JUST PASSING THROUGH: A HISTORY AND CRITICAL ANALYSIS OF FDIC INSURANCE OF DEPOSITS HELD BY BROKERS AND OTHER CUSTODIANS

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I. Introduction

Scroll through the website of any securities brokerage firm catering to retail investors[1] and you may think you have mistakenly

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stumbled onto the website of a bank. Investment and savings products insured by the Federal Deposit Insurance Corporation ("FDIC") are ubiquitous. As a customer of the brokerage firm, you can choose to invest in FDIC-insured certificates of deposit ("CDs"), or have your money deposited into an FDIC-insured savings deposit account at one or more banks and access your funds via check or debit card.

The explanatory materials provided to you by the brokerage firm may prove puzzling. You will be told that your deposit account has been established at the bank in the name of your broker, or in the name of another entity such as The Depository Trust Company ("DTC"). You will also be told that you cannot access your funds directly at the bank; funds may only be accessed through your broker. Yet, your broker will assure you that you have the same FDIC insurance coverage as you would if you had opened your deposit account directly at the bank. How is this possible?

The FDIC was created by the Banking Act of 1933, commonly referred to as the Glass-Steagall Act, to maintain public confidence in the banking system by, among other things, insuring bank deposits within a specified limit.[2] Initially, the insurance limit was $2,500, but it has been raised a number of times since 1933 and is currently $250,000. Insurance payments are made by the FDIC from a fund financed by the assessment of premiums on insured banks. In addition to premium assessments, the FDIC has a line of credit to the U.S. Treasury that it can access under specified conditions.

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possible without the invaluable assistance of Seward & Kissel colleagues Daphne A.L. Trainor and Michele A. Downey. In addition, the significant role of Seward & Kissel partner Anthony C.J. Nuland in developing many of the legal concepts discussed in this article is gratefully acknowledged.

[1] *See, e.g.*, *Cash Management*, MERRILL LYNCH, http://wealthmanagement.ml.com/wm/pages/ArticleViewer.aspx?title=cash-management-account(last visited Oct. 27, 2012); *CDs & Money Market Funds*, CHARLES SCHWAB, http://www.schwab.com/public/schwab/investing/accounts_products/investment/cds_money_markets (last visited Oct. 27, 2012); *Wealth Management*, MORGAN STANLEY, http://www2.morganstanley.com/wealth/ (last visited Oct. 27, 2012).

[2] *See generally* FDIC, THE FIRST FIFTY YEARS: A HISTORY OF THE FDIC 1933-1983 (1984). The fund, which is currently named the Deposit Insurance Fund, is generically referred to in this article as the "insurance fund."

From its creation, the enabling statute for the FDIC has contemplated the insurance of a deposit account established for one person at a bank by another person.[3] FDIC regulations adopted in 1946 were the first to recognize that FDIC insurance could "pass through" a custodian to the principals for whom the custodian was acting.[4] Current FDIC regulations recognize that deposit insurance can pass through one or more types of intermediaries—including agents, nominees, and custodians—that have established a deposit account at a bank, as well as any additional levels of intermediaries, to the ultimate owner of the deposit account.[5]

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[3] The statutory provisions creating the FDIC in 1933 were codified as Section 12B of the Federal Reserve Act. Banking Act of 1933, Pub. L. No. 73-66, § 8, 48 Stat. 168 (codified as amended at 12 U.S.C. § 261, 262, 342 (2006)). Section 12B(*l*) of the Federal Reserve Act provided that "in determining the amount due to such owner . . . there shall be added together all net amounts due to such owner in the same capacity or the same right, on account of deposits, *regardless of whether such deposits be maintained in his name or in the name of others for his benefit*." 12 U.S.C. § 264(*l*) (1946) (repealed 1950) (emphasis added). In 1950, Section 12B was withdrawn from the Federal Reserve Act and established a separate act known as the Federal Deposit Insurance Act ("FDIA"). *Id.* §§ 1811–1831 (2006). The principle set forth originally in Section 12B(l) of the Federal Reserve Act is currently set forth in Section 11(a)(1)(C) of the FDIA: "For the purpose of determining the net amount due to any depositor . . . , the [FDIC] shall aggregate the amounts of all deposits in the insured depository institution which are maintained by a depositor in the same capacity and the same right for the benefit of the depositor *either in the name of the depositor or in the name of any other person* . . . ." *Id.* § 1821(a)(1)(C) (emphasis added).

[4] *See* 11 Fed. Reg. 177A-431, 177A-449 (Sept. 11, 1946) ("The owner of any portion of a deposit apeparing [sic] on the records of a closed bank under a name other than that of the claimant, whose name or interest as such owner is not disclosed on the records of the closed bank as part owner of said deposit, will be recognized for all purposes of claim for insured deposits to the same extent as if his name and interest were disclosed on the records of the bank . . . .").

[5] This article will focus on deposit accounts held through custodial arrangements and not on deposit accounts held through other types of intermediaries, such as trust arrangements. This pass-through, or "look-through," approach to the application of regulations is commonly used by the federal banking regulators. For example, the Board of Governors of the Federal Reserve System will look through an intermediary to apply restrictions on NOW account ownership, transaction limitations on savings deposits, and minimum deposit restrictions on credit card banks. *See* NOW Account Eligibility, 157 Fed. Res. Reg. Serv. 2-275 (1981); Letter from

The Depository Institutions Deregulation and Monetary Control Act of 1980[6] de-regulated interest rates on deposit accounts[7] and raised the insurance limit from $40,000 to $100,000.[8] Taking advantage of these changes, brokerage firms such as Merrill Lynch, Dean Witter, Prudential Securities, and Shearson/American Express—acting as agent and custodian for their customers—began offering bank CDs at market interest rates to their retail customers on the basis of the availability of FDIC pass-through insurance to the customer up to the new limit.[9] Savings deposits, also referred to as money market deposit accounts ("MMDAs"), were offered by a few brokerage firms, but would not become widely offered for another twenty years.

Oliver I. Ireland, Assoc. Gen. Counsel, Bd. of Governors of the Fed. Reserve Sys., to Gilbert T. Schwartz, Esq., Skadden, Arps, Slate, Meagher & Flom LLP (June 22, 1988), *available at* 1988 Fed. Res. Interp. Ltr. LEXIS 141; Letter from Oliver Ireland, Assoc. Gen. Counsel, Bd. of Governors of the Fed. Reserve Sys., to Philip E. Taken, Esq., Senior Vice President & Gen. Counsel, First USA, Inc. (Sept. 4, 1996) (on file with author); Letter from William W. Wiles, Sec'y, Bd. of Governors of the Fed. Reserve Sys., to Seward & Kissel (June 22, 1983) (on file with author).

[6] Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 132 (1980).

[7] *Id.* § 207, 94 Stat. at 144 (amending Section 19(i) of the Federal Reserve Act, 12 U.S.C. § 371a (1976) (repealed 1980), Section 5(b)(1)(B) of the Home Owners' Loan Act, 12 U.S.C. § 1464(b)(1)(B) (1976) (repealed 1980), and Section 18(g) of the FDIA, 12 U.S.C. § 1828(g) (1976) (repealed 1980)). The one exception was that banks were prohibited from offering interest on demand deposit accounts held by businesses; this prohibition was repealed by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank"), Pub. L. No. 111-203, § 627, 124 Stat. 1376, 1640 (codified in scattered sections of 12 U.S.C.).

[8] Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, § 308(a)(1)(C), 95 Stat. 132, 147 (amending Section 11(a)(1) of the Federal Deposit Insurance Act, 12 U.S.C. § 1821(a)(1) (2006)). The insurance limit was raised from $100,000 to the current $250,000 on a temporary basis by the Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 136, 122 Stat. 3765, 3799 (2008). In 2010, the insurance limit was raised to $250,000 on a permanent basis by Dodd-Frank. 12 U.S.C. § 1821(a)(1)(E) (Supp. V 2011).

[9] *See generally* Alice Arvan, *Bache to Market Deregulated CDs For City Federal S&L of New Jersey*, AM. BANKER, Aug. 3, 1982. Bache Halsey Stuart Shields was a predecessor firm of Prudential Securities.

Today, the amount of brokerage firm customer funds in savings and transaction accounts at banks is likely three times the amount in CDs. This growth in deposits in savings and transaction accounts is attributable to the *en masse* replacement of money market mutual funds with FDIC-insured deposit accounts as the primary automatic investment, or "sweep," option for a brokerage customer's uninvested cash, a shift initiated by Merrill Lynch's launch of its "Beyond Banking" product in 2000.[10] As a result of eliminating taxable money market mutual funds as an automatic investment option and sweeping customer funds to deposit accounts at its affiliated banks, the deposit base of Merrill Lynch Bank USA rose from $3.6 billion at the end of 1999 to $60 billion at the end of 2001.[11] Brokerage firms with affiliated banks—including Lehman Brothers, Smith Barney, Charles Schwab, UBS, E*Trade, and Morgan Stanley—followed shortly thereafter. The announced consummation of the acquisition of Smith Barney by Morgan Stanley in 2015 will reportedly result in the movement of over $53 billion of Smith Barney customer funds from Citibank, Smith Barney's affiliate, to Morgan Stanley banks.[12]

Beginning in 2003, a large number of banks began actively to offer deposit accounts at other banks as a means to offer their customers access to more FDIC insurance. Like brokers, these banks hold the deposit accounts at other banks as custodian for their

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[10] In 2000, Merrill Lynch introduced the "Beyond Banking" feature (now called the "Bank Deposit Program") of its Cash Management Account, or CMA, which offered a savings deposit linked to a transaction account, permitting Merrill Lynch customers full transaction capabilities through their CMA. *See* Cheryl Winokur, *Merrill, Late to the Party, Offers Premium FDIC-Insured Account*, AM. BANKER, Feb. 2, 2000, *available at* http://www.americanbanker.com/issues/165_20/-119055-1.html.

[11] These data are derived from the Consolidated Reports of Condition and Income ("Call Reports") that Merrill Lynch Bank USA filed for the relevant periods.

[12] *See* Press Release, Morgan Stanley & Citigroup, Morgan Stanley and Citigroup Reach Agreement for Full Purchase of MSSB, and Related Deposits, by June 2015 at a $13.5 Billion Valuation, Subject to Regulatory Approval (Sept. 11, 2012), *available at* http://www.morganstanley.com/about/press/print/90a5896e-6f7a-4ec1-bea2-45faa9b0dd33.html.

customers.[13]

While precise data are not available, it can be reasonably estimated that over $800 billion of customer funds are currently maintained in deposit accounts at FDIC-insured banks that are offered by, and held through, registered broker-dealers and banks.[14] Frequently referred to as "brokered deposits"—a term with a defined legal meaning[15] that is also used colloquially to refer to many intermediated deposit accounts that do not meet the legal definition[16]—these deposit accounts are both a core investment and savings product offered by brokerage firms and banks to their customers and a significant source of capital markets funding for the banking industry.

Utilizing a deposit broker, banks can offer their deposit accounts to the public in the same manner that corporate debt obligations are offered to the public. Banks can select from funding options that include transactional deposit accounts offered through a broker's "sweep" program and priced to an overnight funding index

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[13] *See CDARS Overview*, PROMONTORY INTERFINANCIAL NETWORK, LLC, http://promnetwork.com/our-services/cdars/overview.aspx (last visited Nov. 28, 2012).

[14] These data are derived from DTC, brokered deposits reported in Call Reports, and other industry sources.

[15] A "brokered deposit" is defined in the FDIC regulations as "any deposit that is obtained, directly or indirectly, from or through the mediation or assistance of a deposit broker." 12 C.F.R. § 337.6(a)(2) (2012). A "deposit broker" is defined in relevant part as "[a]ny person engaged in the business of placing deposits, or facilitating the placement of deposits, of third parties with insured depository institutions . . . ." *Id.* § 337.6(a)(5). *See also* Federal Deposit Insurance Act § 29(g)(1), 12 U.S.C. § 1831f(g)(1) (2006).

[16] There are several exceptions to the definition of "deposit broker," including a person whose "primary purpose" is not the placement of deposits. In 2005, the General Counsel of the FDIC issued an interpretive letter to a broker-dealer concerning the broker's sweep feature, pursuant to which the broker swept clients' free credit balances into accounts at affiliated banks for which the broker received a fee from the banks on a per-account basis rather than as a percentage of the deposits. The FDIC General Counsel concluded that the broker satisfied the "primary purpose" exception with respect to its sweep feature and, therefore, the client funds swept into accounts at affiliated banks were not "brokered deposits." Letter from William F. Kroener, III, Gen. Counsel, FDIC, to Unidentified Party (Feb. 3, 2005), *available at* 2005 WL 1276372. As a result of this position, there are currently in excess of $250 billion in deposits placed by brokers in their affiliated banks that are not reported as "brokered deposits."

and CDs with a range of interest and other features. "Callable" CDs, for example, permit banks to issue CDs that can be redeemed at their discretion, permitting the banks to issue CDs with maturities of up to twenty years. In 2002 so-called "reciprocal" deposit programs were introduced that permit banks to place customer funds with other banks and receive a like amount of deposits in return.

In addition, because many brokers offer liquidity to their customers by maintaining a secondary market in CDs, banks need only provide limited early withdrawal options on these CDs, typically only upon the death of the CD holder. Because the funds can only be withdrawn under these limited circumstances, the CDs provide a stable source of funding that is not affected by a change in the interest rate environment or the perception of the bank's financial condition.

Although the FDIC pass-through regulations applicable to deposit accounts held through intermediaries utilize some terminology that, as described *infra*, is legally meaningless and potentially confusing, pass-through deposit insurance, the foundation on which this investment edifice is built, is fairly simple in both concept and execution. A deposit account established at a bank by a "fiduciary," defined by the FDIC to include agents, custodians, and nominees, on behalf of others, is eligible for pass-through insurance if (1) the account is established in a manner that indicates that the fiduciary is acting for others and (2) the fiduciary maintains records in "good faith and in the regular course of business" with respect to the owners of the deposit account.[17]

In the wake of the 2008 financial crisis, and in response to a 2010 bank failure that exposed a complex web of deposit accounts at numerous banks that varied from disclosures provided to depositors by their custodians,[18] the FDIC has provided interpretive guidance in a variety of forms setting forth criteria for the availability of pass-through insurance for deposit accounts held through a fiduciary relationship. While the FDIC has published some of this guidance, the most expansive discussion of these criteria appears in FDIC staff

[17] 12 C.F.R. § 330.5(b).

