Ledger Balance*

Upon taking control of a failed institution, the FDIC must construct an ending balance sheet for the institution (which becomes the beginning balance sheet for the receivership), and determine the value and nature of claims to be made by depositors, general creditors, subordinated creditors, shareholders and others. Except in certain circumstances discussed below, the receiver will determine these claims based on end-of-day ledger balances for each deposit or other liability account using normal posting procedures.

### *B. FDIC Cutoff Point*

The FDIC will use cutoff rules previously applied by the failed institution in establishing the end-of-day ledger balances for deposit insurance determination purposes, but may establish a certain cutoff point ("FDIC Cutoff Point") coinciding with the point at which the FDIC, as

receiver, acts to stop deposit transactions that may result in creating or extinguishing liabilities. The FDIC Cutoff Point facilitates the orderly windup of the institution and the FDIC's final determination of the ledger balances of the institution's accounts. If the institution's ordinary cutoff time for any particular kind of transaction precedes the FDIC Cutoff Point, the ordinary time will be used. If the ordinary cutoff time is later than the FDIC Cutoff Point, however, the latter will control.

## Sweep Account Disclosures

Of particular note, the Final Rule imposes certain disclosure requirements on institutions with respect to sweep accounts. These require initial written disclosure to sweep account customers about whether swept funds are deposits, and annual disclosures for all new or renewal sweep account contracts. Institutions may comply with the initial and periodic disclosure requirements through customer letters, transaction confirmation statements or account statements.

If swept funds are not deposits, an institution must further disclose the status of the funds in the event the institution was to fail (i.e., general creditor status or secured creditor status). All disclosures must be consistent with how the institution reports such funds on its Call Report or Thrift Financial Report.

As previously mentioned, determining whether funds in sweep accounts are deposits and, if not, what status the sweep account customer would have with respect to the underlying funds or securities, can be difficult. The way the FDIC will treat funds of sweep account customers for purposes of determining deposit insurance and the value and nature of claims depend on the type, timing and construction of the sweep transaction. These variables affect what claims the customer may have against the failed institution. The Final Rule discusses different treatment of funds for deposit-to-deposit sweeps, retail or reserve sweeps, Eurodollar and international banking facility ("IBF") sweeps, repurchase agreements or repo sweeps, money market mutual fund sweeps, federal funds sweeps, holding company commercial paper sweeps and loan sweeps.

Among these, there are variables within each sweep type that further affect treatment of the funds. For example, money market mutual fund ("MMMF") sweeps are treated differently depending on (i) whether shares are held directly in the name of the sweep account holder, depository institution or transfer agent, (ii) whether the sweep results in a "same-day" or "next-day" purchase of fund shares, (iii) whether the institution wires funds to the MMMF or keeps funds in an account maintained by the MMMF at the institution, (iv) whether, in the event an account is maintained by the MMMF, the account is actually owned by the MMMF or for the benefit of the sweep customers, (v) whether the sweep occurs before or after the applicable cutoff point, and/or (vi) whether another institution purchases and assumes the sweep transaction after failure.

Depending on the above factors, the following results could occur: (a) funds could be swept back to the customer's account on the following business day, (b) the customer could receive a check or other payment from the receiver for the value of the ownership interest in the money market mutual fund, or (c) funds could be prevented from being swept and treated as deposits, either insured or uninsured depending on the type of deposit account and current FDIC insurance cap.

It is clear that insured depository institutions currently offering sweep accounts may experience difficulty making such determinations. Nonetheless, institutions are responsible for accurately disclosing the treatment of funds involved in sweep accounts. Even if an institution believes it knows what type of sweep account it has constructed, such institution may want to reevaluate to ensure that it is properly crafted. Institutions could find that sweep accounts they thought were properly constructed, in fact, have deficiencies that could compromise deposit treatment.

It is our experience, for example, that insured institutions typically believe that, in the event of a receivership, all repurchase arrangements will be recognized by the FDIC as either insured deposits or the equivalent value of securities ultimately deemed to be held by the depositor. However, an analysis of the architecture of most repurchase agreements would conclude that the underlying funds are not insured or the depositor would not be deemed the owner of the equivalent value in securities because the depositor never perfected its interest in the securities purchased via the repurchase agreement.

Accordingly, the FDIC has "observed that some institutions' repo arrangements are not properly executed. In those situations, the sweep customer obtains neither an ownership interest nor a perfected security interest in the applicable securities."[1] In this example, an institution could make inaccurate disclosures to customers, which could result in customers' loss of funds in the event they are not considered insured deposits or properly perfected securities owned by the depositor. Additionally, the institution could be in violation of the Final Rule if it does not report funds accurately on its Call Report or Thrift Financial Report. This affects all institutions, regardless of whether an institution is at risk of failure.

Adoption of this Final Rule impacts insured depository institutions and regulates various aspects of deposit and sweep accounts in the event of an institution's failure. The FDIC requires compliance with the Final Rule no later than February 21, 2009, except for the disclosure requirement, which becomes effective July 1, 2009.

## CONCLUSION

In reviewing numerous repurchase agreements over the last year, it has become apparent that a degree of laxity has crept into financial institution repurchase agreement forms. While most institutions carefully constructed their repurchase agreement forms following the thrift crisis of the late 1980s, since then the construction of the repurchase process has changed. Today, we see repurchase agreements initially designed to protect depositors now structured in a manner that benefits the institution and with ambiguities that potentially compromise the protected status of the depositor. It is in the best interest of institutions and their depositors to ensure that repo and similar sweep arrangements are clearly constructed to reflect the understanding of all parties.

[1] 12 CFR Part 360.6(a).

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