[18] In conversations with FDIC staff, the author was informed that the issuance of the interpretive guidance was occasioned by the discovery of irregular custodial recordkeeping upon the failure of Waterfield Bank on March 5, 2010.

interpretive letters that the FDIC has not published.[19]

In 2010, the FDIC issued a Financial Institution Letter (the "2010 FIL")[20] to clarify misunderstandings with respect to insurance coverage of accounts held by fiduciaries. The 2010 FIL stated that "pass-through" coverage is available only if (1) the fiduciary relationship is expressly disclosed on the records of the bank, (2) the records of the bank, the fiduciary, or an authorized third party identify the actual owners, and (3) "the funds actually are owned by the customer(s) and not the entity performing in a fiduciary capacity."[21] The 2010 FIL also stated that the third requirement is likely not satisfied if there is a mismatch between the terms of the deposit account offered by the fiduciary to the customer and the terms of the deposit account at the bank.[22]

In non-public interpretive letters issued by the FDIC subsequent to the 2010 FIL, the staff has expanded on the fundamental principle set forth in the 2010 FIL. These letters specifically address fiduciaries acting as an agent or custodian, and frequently use these terms interchangeably. These letters indicate that:

- The parties must be in a *bona fide* agency/custodial relationship—which means that the agent/custodian must actually be an agent/custodian and the "deposit" must actually belong to the alleged owners (the customers).[23]

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[19] This includes a 2010 letter to the author and letters that have been posted on the websites of market participants (but not on the FDIC's website).

[20] Guidance on Deposit Placement and Collection Activities, FDIC Financial Institution Letter No. 29-2010, (June 7, 2010) [hereinafter 2010 FIL], *available at* http://www.fdic.gov/news/news/financial/2010/ fil10029.html. FILS are the means by which the FDIC communicates matters of general interest to the banking industry. These matters range from administrative matters (e.g., announcing the call dates for quarterly call reports) to regulatory matters (e.g., announcing new rules or rule amendments and interpretive guidance such as the 2010 FIL). FILS are distributed to banks by mail or electronically and are available to the public on the FDIC's website.

[21] *Id.*

[22] *Id.*

[23] *See* Letter from Daniel G. Lonergan, Counsel, FDIC, to author (Feb. 8, 2011) [hereinafter 2011 Clark Letter] (on file with author); Letter from Christopher L. Hencke, Counsel, FDIC, to William R. Burdette, President,

- The terms of the agreement between the parties may not create independent obligations on behalf of the agent/custodian, which would result in a debtor-creditor, not a principal-agent, relationship.[24] An independent obligation could be created when the terms of the deposits offered by an agent/custodian do not match the terms of the deposit accounts at the bank and the principal must look to the agent/custodian, not the bank, for payment.
- The customer must own an interest in specific deposits, not a *pro rata* interest in a pool of deposits.[25]

The FDIC also noted in these unpublished letters, though not in the 2010 FIL, that FDIC regulations do not permit the pass-through of deposit insurance for deposit accounts held through arrangements that have registered, or should register, with the Securities and Exchange Commission ("SEC") as investment companies pursuant to Section 8 of the Investment Company Act of 1940 ("ICA").[26] The SEC staff has taken the view that under certain circumstances a multi-bank deposit placement arrangement offered by a broker or other entity, even though not organized as a separate legal entity, can be an investment company for purposes of the ICA that must be registered with the SEC.[27]

The nature of the FDIC guidance, which endeavors to provide criteria for determining when an agent/custodial relationship is genuine, and the limited availability, and absence of public discussion, of this guidance, invite several avenues of inquiry.

Institutional Deposits Corp. (Sept. 23, 2010) [hereinafter Burdette Letter] (on file with author). Both of these letters involved arrangements in which an agent/custodian was placing funds at multiple banks and was maintaining the account records. Except for one instance in which the term "deposit accounts" was used by the FDIC, the term "deposits" was used.

[24] *See* 2011 Clark Letter, *supra* note 23; Burdette Letter, *supra* note 23.

[25] 2011 Clark Letter, *supra* note 23. In connection with this letter, the FDIC sought and received from the author a representation that a security had not been created by the program that was the subject of the letter.

[26] *See* 15 U.S.C. § 80a-8 (2006); 12 C.F.R. § 330.11(a)(2) (2012).

[27] *See* Kemper Fin. Servs., Inc., SEC No-Action Letter, 1985 WL 55652 (Oct. 30, 1985) [hereinafter Kemper Letter].

Lack of Meaningful Standards

First, are the criteria set forth in the guidance meaningful? The section of the Federal Deposit Insurance Act ("FDIA")[28] that establishes the basis for pass-through insurance speaks to deposits established "for the benefit" of a depositor. This terminology is sufficiently broad to encompass the wide variety of fiduciary relationships set forth in the FDIC's regulations and, arguably, to require the insurance of deposit accounts established by an agent for a principal whether the terms of the guidance have been met or not.

The FDIC guidance in some instances uses the broader term "fiduciary" and in other instances moves back and forth between the terms "agent" and "custodian." This vacillation between terms makes the scope of the guidance unclear and clouds the underlying issues. In the most basic sense, a custodial relationship is a type of agency relationship in which one party holds property in accordance with the agreement that creates the custodial relationship.[29] For example, a securities broker holds financial assets as agent for a principal—its customer—and purchases or disposes of assets either at the direction of the principal or pursuant to a contractual authorization to utilize investment discretion. In contrast, an escrow arrangement—a common custodial relationship granted pass-through insurance by the FDIC—is a hybrid in which the "agent" may not be a true agent for either party, and no party to the arrangement unconditionally "owns" the assets held in escrow.[30] Under the terms of the escrow agreement, the principals to the arrangement may have the power to specify or direct the investment of the assets, or may have no knowledge of where the assets are held for safekeeping.[31]

This lack of clarity with respect to both the scope of the guidance and the characteristics of different types of custodial relationships is further complicated by the requirement that funds be "actually owned" by the principal, a reference also included in the

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[28] 12 U.S.C. §§ 1811–1835A (2006).

[29] A.O. AUSTEN-PETERS, CUSTODY OF INVESTMENTS: LAW AND PRACTICE 25–26 (2000).

[30] *See generally* RESTATEMENT (THIRD) OF AGENCY § 8.09(d) (2006).

[31] In a typical residential real estate purchase transaction, the escrow agent under most state statutes is merely required to deposit the funds in a bank, but is not required to inform the parties of the identity of the bank. *See, e.g.*, DEL. CODE ANN. tit. 24 § 2923(a) (West 2012); N.J. STAT. ANN. § 45:15-12.5 (West 2012).

regulations and other interpretive guidance, though not in the provision of the FDIA requiring pass-through insurance.[32] No person depositing funds with a bank "owns" the deposited funds. Instead, the acceptance of the funds by the bank creates a creditor/debtor relationship between the depositor (the creditor) and the bank (the debtor). The depositor has a claim against the bank for the repayment of the amount lent to the bank according to the terms of the deposit account the depositor has established with the bank. Because a direct depositor will merely have a claim against the bank as a creditor, not the "ownership" of any funds, how can a party to a custodial relationship in which deposit accounts are established in the name of the custodian ever have anything more than a claim against the custodian for the custodian's claim against the bank?

It is significant that the FDIC makes no reference in its published interpretive letters to Article 8 of the Uniform Commercial Code ("Article 8"), which establishes the legal framework for the custodial relationships utilized by brokers and banks in the United States holding "financial assets" for investors. For purposes of Article 8, the term "financial assets" includes deposit accounts.[33] Under the Article 8 framework, which permits an "indirect" holding of financial assets on a book-entry basis through one or more "securities intermediaries," a brokerage firm's or bank's customer is the holder of a "security entitlement" to a financial asset.[34] Article 8 abandons the concept of legal title and instead empowers an "entitlement holder" to give an "entitlement order" to a securities intermediary with respect to the disposition of a financial asset.[35]

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[32] 12 C.F.R. § 330.5(a). *See also* Insurability of Funds Underlying Stored Value Cards and Other Nontraditional Access Mechanisms, 73 Fed. Reg. 67155-01, (Nov. 13, 2008) [hereinafter General Counsel's Opinion No. 8]; Letter from Joseph A. DiNuzzo, Counsel, FDIC, to Unidentified Party (Aug. 16, 2002), *available at* 2002 WL 32068161; Letter from Patti C. Fox, Attorney, FDIC, to Unidentified Party (Oct. 10, 1986), *available at* 1986 WL 379668; Letter from Patti C. Fox, Attorney, FDIC, to Unidentified Party (Aug. 31, 1988), *available at* 1988 WL 583097; Letter from Christopher L. Hencke, Counsel, FDIC, to Unidentified Party (May 20, 2002), *available at* 2002 WL 32068160; Letter from Christopher L. Hencke, Counsel, FDIC, to Unidentified Party (July 6, 2005), *available at* 2005 WL 1902674; Letter from Claude A. Rollin, Attorney, FDIC, to Unidentified Party (Mar. 29, 1988), *available at* 1988 WL 583139.

[33] U.C.C. § 8-102(a)(9) (1994).

[34] *Id.* § 8-501.

[35] *Id.* § 8-507.

An equally important element of the guidance, though perplexing in its own way, is the requirement that the customer own an interest in specific deposit accounts rather than "a pro rata interest in a pool of deposits," and the reminder that deposit accounts held through an arrangement that is, or should be, registered with the SEC as an investment company are not eligible for pass-through deposit insurance.[36] These requirements are related by the fact that an investment company is a pool of assets in which each investor has an undivided interest, and not a claim against a specific asset.[37] However, while precluding pass-through insurance to deposit accounts held by investment companies, FDIC regulations specifically permit pass-through deposit insurance for deposit accounts held by a custodian in which funds of multiple principals have been commingled, i.e., "pooled" in a deposit account.[38] In such case, depositors are insured on a *pro rata* basis.[39] This provision of the regulations, adopted in 1990 and based upon a longstanding codified interpretation,[40] is not addressed in the recent guidance and, in fact, is not cited in any published interpretive letter.[41]

At some level, commingling occurs in all custodial relationships in which a custodian deposits the funds of multiple principals into a deposit account. Money deposited with a bank—whether in currency, by negotiable instrument, or electronically—is fungible and is not segregated by the bank from other deposited funds. Indeed, the deposited funds are used by the bank in its business to make loans and other permissible investments.

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[36] 2011 Clark Letter, *supra* note 23.

[37] *See generally,* ROBERT H. ROSENBLUM, INVESTMENT COMPANY DETERMINATION UNDER THE 1940 ACT, EXEMPTIONS AND EXCEPTIONS (2d ed. 2003).

[38] *See* 12 C.F.R. § 330.11(a)(2) (2012) (mandating that deposit accounts held by companies required to register with the SEC under the Investment Company Act of 1940 are to be treated as corporate accounts for FDIC-insurance purposes); *id.* § 330.5(a)(2).

[39] *Id.* § 330.5(a)(2).

[40] *See* 12 C.F.R. §330.101 (1968).

[41] The only reference in a published letter is a reference to the codified interpretation, subsequently incorporated into the body of the FDIC's regulations. *See* Letter from Claude A. Rollin, Attorney, FDIC, to Unidentified Party (Jan. 19, 1989), *available at* 1989 WL 609514 (applying Section 330.5(a)(2)—then 12 C.F.R. § 330.101 (1989) and currently codified at 12 C.F.R. § 330.5(a)(2) (2012))—to escrow arrangements).

Since commingling of funds occurs at the bank, the commingling that the FDIC is concerned about must be on the books and records of the custodian. When a broker or bank acts as a custodian in holding deposit accounts as an investment asset for its customers, each customer's security entitlement with respect to the deposit accounts is evidenced by the books and records maintained by the custodian and each customer's security entitlement can be enforced separately from the security entitlements of other customers. If, as in an escrow arrangement, the custodian is merely safekeeping funds with the obligation to transfer an equal amount of funds to one of the parties upon the occurrence of an event, then the sole claim of the parties against the custodian would be for the payment of the money, and they would have no rights with respect to a specific deposit account at a specific bank.[42] The claims of the parties to the escrow arrangement, therefore, are commingled on the books of the custodian.

Because the FDIC insures deposits held in escrow arrangements on a pass-through basis, it needs to make a clearer statement about the circumstances in which commingling of claims on the books of a custodian defeats pass-through insurance. Furthermore, is there a policy reason to deny insurance when the various principals merely hold claims against a custodian for the payment of specified amounts and the funds entrusted to the custodian can be traced to one or more deposit accounts at specific banks?

Obtaining clarity on this issue is further complicated by the FDIC's statement that it will not provide pass-through insurance when the custodian has created additional obligations that convert the custodial relationship into a "debtor-creditor" relationship. This terminology is vague and does not accurately capture the circumstances in which a custodian may have offered, or undertaken, additional obligations in connection with a custodial relationship. And it is not clear why such additional obligations should defeat insurance coverage of deposit accounts held by the custodian. The FDIA requires insurance of any deposit maintained for the benefit of a depositor. The creation by the custodian of obligations to the principal that are separate from the deposit accounts at one or more banks would appear to be irrelevant to a determination of whether deposit accounts are for the benefit of identifiable principals.

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[42] AUSTEN-PETERS, *supra* note 29, at 23–30.

The FDIC appears to be attempting to implement criteria similar to, though much less precise than, the criteria utilized by the SEC to determine whether a custodian has created a "security" for purposes of the federal securities laws, an analysis also applied in connection with determining whether an investment company has been created.[43] The SEC's criteria, referred to herein as the "rights and status" analysis, assist the SEC in determining whether an investor holding a financial asset through a custodian—typically, though not necessarily, a securities broker—has the rights and status in the financial asset that the investor would have if the financial asset were held by the investor directly with the issuer of the asset, or whether the custodian has created risk for the investor by undertaking a separate obligation to the investor.[44] The criteria established by the SEC are much more precise than the vague debtor-creditor relationship, and the inaccurate "ownership of funds," criteria articulated by the FDIC, and would be more useful to the FDIC in determining the existence of obligations that modify the nature of the custodial relationship in a manner that should affect the availability of insurance.

Failure to Publish Interpretive Guidance

Second, why is significant interpretive guidance not published? While the FDIC claims to make a representative sampling of interpretive letters available as a public service,[45] its publication of interpretive letters, first in various reporting services and now on its website, has been sporadic. As of December 1, 2012, no staff interpretive letters addressing deposit insurance coverage issued after July 6, 2005 appear on the FDIC website.[46] Yet, based on the results of Freedom of Information Act inquiries and letters received by the author, a number of significant interpretive letters *were* issued

[43] *See infra* notes 268–274 and accompanying text.
[44] Apfel & Co., SEC No-Action Letter, 1991 WL 176885 (July 18, 1991) [hereinafter Apfel Letter] (setting forth the "rights and status" test).
[45] *See Introduction to the FDIC Advisory Staff Opinions,* FDIC: FEDERAL DEPOSIT INSURANCE CORPORATION, www.fdic.gov/regulations/laws/rules/4000-50.html (last updated Dec. 3, 2009).
[46] With respect to other issues, there have been only four interpretive letters posted on the FDIC website since July 6, 2005. These relate to interstate branching, the treatment of auto leases, and the acceptance of employee benefit plan deposits by less than adequately capitalized banks.

between 2005 and 2012. In some cases letters issued during this period directly contradict each other, creating confusion that is exacerbated by the lack of publication.[47]

FDIC staff interpretive letters have historically provided important guidance to the financial industry and depositors, and are an important source of clarification of broadly written FDIC regulations. Indeed, in many cases FDIC staff treats previously issued interpretive letters as having precedential value, citing them as authority to support a response to a request for interpretive guidance. However, the FDIC has never acknowledged that the distribution of deposit accounts (debt obligations) by banks to the public through brokers and other banks based upon the availability of FDIC insurance is conducted in a large, robust national market, and that the FDIC is and has been for at least two decades, a capital markets regulator. With hundreds of billions of investor dollars at risk, and with depositors and the financial industry relying on the guidance contained in such letters, transparency and consistency should be a priority for the FDIC.

Equally, if not more importantly, there is not a single suggestion in consumer education materials prepared by the FDIC that pass-through insurance can be denied on technical grounds.[48] The very people that FDIC insurance is intended to protect are largely unaware of the potential risks, however remote, of holding deposit accounts through a custodian.

Unfairly Punishing Depositors

Third, is it fair, or even reasonable, to punish depositors by denying FDIC insurance if a deposit program offered by an intermediary fails to satisfy technical criteria established by the FDIC? Since the primary purpose of deposit insurance is to instill

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[47] *Compare* Letter from Christopher L. Hencke, Counsel, FDIC, to Unidentified Party (Feb. 13, 2009) (on file with author), *with* Letter from Joseph A. DiNuzzo, Counsel, FDIC, to author (May 21, 2009) (on file with author).

[48] *See, e.g.*, FDIC, YOUR INSURED DEPOSITS (2011), *available at* http://www.fdic.gov/deposit/deposits/insured/. This pamphlet, which is widely disseminated to bank customers, explains in general terms the nature of "fiduciary accounts," but does not discuss the circumstances in which a fiduciary relationship may not serve as the basis for pass-through insurance or the consequences of such a result.

public confidence in the U.S. banking system,[49] does the possibility that the FDIC will disallow an insurance claim on technical grounds beyond the control of the depositor, and likely beyond the depositor's comprehension, undermine this purpose? In this regard, the SEC requires broker-dealers to obtain an opinion of outside counsel concerning the availability of FDIC pass-through insurance for some, but not all, deposit programs offered to customers.[50] However, neither SEC staff nor the staff of the Financial Industry Regulatory Authority ("FINRA") has ever coordinated with FDIC staff on what authority such opinions should rely upon and, more specifically, whether such opinions should address whether the program is an investment company for purposes of the ICA. The federal banking regulators impose no opinion of counsel requirements on banks offering deposit placement arrangements.

Lack of Enforcement

Fourth, does the FDIC's technical criteria for determining eligibility for pass-through insurance, whether published or not, really matter? Historically, nearly all uninsured deposits have been protected by the FDIC either through arranged mergers, transfers of deposits to healthy banks, or direct payment. Indeed, the U.S. Supreme Court's landmark 1982 decision in *Marine Bank v. Weaver,*[51] holding that bank deposit accounts are not "securities" for purposes of the anti-fraud provisions of the Securities Exchange Act of 1934 ("Exchange Act"), noted that through 1980 the FDIC had paid nearly all depositors in failed banks, whether insured or uninsured, creating a "virtual guarantee" of deposit accounts by the FDIC.[52] The FDIC took a

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[49] *See FDIC Mission, Vision, and Values*, FDIC: FEDERAL DEPOSIT INSURANCE CORPORATION, www.fdic.gov/about/mission/Index.html (last updated May 4, 2009) (stating that the FDIC was created by Congress to "maintain stability and public confidence in the nation's financial system"). *See also* George Seward & Roger Zaitzeff, *Insurability of Brokered Deposits: A Legislative Analysis*, 39 BUS. LAW. 1705, 1706 (1984).

[50] *See* Sweep Guidelines, Draft (2006) (unpublished) (on file with author). These guidelines were developed by the staffs of the SEC (Trading and Markets Division) and the Financial Industry Regulatory Authority ("FINRA"), and provided in draft form to select FINRA members affected by the guidelines, but never published.

[51] 455 U.S. 551 (1982).

[52] *Id.* at 558 (citing the 1980 FDIC ANN. REP. 18–21). *See also Managing the Crisis: The FDIC and RTC Experience: Chronological Overview:*

similar approach to insuring depositors in both the savings and loan crisis of the late 1980s and the recent financial crisis.[53]

There is no evidence that the few depositors that have not been paid by the FDIC were disqualified because of technical non-compliance with FDIC pass-through insurance requirements.[54]

Furthermore, while the FDIC has written procedures for the submission of insurance claims by custodians, there is no evidence that procedures exist to review custodial arrangements set forth on a failed bank's records in order to determine whether each such custodial relationship conforms to FDIC policies. More important, a review of custodial relationships for technical compliance with FDIC policies is probably not practicable: the FDIC has publicly declared that its goal is to make deposit insurance payments within two business days of an insolvency.[55]

If the FDIC intends to continue to adhere to its unspoken policy of paying off almost all deposits in failed banks rather than enforcing its vague pass-through insurance requirements, is there sufficient motivation to comply with these requirements?

Chapter 5—1982, FDIC: FEDERAL DEPOSIT INSURANCE CORPORATION, http://www.fdic.gov/bank/historical/managing/Chron/1982/index.html (last updated Jan. 5, 2005) (stating that 97.2% of uninsured deposits had been paid by the end of 1981).

[53] *See generally* FDIC, MANAGING THE CRISIS: THE FDIC AND RTC EXPERIENCE, 1980–1994 (1998) (stating that, between 1986 and 1991, 83% of all bank failures were resolved in a manner that protected uninsured deposits). According to data derived from data made publicly available by the FDIC, between July 2008 and July 2012, 93.4% of all bank failures were resolved in a manner that fully protected uninsured deposits. Bert Ely, Failed Banks and Thrifts—2007 to 2012 (Dec. 26, 2012) (unpublished spreadsheet) (on file with author).

[54] The depositors in the arrangement that prompted the 2010 FIL were paid by the FDIC. *See* 2010 FIL, *supra* note 20. In over 25 years of practice in this area, the author has encountered only one case in which the FDIC rejected a claim for pass-through deposit insurance. In that case, an informal retirement fund maintained by a convent in its corporate capacity for retired nuns was deemed not to be eligible for pass-through deposit insurance, although the FDIC staff worked energetically to attempt to find a basis for pass-through insurance.

[55] *See When a Bank Fails—Facts for Depositors, Creditors, and Borrowers*, FDIC, http://www.fdic.gov/consumers/banking/facts/payment.html (last updated July 27, 2010). The FDIA requires the FDIC to make payments of insured deposits "as soon as possible" upon the failure of a bank. *See* 12 U.S.C. § 1821(f)(1) (2006).

II. Basics of FDIC Coverage

The FDIA,[56] the enabling statute for the FDIC, states that, in determining the amount of insurance owed to a depositor, the FDIC "shall aggregate the amounts of all deposits in the insured depository institution which are maintained by a depositor in the same capacity and the same right for the benefit of the depositor, either in the name of the depositor or in the name of any other person."[57] Embodied in this formulation are three important concepts that inform FDIC coverage:

(1) A person—a depositor—must have a "deposit";
(2) The depositor may maintain deposits in different rights and capacities, each of which is eligible for separate insurance coverage; and
(3) A deposit account maintained for the benefit of a depositor by another person will be insured as if established by the depositor directly with the bank.

A. Definition of Deposit

The FDIA defines a "deposit" as

> the unpaid balance of money or its equivalent received or held by a bank . . . in the usual course of business and for which it has given or is obligated to give credit, either conditionally or unconditionally, to a commercial, checking, savings, time, or thrift account, or which is evidenced by its certificate of deposit, thrift certificate, investment certificate, certificate of indebtedness, or other similar name, or a check or draft drawn against a deposit account and certified by the bank . . . or a letter of credit or a traveler's check on which the bank . . . is primarily liable.[58]

[56] 12 U.S.C. §§ 1811–1835A.
[57] 12 U.S.C. § 1821(a)(1)(C).
[58] 12 U.S.C. § 1813(*l*).

The FDIC references this statutory definition in its regulations without change or embellishment.[59]

The FDIC's definition of "deposit" reflects the debtor-creditor nature of a deposit relationship: a depositor lends money to a bank that the bank is obligated to re-pay—"give credit"—based upon the terms and conditions of the deposit account established by the depositor with the bank. As stated in a recent FDIC interpretation, a depositor is a "creditor with a particular type of claim against a depository institution."[60] For example, a depositor with a balance of $5,000 in a demand account is a creditor of the bank for that amount and may demand payment at any time, a demand that the bank is contractually obligated to honor. This debtor-creditor relationship differs from a bailor-bailee relationship, in which one party holds specific property for another until such time as the bailor requests or is entitled to a return of the property.[61] As noted by one commentator, "[a] positive [balance in a] demand deposit account has not traditionally been considered 'property' of the depositor in the sense that he 'owns' the funds on deposit. The balance in the account is simply a reflection of the debtor-creditor relationship . . . ."[62]

The FDIC insures all "deposits" equally. It has not adopted regulations that define types of deposit accounts, and for insurance purposes such regulations are not necessary. The Board of Governors of the Federal Reserve System ("Board") has defined types of deposit accounts for purposes of its regulations on bank reserve requirements. While the FDIC has noted that a "deposit for reserve purposes is not necessarily the same as a deposit for insurance . . . purposes,"[63] the terminology developed by the Board is a useful reference in discerning types of deposit accounts and is utilized by the federal banking regulators in regulatory reports banks are required to file.[64] The basic categories are:

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[59] 12 C.F.R. § 330.1(d) (2012).
[60] General Counsel's Opinion No. 8, *supra* note 32, at 67155.
[61] *See* Peoples Westchester Sav. Bank v. FDIC, 961 F.2d 327, 332 (2d Cir. 1992).
[62] BARKLEY CLARK & BARBARA CLARK, THE LAW OF BANK DEPOSITS, COLLECTIONS AND CREDIT CARDS ¶3.01[1] (2007).
[63] *See* Deposit Liabilities, 53 Fed. Reg. 47,723 (proposed Nov. 25, 1988).
[64] *See* FED. FIN. INSTS. EXAM'N COUNCIL, INSTRUCTIONS FOR PREPARATION OF CONSOLIDATED REPORTS OF CONDITION AND INCOME (FFIEC 031 & 041) A-17 to -25, *available at* http://www.ffiec.gov/PDF/FFIEC_forms/ FFIEC031_041_200503_i.pdf.

- *Time deposits*, deposits with a stated maturity of more than seven days;[65]
- *Transaction accounts*, including accounts payable on demand ("demand deposit accounts" or "DDAs") and "NOW" accounts, accounts that have no limitations on the number of withdrawals, but permit the bank to require seven days' advance written notice of a withdrawal; and
- *Savings deposits*, including MMDAs, deposits that have limitations on the number of withdrawals per month and permit the bank to require seven days' advance written notice of a withdrawal.

These definitions are descriptive rather than prescriptive: a bank is not required to offer the types of deposit accounts set forth in the Board's regulations, but a bank that does offer accounts with the relevant features must comply with the applicable reserve requirements. For example, nothing precludes a bank from offering a "time deposit" that permits early withdrawal of any amount without penalty at any time after the first seven days. While having the basic feature of a demand account, the deposit account would be treated as a "time deposit" for reserve purposes.

As a general matter, the establishment of a deposit account, and the terms of the account, are a matter of state contract law, and the FDIC will defer to state law in most instances.[66] However, the FDIC retains the right to determine what constitutes a "deposit" for insurance purposes.[67]

The FDIC has wrestled with the scope of the term "deposit" over the years. In 1988, the FDIC, prompted by the issuance of

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[65] Time deposits are popularly referred to as CDs, although banks typically do not issue certificates. FDIC regulations do not define the terms "certificate of deposit" or "CD."

[66] *See* Letter from Joseph A. DiNuzzo, Counsel, FDIC, to Seward & Kissel (Sept. 7, 1994) (on file with author); *see also* Letter from Julie L. Williams, First Senior Deputy Comptroller & Chief Counsel, Office of the Comptroller of the Currency, to Fred H. Miller, President, Nat'l Conference of Comm'rs on Unif. State Laws, and Lance Liebman, Director, Am. Law Inst. (June 10, 2004), *available at* http://www.occ.gov/static/interpretations-and-precedents/sep04/intsep04.html.

[67] *See* 12 U.S.C. § 1820(g)(2) (2006).

"bank notes" by some large, highly rated banks,[68] proposed a rule to define a "deposit liability" broadly to include any liability of the bank on any "promissory note, bond, acknowledgement of advance, or similar obligation that is issued or undertaken by the insured bank as a means of obtaining funds."[69] Bank notes were offered by these banks as non-deposit, uninsured liabilities. While the FDIC evidenced concern about possible confusion in the marketplace over whether the notes were insured or not, it also noted the loss to the FDIC of deposit insurance premium assessments on such notes.[70] Nevertheless, the proposed regulation included an exception for any obligation that was "subordinate to the claims of creditors, including depositors and general creditors."[71] The proposed rule was never acted upon and was withdrawn in 1995,[72] leaving open the question of whether a bank can issue debt obligations that are not deposits by simply declaring them not to be deposits and excluding the obligations from its deposit base for insurance premium assessments.

The FDIC has placed some parameters on obligations that it will treat as deposits, mostly in the context of time deposits that pay interest by referencing a stock market measure, such as the S&P 500®, or other index.[73] These products, which have become popular in the last decade, are a good example of why the FDIC needs to recognize that it is a capital markets regulator.

Since 1986, the FDIC has confirmed on several occasions that a time deposit that pays interest based on the performance of a stock market index is a "deposit" eligible for FDIC insurance because the manner in which interest is calculated on a deposit account does not determine whether it is a "deposit" for purposes of the FDIA.[74] Subsequent to the initial guidance on those deposit

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[68] Deposit Liabilities, 53 Fed. Reg. 47,723 (proposed Nov. 25, 1988).
[69] *Id*.
[70] *Id*.
[71] *Id*.
[72] Deposit Liabilities, Withdrawal of Proposed Rule, 60 Fed. Reg. 66,951 (Dec. 27, 1995).
[73] *See, e.g.*, Letter from Joseph A. DiNuzzo, Counsel, FDIC, to author (Aug. 13, 2004) [hereinafter 2004 Clark Letter], *available at* http://www.fdic.gov/regulations/laws/rules/4000-10290.html; *see also* Letter from Joseph A. DiNuzzo, Counsel, FDIC, to Sharon G. Bias, Comm'r of Banking, State of W.V. (Aug. 21, 2000) [hereinafter Bias Letter] (on file with author).
[74] *See, e.g.*, Letter from Roger A. Hood, Assistant Gen. Counsel, FDIC, to Unidentified Party (Dec. 24, 1986), *available at*

accounts, FDIC staff issued interpretive letters stating that the FDIC would not treat an obligation as a "deposit" if the depositor could incur a loss of principal as a result of a decline in the referenced index.[75] A recent consumer alert issued by the FDIC states, "If the principal is subject to loss—other than for an early withdrawal penalty—the product is not insured by the FDIC."[76] An early withdrawal penalty is, in essence, a liquidated damage that a depositor agrees to pay to a bank for breaking the depositor's agreement to maintain money on deposit until the stated maturity date.[77] Banks are not required to permit early withdrawal, and the FDIC has issued no guidance on what constitutes an appropriate penalty or, conversely, whether certain penalties are inappropriate.[78]

The FDIC staff has also taken the position that when interest is calculated based upon the performance of an index over the life of a time deposit and not payable until maturity, the interest is "contingent" and not eligible for deposit insurance if the bank fails prior to the maturity of the time deposit.[79] While acknowledging that this position conflicts with the plain language of FDIC regulations that call for the insurance of "ascertainable amounts of interest" at the date of failure, "accrued at the contract rate . . . which the insured depository institution in default would have paid if the deposit had matured on that date,"[80] the staff believes that its position is consistent with the policy objective of providing deposit insurance

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http://www.fdic.gov/regulations/laws/rules/4000-2310.html; Letter from Roger A. Hood, Assistant Gen. Counsel, FDIC, to Unidentified Party (Sept. 18, 1987), *available at* 1987 WL 451239.

[75] *See, e.g.*, Letter from William Taylor, Chairman, FDIC, to Doug Barnard, Jr., Chairman, Subcomm. on Commerce, Consumer & Monetary Affairs, Comm. on Gov't Operations (July 22, 1992) (on file with author).

[76] FDIC, *Market-Linked CDs: Don't Let the Possibility of Higher Returns Cloud Your View of the Potential Risks*, FDIC CONSUMER NEWS, Spring 2012, at 2, *available at* http://www.fdic.gov/consumers/consumer/news/cnspr12/index.html (quoting Martin W. Becker, an FDIC Senior Deposit Insurance Specialist).

[77] *See* Colonial Sav. Ass'n v. Comm'r, 854 F.2d 1001, 1007 (7th Cir. 1988).

[78] For at least a decade, FDIC staff has informally advised that an early withdrawal penalty that is based upon the market price of a CD, whether determined by the bank or a third party, is not an appropriate penalty and would cause the CD to be a non-deposit financial product.

[79] 2004 Clark Letter, *supra* note 73; *see also* Bias Letter, *supra* note 73.

[80] 12 C.F.R. § 330.3(i) (2012).

coverage based on the "depositor's legal entitlement as of the date of the institution [sic] failure."[81]

The staff has been reluctant to treat deposit account arrangements that appear to make the bank and the depositor co-venturers in an investment as a "deposit" for insurance purposes. In a 1985 letter, the staff responded to an inquiry about an "Enhanced Yield Certificate of Deposit," which would pay interest, in part, based upon the performance of investments made by a partnership involving a subsidiary of the bank and funded by a line of credit from the bank.[82] The depositor would be allowed to extend the maturity of the CD in order to enhance its profits if a final distribution of partnership profits were delayed. The FDIC declined to confirm that the arrangement was a deposit for insurance purposes.[83] Instead, the FDIC referred the requesting party to the SEC for confirmation that the arrangement was not a "security" for purposes of the federal securities laws, suggesting that if an obligation of a bank is a "security," or forms part of an investment promoted by the bank that is a "security" under the federal securities laws, it cannot be a deposit for FDIC purposes.[84]

B. Insurable Rights and Capacities

From its inception in 1933, the FDIC has been required to provide the insurance due on all deposit accounts of a depositor owned "in the same capacity or the same right."[85] This requirement was continued in 1950 when the FDIA was adopted to replace

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[81] 2004 Clark Letter, *supra* note 73.

[82] Letter from Gerald J. Gervino, Counsel, FDIC, to Unidentified Party (Oct. 25, 1985), *available at* 1985 WL 303864 (Oct. 25, 1985). The Office of the Comptroller of the Currency also has noted that a deposit account cannot be contingent on the bank's strategies to hedge its interest rate exposure. *See Decision of the Comptroller of the Currency on the Request by Chase Manhattan Bank, N.A. to Offer the Chase Market Index Account* (Aug. 8, 1988) (on file with author).

[83] Letter from Gerald J. Gervino to Unidentified Party, *supra* note 82.

[84] *Id*. at *2. In a meeting with the author in August 2009, FDIC staff informally declined to confirm that a CD characterized as a "security" by the bank was a "deposit." Similarly, the FDIC has sought and obtained a representation that a security had not been created by a program discussed in correspondence seeking the opinion of FDIC staff. *See* 2011 Clark Letter, *supra* note 23.

[85] 12 U.S.C. § 1821(a)(1)(C) (2006).

Section 12B of the Federal Reserve Act.[86] However, the FDIC did not identify specific rights and capacities that were eligible for separate insurance until 1967. Prior to that time, the FDIC relied upon state law to determine different forms of deposit account ownership.[87] Because of differences in state law, this approach—as noted in an FDIC publication celebrating the first fifty years of the FDIC—"often led to confusion and sometimes hard feelings on the part of depositors in closed banks."[88]

In 1967, the FDIC—utilizing authority granted to it by Congress in 1966 to define terms in the FDIA for the purpose of clarifying and defining insurance coverage[89]—adopted regulations that enumerated seven distinct categories of deposit account ownership that would receive separate insurance for deposits at the same bank:[90]

1. Single ownership;
2. Accounts held by executors, including revocable trusts, payable-on-death accounts and Totten Trusts;
3. Corporations/Partnerships;
4. Unincorporated Associations;
5. Public Unit Accounts;
6. Joint Accounts; and
7. Trust Accounts.[91]

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[86] *See supra* note 3.
[87] *See* FDIC, *supra* note 2, at 69.
[88] *See id.* at 70.
[89] Financial Institutions Supervisory Act of 1966, Pub. L. No. 89-695, § 303(a), 80 Stat. 1028 (1966) (amending 12 U.S.C. § 1813(m) (1964)). In 1991, Congress revised Section 3(m) of the FDIA and, in doing so, eliminated that authority. At the same time, Congress added a new subsection to Section 10 of the FDIA that confers on the FDIC the authority to define by regulation all terms as necessary to carry out the FDIA, except to the extent such authority is conferred on any of the other federal banking agencies. 12 U.S.C. § 1820(g) (2006).
[90] Clarification and Definition of Deposit Insurance Coverage, 32 Fed. Reg. 10,408 (July 14, 1967) (codified at 12 C.F.R. pt. 330).
[91] It should be noted that the FDIA, as originally enacted in 1950, provided that the insurance for trust funds held by an insured depository institution in a fiduciary capacity at that institution *or at another insured depository institution* was to be "separate from and additional to that covering other deposits of the owners of such trust funds or the beneficiaries of such trust estates." Federal Deposit Insurance Act, Pub. L. No. 81-797, 64 Stat. 873,

In 1978, Congress amended the FDIA to provide separate insurance coverage for deposit accounts held in Individual Retirement Accounts ("IRAs") and retirement accounts permitted for self-employed individuals, referred to as "Keogh" accounts.[92] The ambiguous language of the statute led to certain illogical results that had to be addressed in a staff advisory opinion, including the fact that time and savings deposits would be eligible for the separate insurance available to IRAs and Keoghs, but demand deposit accounts would be aggregated with deposits at the bank held through any other trust arrangements of which the depositor was a beneficiary and not covered by the separate insurance applicable to the IRA or Keogh. Deposit accounts held in an IRA were eligible for separate insurance from deposit accounts held in a Keogh in most, but not all, circumstances.[93]

The savings and loan crisis of the 1980s, and the resulting insolvency of the Federal Savings and Loan Insurance Corporation ("FSLIC"), led to the adoption of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA"). [94] FIRREA

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879 (1950) (codified as amended at 12 U.S.C. § 1817(i) (2006). Although mentioned in the FDIA, this separate insurance coverage was not incorporated in the FDIC's regulations until 1990, when the FDIC adopted uniform deposit insurance regulations for both banks and savings associations. The Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA") eliminated this separate insurance coverage for trust funds generally, but retained it for funds held by an insured depository institution in a fiduciary capacity at the fiduciary institution itself or at another institution as trustee pursuant to an irrevocable trust established pursuant to any statute or written trust agreement. Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, § 311(b)(3), 105 Stat. 2236 (1991). The FDIC's regulations were revised accordingly. *See* Deposit Insurance Coverage, 58 Fed. Reg. 29, 952 (May 25, 1993) (codified at 12 C.F.R. pt. 330).

[92] Financial Institutions Regulatory and Interest Rate Control Act of 1978, Pub. L. No. 95-630, § 1401(a), 92 Stat. 3641 (1978) (adding Section 11(a)(3) of the Federal Deposit Insurance Act, 12 U.S.C. § 1821(a)(3) (2006)).

[93] Memorandum from Robert E. Feldman, Attorney, FDIC, to Roger A. Hood, Assistant Gen. Counsel, FDIC (Jan. 27, 1982), *available at* 1982 WL 213073.

[94] Pub. L. No. 101-73, § 301, 401 Stat. 183 (1989). Two separate deposit insurance funds were established by FIRREA—the Bank Insurance Fund and the Savings Association Insurance Fund—each administered by the FDIC. The two funds were later merged and renamed the Deposit Insurance

incorporated the independent Federal Home Loan Bank Board ("FHLBB"), which had administered the FSLIC and regulated savings and loan associations, into an office of the Department of the Treasury named the Office of Thrift Supervision and brought the insurance of deposits at savings and loans under the regulation of the FDIC. FIRREA required the FDIC to adopt uniform deposit insurance regulations taking into account "regulations, principles and interpretations for deposit insurance coverage established by the former [FSLIC]."[95] As adopted in 1990, these new regulations added separate insurance coverage for employee benefit plans, including defined benefit and defined contribution plans. Employee benefit plans had previously been insured under the trust account provisions of these regulations. Deposit accounts held by such retirement plans would be aggregated with other deposited funds at the same bank representing the interest of the same beneficiary "in other employee benefit plans . . . established by the same employer or employee organization."[96]

The final significant change to the rights and capacities eligible for separate insurance was made by The Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA").[97] FDICIA granted the beneficiaries of certain retirement plans established by state and local governments—known as "457 Plans" for a section of the Internal Revenue Code ("Code")—pass-through deposit insurance, but required aggregation of deposit accounts at the same bank held through 457 Plans, IRAs, Keoghs, and other self-directed retirement accounts for insurance purposes.[98] Regulations adopted in 1993 to implement the changes made by FDICIA incorporated this new provision.[99]

Subsequent to the passage of FDICIA by Congress and the adoption of implementing regulations by the FDIC, the FDIC—by informal statement, interpretive advice, or rule—has clarified the insurance treatment of certain additional types of accounts that were

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Fund. Federal Deposit Insurance Reform Act of 2005, Pub. L. No. 109-171, § 2102, 120 Stat. 4 (2006).

[95] Deposit Insurance Coverage, 54 Fed. Reg. 52,399 (Dec. 21, 1989).

[96] 12 C.F.R. § 330.14(b) (2012).

[97] Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, 105 Stat. 2236.

[98] *Id.* § 311(b)(2), 105 Stat. at 2364–65.

[99] Deposit Insurance Coverage, 58 Fed. Reg. 29, 952, 29,957 (May 25, 1993) (codified at 12 C.F.R. pt. 330).

established pursuant to acts of Congress. For instance, the FDIC has stated informally that Coverdell Education Savings Accounts (sometimes referred to as Education IRAs), which were established by Congress in 1997, are treated as irrevocable trust accounts and not individual retirement accounts.[100] Medical Savings Accounts—which were established by Congress in 1998—may, depending on how they are structured, be treated as (1) individual accounts and aggregated with a person's other individual accounts; (2) revocable trusts entitled to separate insurance coverage; or (3) employee benefit plan accounts and entitled to separate insurance coverage.[101] In 2005, the FDIC amended its regulations to provide that accounts held by "529 Plans," education savings plans established by Congress in 1996 under Section 529 of the Code, would not be treated as corporations, i.e., insurance would "pass through" the 529 Plan to its participants, provided certain conditions are met.[102]

C. Accounts Established by Another Person

Like the requirement to insure deposit accounts held in separate rights and capacities, the requirement to insure deposit accounts established by an intermediary dates to the Banking Act of 1933, which required the FDIC to add together all net amounts due to an owner of an insurance claim "whether such deposits be maintained in his name or in the name of others for his benefit."[103] The FDIC's implementation of this statutory requirement over the last 80 years has evolved significantly, both with respect to the types of relationship that are eligible for pass-through insurance, and the conditions for eligibility.

The FDIC promulgated its first regulations in 1938, but did not address deposit accounts held by an agent, custodian, or other

[100] *See Your Insured Deposits: Questions and Answers*, FDIC: FEDERAL DEPOSIT INSURANCE CORPORATION, http://www.fdic.gov/deposit/deposits/insured/faq.html#coverdell (last updated Aug. 22, 2011).
[101] Letter from Joseph A. Genova, Jr., Senior Regional Attorney, FDIC, to Unidentified Party (June 22, 1998), *available at* 1998 WL 794894.
[102] *See* Deposit Insurance Coverage; Accounts of Qualified Tuition Savings Programs Under Section 529 of the Internal Revenue Code, 70 Fed. Reg. 62,057 (Oct. 28, 2005) (codified at 12 C.F.R. pt. 330) (amending 12 C.F.R. § 330.11(a)(2) (2005).
[103] 12 U.S.C. § 264(*l*) (1946) (repealed 1950).

intermediary.[104] The regulations did contain a section titled "Recognition of Deposit Ownership Not on Bank Records," which addressed the treatment of certain negotiable instruments, such as certificates of deposit and letters of credit, and permitted the holders of these instruments to be "recognized for all purposes of claims for insured deposits to the same extent as if his name and interest were disclosed on the records of the bank."[105]

In 1946, the FDIC adopted the first regulations that specifically recognized the pass through of insurance on "deposits" held through a custodial relationship.[106] The regulations permitted recognition of the amount of "any portion of a deposit" on the records of a bank "under a name other than that of the claimant, whose name or interest as such owner is not disclosed on the records of the closed bank . . . to the same extent as if his name and interest were disclosed on the records of the bank."[107] The deposit account was required to be maintained as a "specifically designated deposit account or accounts in such a manner as to disclose the custodial nature thereof." Furthermore, the name and interest of each such owner had to be disclosed in the records of the person maintaining the deposit in "good faith and in the regular course of business."[108] No reference was made to deposit accounts maintained by an "agent or nominee," and no definition of the term "custodial nature" was provided.

In 1967, after the enactment of the Financial Institutions Supervisory Act of 1966, the FDIC adopted regulations[109] that significantly revised the 1946 regulations. For the first time, the regulations set forth an operational framework for determining the insurance of deposit accounts. These "General principles applicable in determining insurance of deposit accounts," as the relevant section of the regulations was titled, provided the foundation for pass-through insurance as it exists today.[110] Under the general principles, the deposit accounts of a bank "shall be conclusive as to the

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[104] *See* 12 C.F.R. § 305.1 (1938).
[105] *Id.*
[106] 11 Fed. Reg. 177A-431, 177A-449 (Sept. 11, 1946) (codified at 12 C.F.R. § 330.4).
[107] *Id.*
[108] *Id.*
[109] *See supra* notes 89–91 and accompanying text.
[110] Clarification and Definition of Deposit Insurance Coverage, 32 Fed. Reg. 10,408 (July 14, 1967) (codified at 12 C.F.R. pt. 330).

existence of any relationship . . . on which a claim for insurance coverage is founded."[111] The section then lists, as "examples," deposit accounts held by a trustee, agent, custodian, or executor. If the deposit account records "disclose the existence of a relationship which may provide a basis for additional insurance, the details of the relationship and the interests of other parties in the account must be ascertainable either from the records of the bank or the records of the depositor maintained in good faith and in the regular course of business."[112]

Having set forth a reasonable set of principles, the regulations proceed to confuse. As discussed above, the 1967 regulations specified, for the first time, the various rights and capacities that would be eligible for separate insurance coverage. Under the section entitled "Single ownership accounts"—which were defined to include an individual "(or by the community between husband and wife, of which the individual is a member)"—are two subsections entitled "Accounts held by agents or nominees" and "Accounts held by guardians, custodians, or conservators," respectively.[113] Since the single ownership capacity was the only capacity in the regulations that specified the pass through of insurance for accounts established by an intermediary, it follows that deposit accounts established by an intermediary on behalf of corporations, partnerships, public units, or other recognized insurable capacities would not have been eligible for pass-through insurance.

In addition, while the subsection on agents and nominees did not limit the scope of such relationships, the scope of a recognized custodial relationship was narrow: "[f]unds held by a guardian, custodian, or conservator for the benefit of his ward or for the benefit of a minor under a [sic] Uniform Gifts to Minors Act."[114] The adopting release did not explain the scope of the pass-through provision, leaving it unclear whether the FDIC intended to include broader custodial relationships (such as those maintained at a broker-dealer or bank) through the agency section, or preclude pass-through insurance altogether in the case of such relationships.

Adding to the confusion, the FDIC included in the regulations an "Interpretation of the Board" concerning the insurance of fractional interests in commingled funds held through a "custodial

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111 *Id.*
112 *Id.*
113 *Id.*
114 12 C.F.R. § 330.7(b) (2012).

account" at a bank.[115] The FDIC Board concluded that if the general principles for insurance coverage were met—i.e., the deposit account records indicated the existence of a custodial relationship and records "maintained in good faith and the regular course of business" reflected the name and ascertainable interest of each owner "in a specifically designated custodial deposit"—the interest would be insured on a fractional or percentage basis.[116] There is no indication whether the guidance was directed solely to the custodial accounts set forth under the "single ownership" section or to a broader range of custodial relationships as suggested by the "general principles."

In 1977, the FDIC amended its regulations with respect to insurance coverage for corporations to provide that "any trust or other business arrangement which has filed or is required to file a registration statement with the Securities and Exchange Commission pursuant to Section 8 of the Investment Company Act of 1940 . . . shall be deemed to be a corporation."[117] The effect of this amendment was to prohibit pass-through deposit insurance for many investment companies—mutual funds—organized as business trusts rather than corporations, even though beneficiaries of a trust were

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[115] Clarification and Definition of Deposit Insurance Coverage, 32 Fed. Reg. 10,408, 10,409 (July 14, 1967) (codified at 12 C.F.R. pt. 330).

[116] *Id.* at 10,410.

[117] 12 C.F.R. § 330.11(a)(2) (2012). The rule was modified in 1990 to deny insurance to any trust or business arrangement that would be required to register as an investment company "but for sections 2(b), 3(c)(1) or 6(a)(1)" of the ICA. Deposit Insurance Coverage, 55 Fed. Reg. 20,111, 20,126 (May 15, 1990) (codified at 12 C.F.R. pts. 330, 331, 386). Section 2(b) states that the ICA is inapplicable to any corporation owned directly or indirectly by one or more of the United States, a State or any political subdivision. 15 U.S.C. § 80a-2(b) (2006). Section 3(c)(1) excludes any issuer that is beneficially owned by 100 persons or less from the definition of investment company and therefore from compliance with the ICA. *Id.* § 80-a3(c)(1). Section 6(a)(1) exempts investment companies that would otherwise be required to comply with the ICA from compliance if such company is organized or otherwise created under the laws of and having its principal place of business in Puerto Rico, the Virgin Islands, or any other possession of the United States and does not offer any security to a resident of any state other than the state in which it is organized. *Id.* § 80-a6(a)(1) (2006). The rule was modified again in 2005 to provide that 529 Plan accounts would not be deemed corporations so long as certain requirements are met. Deposit Insurance Coverage; Accounts of Qualified Tuition Savings Programs Under Section 529 of the Internal Revenue Code, 70 Fed. Reg. 62,057, 62,058 (Oct. 28, 2005) (codified at 12 C.F.R. pt. 330).

typically eligible for pass-through insurance. In addition, the language "or is required to file a registration statement" denied pass-through coverage to arrangements that were investment companies but have failed to register with the SEC.

The rationale for this amendment was not stated in the adopting release. However, the 1970s were a time of rising interest rates. Money market mutual funds, which, unlike banks, were not restricted on the interest rates they could offer, were attracting—or "disintermediating"—deposits from banks. In 1975, at least one money market fund organized as a business trust was marketing the availability of FDIC pass-through insurance to shareholders on CDs purchased by the fund based upon its status as a trust and a letter from an FDIC staff attorney. The letter was subsequently withdrawn.[118] It is likely that the FDIC acted to prevent money market funds from enjoying both the advantage of higher interest rates and FDIC insurance.

The FDIC staff provided important interpretive guidance concerning the application of the insurance regulations to custodial relationships in July of 1983.[119] A broker-dealer that wished to offer MMDAs to its customers requested confirmation that deposit insurance would "pass through" to the customer, or to persons for whom the customer was acting, if the broker established the MMDA in its name at each bank. Each MMDA would "be evidenced by a book-entry on the records of the bank as follows: '[t]he Broker-Dealer for itself and as nominee or custodian for others; including trusts, pension and retirement plans and accounts, fiduciaries, custodians, and nominees.'"[120] The staff did not discuss the broker's role as "nominee or custodian," but referred to the broker-dealer as an "agent" and confirmed the availability of pass-through insurance to each beneficial owner based upon the existence of an "ascertainable and contingency-free interest" in the MMDA determined by records maintained by the broker-dealer and, as applicable, records maintained by any "fiduciary" for whom the broker was acting.[121]

The letter is important for several reasons. It is one of the earliest FDIC interpretive letters to confirm the availability of pass-

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[118] *See The Coup That Collapsed*, FORBES, Jan. 15, 1975.
[119] Letter from Joseph A. DiNuzzo, Senior Attorney, FDIC, to Seward & Kissel (July 29, 1983) (on file with author).
[120] *Id.*
[121] *Id.*

through insurance for deposit accounts made available through a broker-dealer.[122] It clarifies the scope of the section of the FDIC's regulations concerning accounts established for individuals—single owners—by "agents and nominees" by including custodians within the scope of those terms, even though the regulations could be read to give a very narrow reading to the term "custodian." It also appears to permit an agent to establish an account for entities other than individuals. The use of the term "others" would not limit the nature of the broker's clients. Finally, it recognizes that an agent can act for other agents or fiduciaries and provides that the FDIC would look to the records of each agent or fiduciary at each level of ownership in order to identify the ultimate beneficial owner or beneficiary.

As discussed in greater detail below, four months after the 1983 staff interpretive letter, the FDIC and the FHLBB published an Advance Notice of Proposed Rulemaking seeking comment on whether the FDIC and the FHLBB should adopt a rule denying pass-through deposit insurance to deposit accounts established at a bank by a "deposit broker" for its customers.[123] The need to adopt a rule to deny pass-through insurance to brokered deposits suggests that the FDIC Board had concluded, despite the confusing structure of the regulations, that existing regulations required the FDIC to provide pass-through insurance to most, if not all, agency relationships.

The regulations adopted by the FDIC in 1990 after enactment of FIRREA re-structured the regulations adopted in 1967 into the general form in which they appear today.[124] At first glance, it would appear that the regulations concerning pass-through insurance were consolidated under a section headed "Recognition of Deposit Ownership and Recordkeeping Requirements,"[125] which contained some of the "general principles" from the earlier regulations, as well

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[122] Seward & Kissel has advised numerous broker-dealers on brokered deposit arrangements since the inception of the product in the early 1980s and is, therefore, familiar with the history of their regulation by the FDIC. It is the understanding of the author that there may have been several letters issued by the FDIC with respect to brokered deposit arrangements prior to the 1983 letter to Seward & Kissel.

[123] *See infra* Part III.

[124] Deposit Insurance Coverage, 55 Fed. Reg. 20,111 (May 15, 1990) (codified at 12 C.F.R. pt. 330, 331, 386).

[125] *See* 12 C.F.R. § 330.5 (2012).

as specific requirements for pass-through deposit insurance.[126] This section will be referred to as "Regulation 330.5."

A single subsection headed "Recordkeeping requirements" contained the operational requirements for pass-through insurance, including, for the first time, a clear statement that pass-through insurance would be available if deposit account records disclose "the existence of any fiduciary relationship including, but not limited to, relationships involving a trustee, agent, nominee, guardian, executor or custodian."[127] As with the earlier regulations, the identities of other parties with interests in the deposit account must be ascertainable from either the records of the bank or "from records maintained, in good faith and in the regular course of business" by the fiduciary.[128]

The regulations also set forth the manner in which "multi-tiered fiduciary relationships" would be recognized.[129] This could occur when an agent, such as a broker-dealer, is acting for another fiduciary, such as the trustee of an employee benefit plan. In such a case, the regulations would permit pass-through insurance to the beneficiaries of the plan if (1) the bank's deposit account records indicate that the fiduciary is acting on behalf of persons or entities "who may, in turn, be acting in a fiduciary capacity for others";[130] (2) the existence of additional levels of fiduciary relationships is disclosed in records "maintained in good faith and in the regular course of business" at each subsequent level; and (3) the name and interests of the person on whose behalf the fiduciary is acting is

[126] The FDIC's current insurance regulations contain a "general principles" section at 12 C.F.R. § 330.3 (2012), but it does not address pass-through insurance.
[127] 12 C.F.R. § 330.5(b)(1).
[128] *Id.* § 330.5(b)(2).
[129] *Id.* § 330.5(b)(3).
[130] On more than one occasion, FDIC staff has approved the manner in which ownership of deposit accounts will be recorded on the books and records of a bank as adequately reflecting the existence of one or more levels of fiduciary relationship. *See, e.g.*, Letter from Roger A. Hood, Assistant General Counsel, FDIC, to Anthony C.J. Nuland, Esq. (May 24, 1996) (on file with the author), in which the FDIC staff stated that the use of "[Financial Intermediary] for itself and others acting for themselves and others" would "adequately disclose the existence of multiple levels of fiduciary relationships under 12 C.F.R. [§ 330.4(b)(3)(ii)(A)]." 12 C.F.R. § 330.4(b)(3)(ii)(A) is a predecessor version of 12 C.F.R. § 330.5(b)(3)(ii)(A)).

disclosed at each level.[131] Though somewhat repetitive, the regulations clearly permit reliance on the records of the fiduciary at each level to determine insurance.

While this broad provision on deposit accounts held in a "fiduciary relationship" would appear to have clarified the ambiguities in the 1967 regulations created by allocating different types of intermediaries (e.g., agents, nominees, guardians, custodians, etc.) into separate subsections under the "single ownership" section, the FDIC continued the ambiguity by adopting an entirely new, and separate, section entitled "Accounts held by an agent, nominee, guardian, custodian or conservator."[132] This section will be referred to as "Regulation 330.7." One subsection, titled "Agency or nominee accounts," provides that funds of a principal deposited into deposit accounts in the name of an "agent, custodian or nominee" will be insured as if the deposit account is established in the name of the principal.[133] A separate subsection, titled "Guardian, custodian or conservator accounts," narrowly addresses funds held by a guardian, custodian, or conservator for the benefit of a ward or for a minor under the Uniform Gifts to Minors Act.[134] The provision goes on to state that such accounts shall be deemed agency or nominee accounts for purposes of the prior subsection.[135]

No particular purpose appears to be served by including these duplicative and somewhat circular provisions. It can be argued that Regulation 330.7 authorizes pass-through coverage of specified types of intermediary accounts and that Regulation 330.5 on "fiduciary relationships" is merely operational. Indeed, many interpretive letters on pass-through insurance cite both sections of the regulations, though never explaining how the two sections relate.[136] While Regulation 330.7, the more narrowly drafted provision, would not appear to provide a basis for denying pass-through insurance to a "fiduciary relationship" that would qualify under Regulation 330.5, the broader provision described above, the specificity of the type of relationships covered by Regulation 330.7 certainly suggests that there may be some relationships covered by Regulation 330.5 that the FDIC would not recognize as eligible for pass-through insurance.

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131 12 C.F.R. § 330.5(b)(3).
132 *Id.* § 330.7.
133 *Id.*
134 *Id.*
135 *Id.*
136 *See, e.g.*, 2011 Clark Letter, *supra* note 23.

The 1990 regulations also incorporated the interpretation that had been codified in the 1967 regulations concerning the treatment of custodial deposits. That provision stated that "where the funds of an owner are commingled with other funds held in a custodial capacity and a portion thereof is placed on deposit in one or more insured depository institutions without allocation, the owner's insured interest in such a deposit in any one insured depository institution would represent, at any given time, the same fractional share as his or her share of the total commingled funds." As with the earlier "interpretation," no indication was given as to the types of custodial relationships the provision was intended to address or the meaning of the concept of "commingled funds."[137]

The FDIC's regulations have historically deferred to state law with respect to deposit insurance determinations.[138] The 1990 regulations provided an important change in the FDIC's position with respect to deference to state law. The FDIC's regulations as amended in 1990, and as slightly modified since then, currently state:

> [W]hile ownership under state law of deposited funds is a necessary condition for deposit insurance, ownership under state law is not sufficient for, or decisive in, determining deposit insurance coverage. Deposit insurance coverage is also a function of the deposit account records of the insured depository institution and of the provisions of this part, which, in the interest of uniform national rules for deposit insurance coverage, are controlling for purposes of determining deposit insurance coverage.[139]

In 1998, the FDIC amended its regulations to provide greater flexibility in granting pass-through coverage where there is not an express indication of the existence of a fiduciary relationship on the deposit account records, but the titling of the account and the deposit account records sufficiently indicate the existence of a fiduciary

[137] *See* 12 C.F.R. § 330.5(a)(2).
[138] This policy was first codified in 1967 at 12 C.F.R. § 330.1(a) (1968), which reads, "Insofar as rules of local law enter into such [deposit insurance] determinations, the law of the jurisdiction in which the insured bank's principal office is located shall govern."
[139] 12 C.F.R. § 330.3(h) (2012).

relationship.[140] The regulations state that "[t]his exception may apply, for example, where the deposit account title or records indicate that the account is held by an escrow agent, title company or a company whose business is to hold deposits and securities for others."[141]

III. Rejections of Challenges to Pass-Through Insurance

Both the courts and Congress have rejected attempts to limit the scope of pass-through deposit insurance. In the only judicial review of an attempt to limit pass-through insurance, the U.S. District Court for the District of Columbia (and, on review, the U.S. Court of Appeals for the District of Columbia Circuit) rejected an attempt by the FDIC to limit pass-through insurance by re-defining terms in the FDIA, raising questions about the authority of the FDIC in its recent guidance to establish criteria that have the effect of denying deposit insurance when a deposit account is established by a custodian "for the benefit of" a principal.

On January 23, 1984, the FDIC and the FHLBB published proposed regulations that would have aggregated and insured only up to $100,000[142] of all deposits placed by or through a "deposit broker"[143] at a single insured depository institution, without regard to the number of beneficial owners of the deposits.[144] Because the beneficial owner of the deposit would have been denied deposit insurance, this rule would have had the effect of eliminating the brokering of fully insured deposits. The regulations were published in final form on April 2, 1984, and were to take effect on October 1, 1984.[145]

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[140] Simplification of Deposit Insurance Rules, Final Rule, 63 Fed. Reg. 25,750 (May 11, 1998) (codified at 12 C.F.R. pt. 330).
[141] 12 C.F.R. § 330.5(b)(1).
[142] $100,000 was the then current deposit insurance limit. 12 C.F.R. § 330.2 (1983).
[143] The definition of the term "deposit broker" proposed by the FDIC and FHLBB formed the basis of the definition of the term as it currently exists in the FDIA and the FDIC's regulations. *See* 12 U.S.C. § 1831f(g)(1) (2006); 12 C.F.R. § 337.6(a)(5) (2012).
[144] Brokered Deposits; Limitations on Deposit Insurance, 49 Fed. Reg. 2787, 2789 (proposed Jan. 23, 1984).
[145] Brokered Deposits; Limitations on Deposit Insurance, 49 Fed. Reg. 13,003 (Apr. 2, 1984) (codified at 12 C.F.R. pt. 330).

On June 20, 1984, the U.S. District Court for the District of Columbia ruled that the FDIC and FHLBB had exceeded their statutory authority in issuing the regulations, and enjoined the agencies from implementing them. On January 30, 1985, the U.S. Court of Appeals for the District of Columbia Circuit affirmed the District Court's decision.[146]

In overturning the regulations the Court of Appeals quoted the provisions of the FDIA stating that the amount due any depositor shall be determined by adding together all deposits "maintained in the same capacity and the same right for his benefit either in his own name or in the names of others," and concluded:

> These provisions establish a clear and unequivocal mandate that the FDIC shall insure each depositor's deposits up to $100,000, determining the amount of those deposits by adding together all accounts maintained for the benefit of the depositor, whether or not in the depositor's name. There is no exception based upon the identity of the person opening, or responsible for opening, the account.[147]

The Court of Appeals also rejected the FDIC's claim that its authority to define terms in the statute provided authority for the regulations. The court held that "[a] general authority to define terms, and the extent of insurance coverage resulting from those terms, does not confer power to *redefine* those terms that the statute itself defines."[148]

It is significant that the FDIC does not cite the *FAIC Securities* case in any interpretive letters or offer an explanation of how the courts' interpretation of the FDIA affects the FDIC's authority to limit pass-through insurance in cases where a deposit is maintained for the benefit of one person by another.

The controversy surrounding the regulations resulted in three congressional hearings on brokered deposits in the years 1984 and 1985.[149] During these hearings, the Chairmen of the FDIC and the

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[146] FAIC Sec., Inc. v. United States, 595 F. Supp. 73 (D.D.C. 1984), *aff'd*, 768 F.2d 352 (D.C. Cir. 1985).
[147] FAIC Sec., Inc. v. United States, 768 F.2d at 361.
[148] *Id*. at 362 (emphasis in original).
[149] *Proposed Restrictions on Money Brokers: Hearing Before the Subcomm. on Commerce, Consumer and Monetary Affairs of the H. Comm. on*

FHLBB defended the rationale behind their regulations and asserted that fully insured brokered deposits were (1) permitting weak institutions to grow rapidly; (2) causing institutions to fail; and (3) increasing the exposure of the deposit insurance funds.[150] These views were contradicted by members of the securities industry and, to varying degrees, by the Office of the Comptroller of the Currency, the Board, the Treasury Department, and other witnesses. The Comptroller of the Currency testified that brokered deposit abuses by national banks were being controlled through existing supervisory measures and that "there was no need to remove the deposit insurance coverage on brokered funds in order to control the abuses."[151]

In two reports, the House Committee on Government Operations (the "Committee") called the rationale behind the regulations and the concerns of the FDIC and the FHLBB into question. In its 1984 report, the Committee found that brokered deposits were not "a significant source of deposit growth for the great majority of rapidly growing problem institutions during the period from December 31, 1983 through March 31, 1984" and concluded that brokered deposits have a "legitimate and useful function in financial markets and should not be needlessly restricted."[152] The Committee reiterated its conclusions in a subsequent report in 1986.[153]

During congressional consideration of FIRREA in 1989,[154] amendments were adopted that prohibited undercapitalized banks from accepting brokered deposits without a waiver from the FDIC.[155] At a hearing on May 17, 1989, each of the federal banking regulators testified that the restrictions were unnecessary because the agencies could respond to abuses on a case-by-case basis. William Seidman,

Government Operations, 98th Cong. 1 (1984); *Brokered Deposits: Hearing Before the Subcomm. on Financial Institutions and Consumer Affairs of the S. Comm. on Banking, Hous. and Urban Affairs*, 99th Cong. 1 (1985); *Impact of Brokered Deposits on Banks and Thrifts: Risks Versus Benefits: Hearing Before the Subcomm. on General Oversight and Investigations of the H. Comm. on Banking, Finance and Urban Affairs*, 99th Cong. 1 (1985).

150 H.R. REP. NO. 98-1112, at 6 (1984).

151 *Id*. at 7.

152 *Id*. at 9.

153 H.R. REP. NO. 99-676, at 13 (1986).

154 Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, § 101, 103 Stat. 183, 187.

155 12 U.S.C. § 1831f(c) (2006).

who had been appointed Chairman of the FDIC in 1985, framed the issue in a manner that remains one of the clearest statements about the role of deposit funding in bank failures:

> A dollar deposited in an insured institution is the same whether obtained directly from a local depositor or through the intermediation of a deposit broker. There may be differences in the cost and stability of that dollar deposit depending on its source. However, losses in banks do not occur, generally speaking, by virtue of the source of their deposit liabilities. Instead, the losses arise from the quality of and return on loans and investments made with those funds. Consequently, the focus of attention should be on the employment of brokered deposits rather than their source.[156]

Nevertheless, Congress adopted the limited restrictions on brokered deposits.[157]

FIRREA also contained a provision mandating a comprehensive Treasury Department study of the federal deposit insurance system, including the feasibility of restrictions on brokered deposits.[158] The Treasury Department study, released in February 1991, recommended the elimination of deposit insurance for brokered deposits.[159] The basis for this recommendation was that brokered deposits "help insulate depository institutions from the risk-taking checks normally imposed by the market, make it easier to

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[156] *Insured Brokered Deposits and Fed. Depository Insts: Hearing Before the Subcomm. on General Oversight and Investigations of the H. Comm. on Banking, Fin. and Urban Affairs*, 101st Cong. 98 (1989) (statement of L. William Seidman). Chairman Seidman's views on the relative insignificance of the source of funding was echoed by at least one of the banking industry representatives participating in the FDIC's March 18, 2011 Core and Brokered Deposits Roundtable. *See* David Hayes, Remarks at FDIC Core and Brokered Deposits Roundtable (Mar. 18, 2011) (transcript available at *www.fdic.gov/regulations/reform/3-18-11transcript.pdf).*

[157] Financial Institutions Reform, Recovery, and Enforcement Act § 224, 103 Stat. at 273.

[158] *Id.* § 1001(b), 103 Stat. at 507.

[159] U.S. DEP'T OF THE TREASURY, MODERNIZING THE FINANCIAL SYSTEM: RECOMMENDATIONS FOR SAFER, MORE COMPETITIVE BANKS iv-5 (1991).

raise insured deposits—thereby expanding the scope of deposit insurance coverage—and thus increase taxpayer exposure to potential losses."[160]

Prior to the release of the Treasury Department study, the federal banking regulators testified before Congress that brokered deposits provided certain benefits to the banking system,[161] and that FIRREA had established sufficient authority for the regulators to address any problems arising from potential abuses.[162] In hearings conducted after the release of the Treasury Department study, each of the three federal banking regulators who testified endorsed the recommendation to eliminate deposit insurance for brokered deposits.[163]

During congressional deliberations on FDICIA, the Treasury Department's proposal to eliminate deposit insurance on brokered deposits was rejected by both the House and the Senate.[164] Each body opted instead to expand the restrictions on the acceptance of brokered deposits included in FIRREA.[165] The final provisions included in FDICIA utilize the "prompt corrective action" capital

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[160] *Id.*

[161] *See Deposit Ins. Reform: Hearings Before the H. Comm. on Banking, Fin., and Urban Affairs,* 101st Cong. 183–84 (1990) (statement of Alan Greenspan, Chairman, Bd. of the Governors of the Fed. Reserve Sys.).

[162] *See Deposit Ins. Reform and Fin. Modernization: Hearings Before the S. Comm. on Banking, Hous. and Urban Affairs (Vol. III)*, 101st Cong. 439 (1990) (colloquy between Donald W. Riegle Jr., Chairman, S. Comm. on Banking, Hous. and Urban Affairs, and L. William Seidman, Chairman, FDIC).

[163] *See, e.g.*, *Restructuring of the Banking Industry: Hearings Before the Subcomm. on Fin. Inst. Supervision, Regulation and Ins., H. Comm. on Banking, Fin. and Urban Affairs (Part 2),* 102d Cong. 191 (1991) (statement of L. William Seidman, Chairman, FDIC). Following FDIC Chairman Seidman's testimony, the author participated in a meeting with Chairman Seidman in which he said that he had endorsed the Treasury Department's recommendation because defending brokered deposits was distracting him from other important issues and that he would be willing to work toward a compromise solution. The FDIC never objected to the compromise solutions proposed, and ultimately adopted, by Congress.

[164] *Compare* H.R. 1505, 102d Cong. (1991), *and* S. 713, 102d Cong. (1991), companion bills introduced in the House and the Senate on March 20, 1991, at the request of the Administration, which contained the Treasury Department's recommendations, *with* FDICIA, Pub. L. No. 102-242, 105 Stat. 2236 (1991).

[165] *Id.*

categories as a basis for eligibility to accept funds from a deposit broker.[166] A "well capitalized" bank can accept brokered deposits without restrictions.[167] An "adequately capitalized" bank can accept brokered deposits only with a waiver from the FDIC.[168] Banks in capital categories lower than "adequately capitalized" are prohibited from accepting brokered deposits.[169]

As set forth in a 1995 interpretive letter, the FDIC's position on brokered deposits after FDICIA was generally neutral:

> [T]he prudent use of brokered deposits within legal requirements is entirely acceptable. Brokered deposits should be treated and assessed as any other funding alternative having its own special advantages and disadvantages. Furthermore, the acceptance of brokered deposits should not be grounds for criticism *per se* by virtue of the nature or origin of such deposits without considering the manner in which they are used and the impact of such use on the institution's overall condition and operations.[170]

Whether as a result of this more even-handed approach—or, because of changes in bank funding strategies—between December 31, 1992, and June 30, 2008, the amount of fully-insured brokered deposits reported grew from \$46 billion to \$462 billion.[171] This number does not include approximately \$150 to \$200 billion of deposits placed by broker-dealers at their affiliated banks that were exempt from being reported as "brokered" or brokered deposits

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166 *See* 12 U.S.C. § 1831o (2006 & Supp. V 2011). FDICIA established the "prompt correction action" system, which requires the federal banking regulators to take certain corrective actions against the institutions they regulate as an institution's capital levels decrease. Five capital categories were established: well-capitalized, adequately-capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized.

167 *See* 12 U.S.C. § 1831f (2006); 12 C.F.R. § 337.6 (2012).

168 *See* 12 U.S.C. § 1831f (2006); 12 C.F.R. § 337.6 (2012).

169 *See* 12 U.S.C. § 1831f (2006); 12 C.F.R. § 337.6 (2012).

170 Letter from Valerie J. Best, Counsel, FDIC, to Unidentified Party (Apr. 26, 1995), *available at* 1995 WL 788913.

171 These data are derived from Call Reports for the relevant periods.

maintained above the insurance limit.[172]

The failure of IndyMac FSB in July of 2008, and its significant use of brokered deposits, precipitated another debate over brokered deposit use by banks. The response of the FDIC was to impose increased deposit insurance premiums for excessive brokered deposit use.[173] In 2011, the FDIC completed a study of "core" and "brokered" deposits mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").[174] Among other conclusions, the FDIC stated that with respect to "well capitalized" banks "there should be no particular stigma attached to the acceptance of brokered deposits per se and that the proper use of such deposits should not be discouraged."[175]

IV. Overview of Custodial Relationships

As set forth in the Introduction, it is instructive to examine two basic types of custodial arrangements in order to test the application of FDIC policies on pass-through insurance for deposit accounts held in custodial relationships. The first is the safekeeping custodial arrangement used to escrow funds in connection with various types of commercial and consumer transactions. The second is the custodial arrangement established at a broker or a bank to facilitate the purchase, sale, and holding of investment assets by a broker or bank on behalf of customers. Both types of arrangements are, and should be, eligible for pass-through deposit insurance, but each presents different issues to the FDIC in fulfilling its statutory obligation to insure deposit accounts held by one person "for the benefit of" another person.

Custodial arrangements developed at common law and arose under several different legal theories, including debtor-creditor, agency, bailment, fiduciary, and trust.[176] Some of the earliest custodians were banks, whose business consisted of receiving

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[172] *See* Letter from William F. Kroener, III to Unidentified Party, *supra* note 16.

[173] 12 C.F.R. § 327.9(d)(3).

[174] P.L. 111-203, §1506, 124 Stat. 1376, 2222 (2010). *See also* FDIC, STUDY ON CORE DEPOSITS AND BROKERED DEPOSITS (2011), *available at* http://www.fdic.gov/regulations/reform/coredeposit-study.pdf.

[175] FDIC, *supra* note 174, at 61.

[176] AUSTEN-PETERS, *supra* note 29 at 25.

deposits of bullion and other valuables for safekeeping.[177] At common law, "the typical custodian [was] under a personal obligation to return assets transferred into custody to the investor upon the conclusion of the term of custody."[178] The legal rights of the depositor depended entirely on the delivery obligation agreed to by the parties.[179] If the custodian had a specific re-delivery obligation, the depositor retained its proprietary rights in the assets in custody.[180] If the custodian became insolvent, the assets in custody would be returned to the depositor.[181] By contrast, if the re-delivery obligation was non-specific, the depositor did not retain its proprietary rights in the assets held in custody and was simply a general creditor in the event of the custodian's insolvency.[182]

Prior to the adoption and codification of commercial law practices in the UCC, and the subsequent evolution of Article 8, both investment and non-investment custodial relationships in the United States were defined by the common law as interpreted by each state.[183] As the U.S. securities market grew, and investment products became increasingly sophisticated, the law defining investment-purpose custodial relationships diverged from the common law and came under the purview of Article 8. Escrow arrangements generally remain a matter of state common law, though state statutes may impose specific requirements on certain escrow agents.[184] Despite the clear differences in the relationship between the parties to an investment-purpose custodial relationship and to an escrow arrangement, and the different legal regimes in which each type of relationship operates, the FDIC's guidance on custodial relationships makes no distinction between the two.

A. Escrow Arrangements

Escrow arrangements are a common type of custodial relationship established for the safekeeping of assets and utilized in a

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[177] Oulton v. German Sav. & Loan Soc'y, 84 U.S. 109, 118 (1872).
[178] AUSTEN-PETERS, *supra* note 29, at 22.
[179] *Id.*
[180] *Id.*
[181] *Id.*
[182] *Id.* at 22–25.
[183] *Id.* at 25–30.
[184] *See, e.g.*, DEL. CODE ANN. tit. 24, § 2923 (2012); N.J. STAT. ANN. § 45:15-12.5 (West 2012); N.Y. GEN. BUS. Law §778-a (McKinney 2012).

wide variety of transactions. An escrow arrangement is formed by contract. One of its most common forms involves one party to a transaction depositing funds with a third-party custodian (the escrow agent) pursuant to an agreement with the other party to the transaction, and the escrow agent transferring funds to one of the parties upon the fulfillment, or non-fulfillment, of a condition set forth in the escrow agreement.[185] An escrow arrangement can also be created by one party depositing funds with an escrow agent for the benefit of a person that is not a party to the arrangement (such as when funds are placed in escrow for the payment of taxes).

While any type of property can be held in escrow, escrow arrangements are commonly used for the safekeeping of funds pending a commercial or consumer transaction.[186] Banks frequently act as escrow agents and may place escrow funds in deposit accounts established with themselves or at other banks.[187] When an entity other than a bank, such as a title company, acts as an escrow agent, it may place the funds in a deposit account established in its name at one or more banks.

Although the custodian in an escrow arrangement is referred to as the "escrow agent," the custodian cannot be said to be a true agent for either party, and neither party can be said to unconditionally "own" the property held by the custodian.[188] An escrow arrangement is instead a hybrid relationship that imposes agent-like obligations upon the custodian without bestowing either party to the escrow arrangement with an unconditional claim to the property held in escrow.[189] For example, neither party to the

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[185] William A. Ingraham, Jr., Comment, *Escrow Agreements*, 8 MIAMI L.Q. 75, 75 (1953).

[186] *Id.* at 75–76.

[187] *See, e.g.*, *Global Custody and Agency Services: Escrow Solutions*, BANK OF AMERICA MERRILL LYNCH, https://corp.bankofamerica.com/business/ci/custody-agency-services (last visited Feb. 28, 2012); *Escrow Services*, J.P.MORGAN, http://www.jpmorgan.com/tss/General/Escrow_Services/1114735358724 (last visited Feb. 28, 2012); *Escrow Services Group*, U.S. BANK, http://www.usbank.com/cgi_w/cfm/commercial_business/products_and_services/corp_trust/escrow_ps.cfm (last visited Feb. 28, 2012).

[188] *See* Robert L. Flores, *A Comparison of the Rules and Rationales for Allocating Risks Arising in Realty Sales Using Executory Sale Contracts and Escrows*, 59 MO. L. REV. 307, 356–57 (1994).

[189] *See* Roger K. Garrison, *Agency and Escrow*, 26 WASH. L. REV. & ST. B.J. 46 (1951); Lester D. Peterson, Note, *Escrows—Defalcation of Escrow*

arrangement has the ability to pledge the deposit accounts or to enforce their rights in the deposit accounts directly against the bank. Instead, each party's rights to the escrowed property are enforceable against the escrow agent according to the terms of the contract between the parties to the arrangement.

The terms of an escrow agreement may specify how or where the custodian may invest the funds and provide the parties with the right to earn a return on the funds for the duration of the escrow. Alternatively, the parties to the escrow may not have the power to specify the investment of the funds, and may not be aware of how or where the funds are invested during the escrow period.[190]

It is beyond the scope of this article to explore the many forms of escrow arrangements and the legal nuances of such arrangements. However, it seems clear that the FDIC's recent guidance on custodial relationships cannot be readily applied in the escrow context: The deposit account in which funds are placed is not unambiguously "owned" by any party to the arrangement. Also, there may not even be "specific deposits" in which the parties to the arrangement have an interest, as the parties may not know where the funds are deposited. Furthermore, there could be a "commingling" of funds in a single deposit account when an escrow agent is holding funds for parties to multiple escrow arrangements. In at least one interpretive letter prior to the recent guidance, the FDIC staff confirmed that pass-through insurance is available on deposited funds held in an escrow arrangement based upon the FDIC regulations permitting insurance of commingled funds on a *pro rata* basis, implicitly indicating that the recent guidance would not apply to escrow arrangements and that the use of the terms "fiduciary," "custodian" and "agent" in the recent guidance without qualification was overbroad. [191]

A review of the FDIC's approach to the insurance of deposit accounts held through escrow arrangements sheds light on the FDIC's general approach to analyzing legal relationships and

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Holder—Allocation of Loss to Vendor or Vendee—Agency and Trust Theories, 31 OR. L. REV. 218, 231 (1952).

[190] In a typical residential real estate purchase transaction, the escrow agent in a real estate transaction under most state statutes is merely required to deposit the funds in a bank, but is not required to inform the parties of the identity of the bank. *See, e.g.*, DEL. CODE ANN. tit. 24, § 2923(a) (2012); N.J. STAT. ANN. § 45:15-12.5 (West 2012).

[191] *See* Letter from Claude A. Rollin to Unidentified Party, *supra* note 41.

providing interpretive guidance. Based upon available staff interpretive letters, the FDIC's general policy with respect to escrow arrangements is that insurance coverage of deposit accounts held by an escrow agent will be determined by which party has an "ownership interest in the funds deposited pursuant to the Escrow Agreement," a position taken without acknowledging the ambiguous nature of ownership in many escrow arrangements.[192]

In some cases FDIC staff has merely advised a party requesting guidance to consult the escrow agreement and state law.[193] In other cases, FDIC staff has engaged in detailed analysis in order to respond to requests for guidance. A 1989 letter concerning escrow arrangements maintained for residents and prospective residents of a continuing care facility in Florida illustrates this approach.[194] The staff examined two escrow agreements utilized by the provider of continuing care and consulted Florida statutes governing providers of continuing care.[195] One agreement—utilized for the general purpose of holding resident and prospective resident deposits—specifically stated that escrowed funds remained the property of the resident or prospective resident, permitting the staff to make a determination that coverage would be based on treating the escrowed funds as owned by a resident, or prospective resident, and not the provider.[196] The other agreement—utilized to escrow principal, interest, tax, and insurance payments—was apparently silent as to the owner of the funds.[197] The staff concluded that these funds belonged to the provider because the funds were deposited to assure payment by the provider of its contractual obligations.[198]

Not surprisingly, it is most common for issues to arise in the context of escrow arrangements involving real estate transactions. In its interpretive letters, the FDIC staff has taken the position that the party depositing the funds is the "owner" of the funds.[199] This

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[192] *See, e.g.*, *id.*; Letter from Mark A. Mellon, Attorney, FDIC, to Unidentified Party (Apr. 27, 1992), *available at* 1992 WL 813460.

[193] *See, e.g.*, Letter from Patti C. Fox, Attorney, FDIC, to Unidentified Party (July 24, 1985), *available at* 1985 WL 303857; Letter from Claude A. Rollin to Unidentified Party, *supra* note 41.

[194] *See* Letter from Claude A. Rollin to Unidentified Party, *supra* note 41.

[195] *Id.*

[196] *Id.*

[197] *Id.*

[198] *Id.*

[199] *See, e.g.*, Letter from Christopher L. Hencke to Unidentified Party, *supra* note 32.

position, which appears to have first been articulated in a 1988 letter concerning an escrow arrangement used in a Florida real estate transaction, was based upon a 1960 Florida court decision.[200] According to an unpublished 2008 letter (which cites a 1993 District of Columbia court decision) addressed to the American Land Title Association, the FDIC has apparently expanded this position to cover all "traditional real estate transactions"—that is, transactions in which the buyer's purchase money is deposited with an escrow agent pending settlement of the real estate purchase.[201] The letter appears to set forth a policy for the FDIC with respect to all such real estate transactions, although the letter never cites the FDIC regulations permitting the FDIC to establish a uniform policy without regard to differing state laws.[202]

Although the FDIC's position on traditional real estate transactions is laudable for providing certainty with respect to deposit insurance coverage, the FDIC's failure to make this position available to the general public leaves much to be desired. The FDIC staff's conclusions with respect to ownership, however, take court decisions at face value, ignoring academic criticism of these judicial decisions and failing to analyze whether this result is appropriate in the context of determining insurance coverage.

The issue of ownership of escrowed funds in a real estate transaction typically arises when the escrow agent has become insolvent or has absconded with the funds and the court must decide who bears the risk of loss. In other words, the courts have had to develop a basis for determining which "one of two innocent persons must suffer from the wrongful act of a third."[203] In concluding that the purchaser should bear the loss, the courts, without significant analysis, have relied alternatively upon a theory that the escrow agent is the agent of the purchaser because it was selected by the

[200] Letter from Claude A. Rollin, Attorney, FDIC, to Unidentified Party (Nov. 7, 1988), *available at* http://www.fdic.gov/regulations/laws/rules/4000-3630.html#fdic400088-73 (citing Cradock v. Cooper, 123 So. 2d 256, 258 (Fla. Dist. Ct. App. 1960) (setting forth this position without citing any authorities)).
[201] Letter from Christopher L. Hencke, Counsel, FDIC, to Kurt Pfotenhauer, Chief Exec. Officer, Am. Land Title Ass'n (Aug. 29, 2008), *available at* http://www.alta.org/images/PDF/08-09-04_FDIC_letter.pdf (citing Stuart v. Clarke, 619 A.2d 1199 (D.C. Ct. of App. 1993)).
[202] *See* 12 C.F.R. § 330.3(h) (2012).
[203] 28 AM. JUR. 2D § 28 *Escrow* (2012).

purchaser, or, when the selection of the agent was a mutual decision, a theory that the funds are held in trust by the escrow agent for the purchaser.[204]

Ironically, the courts have also typically allocated losses resulting from destruction of the real property prior to settlement to the purchaser.[205] The theory underlying this result is that the purchaser could seek specific performance of the sales contract in equity and, therefore, should be deemed the owner of the property in the event of its destruction.[206]

These conflicting results have been rightfully criticized by at least one commentator:

> It is possible for the two lines of authority to reach different conclusions as to ownership because in truth the attributes of ownership are not found in one party. Neither party can honestly be said to be the owner. Both [rules] impose loss through theories of ownership only by ignoring the fundamental characteristics of the problems they seek to address. They each rely on a concept of sole ownership, when by definition the attributes of ownership are divided and in transition during the periods for which the rules are meant to serve.[207]

The question for the FDIC is whether judicial decisions that have allocated loss based upon a suspect theory of ownership should be used to determine insurance coverage. Equally important, will the FDIC apply its real estate escrow arrangement policy to other types of escrow arrangements?

It may prove helpful to analyze these questions through an example. Suppose that one company buys all of the stock of another company for cash. At settlement, the shareholders of the acquired company transfer their shares to the acquiror and receive 80% of the purchase price. The remainder of the purchase price is placed in escrow with a mutually agreed upon escrow agent for a period of time in order to protect the purchasing company against any unknown liabilities of the acquired company. There are fifteen

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[204] *Id.*
[205] Flores, *supra* note 188, at 307.
[206] *Id.* at 309.
[207] *Id.* at 356–57.

shareholders in the acquired company, each with an equal interest in the escrowed funds. If the bank in which the escrowed funds are placed fails, how does the FDIC determine which party has a claim for FDIC insurance? The acquiror can assert a claim based upon the argument that the funds remain the property of the acquiror until the agreed-upon time has passed without the emergence of latent liabilities. However, the seller can *also* assert a claim, based upon the argument that the shares have been transferred and the escrowed funds are merely pledged as security against any latent liabilities.

Regardless of the merits of each argument, both parties have an interest in the ability of the seller to make the claim for more insurance. If the acquiring company is deemed to be the owner of the claim against the escrow agent for insurance purposes, the deposit account is insured up to $250,000. If the shareholders are deemed the owners of the claim against the escrow agent for insurance purposes, the deposit account is insured up to $3.75 million, a substantial increase in protection.

The determination of which party is the owner of the claim against the escrow agent for insurance purposes may be further complicated in light of decisions that the parties may have made in the interest of administrative convenience. For example, it is common to designate one party to the escrow arrangement to receive the annual "1099" statement, a statement of interest earned on the funds in the escrow account prepared for IRS reporting purposes for the parties to the escrow. Typically, in a corporate acquisition, the acquiror is designated as the recipient of the 1099 so that the bank needs to send only one 1099 (rather than sending one to each shareholder of the purchasing company). Designation as the 1099 recipient does not affect the actual tax liabilities of either party, which are reconciled upon the close of the escrow. Should the fact that the acquiror receives the 1099 and reports interest income for tax purposes during the life of the escrow make the acquiror the "owner" of the claim against the escrow agent for FDIC insurance purposes? The FDIC's regulations and guidance provide no answer to this question nor any clear basis to confidently arrive at an answer.

One option not apparently considered by the FDIC in its review of escrow arrangements is to treat the deposit account as a joint account held by all parties according to their conditional ownership of the amount in escrow. This would alleviate the need for the FDIC staff to parse state law looking for insight.

B. Investment-Purpose Custodial Relationships

While it is clear that the FDIC's general guidance on custodial relationships cannot be applied in its entirety to all custodial arrangements, it seems likely that the FDIC intended to apply it to investment-purpose custodial arrangements. In determining what criteria should be applied to these custodial relationships, it is important to consider the circumstances that led to the development of the current version of Article 8 and how mainstream brokered deposit programs fit within that framework.

The law relating to investment-purpose custodial relationships developed as a means to evidence ownership of, and facilitate trade in, physical assets, rather than securities and other intangible financial assets.[208] In order to overcome the conceptual difficulties inherent in the exchange of intangible assets in a legal regime developed for physical assets, securities issuers created certificates to be held in bearer form, with proprietary rights evidenced by physical possession of certificates, and transfers of securities accomplished by the delivery of certificates.[209] Therefore, custodial relationships established to facilitate the purchase, sale, and holding of investment assets originated in the paper-based securities market and developed under a paper-based legal regime.[210]

Traditionally, securities brokers would deliver certificates or proceeds directly to customers following the purchase or sale of securities and customers were assured of their proprietary interest by virtue of their possession of the certificates.[211] Eventually, however, customers began to leave both stock certificates and cash with brokers for safekeeping and convenience.[212] A customer's securities left with a broker were the property of that customer. So long as a customer could identify specific securities certificates, or proceeds related to the sale of the customer's securities, the customer would be first in line to reclaim his property if the broker became insolvent. If assets left in the custody of an insolvent broker were untraceable, a customer became a general creditor and could only recover his

[208] U.C.C. art. 8 Prefatory Note (1994).
[209] *Id.*
[210] *Id.*
[211] *Id.*
[212] *Id.*

property from a broker's remaining assets.[213]

As the U.S. securities market matured, the physical certificate system became increasingly burdensome. Between 1964 and 1968, the average daily reported volume on the New York Stock Exchange increased 265%, with the number of shares processed per day rising to 12.97 million from 4.89 million.[214] This rapid increase in trading volume triggered a corresponding increase in the paperwork needed to effect those trades; securities brokers were unable to keep up. In 1969, one out of every 8.4 securities transactions failed to deliver by the official settlement day, and many more orders were simply lost.[215] This crisis, or "Paper Crunch," highlighted the unsuitability of a paper-based system for a modern financial industry and triggered the evolution of the law, including revisions to Article 8.

C. Article 8 of the UCC

The FDIC's published interpretive letters make no reference to Article 8, a version of which has been adopted in every state.[216] This is unfortunate, as the vast majority of investment-purpose custodial arrangements holding deposit accounts utilize the Article 8 framework.

Article 8 was originally drafted to provide a legal framework for commercial transactions involving investment securities held in

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[213] *See* Cent. Nat'l. Bank v. Connecticut Mut. Life Ins. Co., 104 U.S. 54, 70 (1881) (holding that an insurance agent charged with collecting premium payments on behalf of the insurance company was not merely a debtor for the amount held, but a trustee); Matter of Fred Dorr, 21 Am. B. R. 752, 759 (1909) (finding an insolvent stockbroker who wrongfully moved proceeds from the sale of customer stock into a personal bank account to have held the money in a trust that is traceable by the customer); In re Hallett's Estate, [1879] 13 Ch. D. 696, 709 (Eng.) (declaring money held by a fiduciary, though not as trustee, that is placed in a personal bank account is held in trust and may be traced provided the beneficial owner can identify them).

[214] Joel Seligman, *Cautious Evolution or Perennial Irresolution: Stock Market Self-Regulation During the First Seventy Years of the Securities and Exchange Commission*, 59 BUS. LAW. 1347, 1366 (2004).

[215] *Id*. at 1367.

[216] As of September 2010, Revised Article 8 had been adopted by the 50 states, the District of Columbia, Puerto Rico, and the U.S. Virgin Islands. *See Table of Enactments of 1994 Amendments (Revised Article 8)*, U.C.C. Rep. Serv. (West) xxi–xxii (Supp. Sept. 2010).

the traditional paper-based securities system.[217] Following the "Paper Crunch," it was amended to codify rules for a paperless, or uncertificated, securities system.[218] This system permitted the elimination of paper certificates, and thus the need for physical delivery of such certificates. Settlement of transactions could be effected either by recordation on the books of the issuer and custodian, or on the books of the custodian only.[219] However, with the exception of mutual funds, the securities industry largely rejected Article 8's wholly uncertificated system.[220]

Instead, the securities markets continued to use physical certificates but moved from a system of direct holdings to an indirect holdings system.[221] In the indirect holdings system, certificates evidencing multiple individual shares, including, in the case of more recent issuances, “master” or “global” certificates, are held by a central securities depository, such as DTC, on behalf of its member banks and brokers, who in turn maintain records of each of their customers’ securities holdings.[222] In the indirect holdings system, securities trades are settled by entries on the books of the various intermediaries.[223] While the securities industry continues to use both systems, the indirect holdings system predominates. In 2011, DTC processed and settled more than $287 trillion in securities transactions, including CDs.[224]

Having determined that the indirect holdings system differed from both the traditional paper system (in which proprietary rights were represented by possession of a paper certificate) and from the uncertificated system (in which proprietary rights were evidenced by the issuer's shareholder registry) the drafters of the UCC amended Article 8 again in 1995, adding Part 5, which provides a legal framework for the indirect holdings system.[225]

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217 U.C.C. § 8-101 cmt. (1962).
218 U.C.C. § 8-101 cmt. (1978).
219 U.C.C. art. 8 Prefatory Note (1994).
220 *Id.*
221 *Id.*
222 *About DTCC: The Depository Trust Company (DTC)*, DTTC, http://www.dtcc.com/about/subs/dtc.php (last visited November 28, 2012).
223 U.C.C. art. 8 Prefatory Note.
224 DEPOSITORY TRUST & CLEARING CORP., 2011 ANNUAL REPORT 16 (2011), *available at* http://www.dtcc.com/about/annuals/2011/index.php.
225 U.C.C. art. 8 Prefatory Note.

Part 5 is based on the concept of a "security entitlement,"[226] the UCC's term for the rights and property interests of an investor,[227] or "security entitlement holder," holding a "financial asset" through a "securities intermediary."[228] "Financial asset" is defined to include both certificated and uncertificated securities and any obligation, share, participation, or other interest recognized as a "medium for investment."[229] It is generally assumed that time deposits, savings deposits, and transaction accounts are all mediums for investment, particularly when offered by a securities intermediary as an investment option. The interest of the security entitlement holder in the financial asset is evidenced by records maintained by the securities intermediary, who acts as custodian for the entitlement holder. Transfers of security entitlements are effected when the entitlement holder gives the securities intermediary an "entitlement order"[230] directing the securities intermediary to transfer the security entitlement on its books.[231]

A security entitlement is a package of rights and interests held by the entitlement holder against the securities intermediary with respect to a financial asset,[232] and Part 5 imposes on the securities intermediary the duty to bestow the economic benefits of ownership of the financial asset upon the entitlement holder, including the right to receive all payments with respect to the financial asset[233] and to direct the disposition of the financial asset.[234] Therefore, Part 5 renders the common law concept of legal title irrelevant, instead focusing on the records of a securities intermediary and its obligations to the security entitlement holders.

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[226] *Id.* § 8-102(a)(17) ("'Security entitlement' means the rights and property interest of an entitlement holder with respect to a financial asset specified in Part 5.").
[227] *Id.* § 8-102 cmt. 17.
[228] *Id.* § 8-102(a)(7).
[229] *Id.* § 8-102(a)(9).
[230] An "entitlement order" means a notification communicated to a securities intermediary directing transfer or redemption of a financial asset to which the entitlement holder has a security entitlement. *Id.* § 8-102(a)(8).
[231] *Id.* art. 8 Prefatory Note.
[232] *Id.* § 8-501 cmt. 5.
[233] *Id.* § 8-505(b).
[234] *See Id.* § 9-108.

D. Application of Article 8 to Brokered Deposits

Article 8 facilitates the two main product areas within the brokered deposit market: (1) CDs, the majority of which are certificated; and (2) uncertificated deposit account sweep arrangements in which customer funds are automatically invested, or "swept," into savings and transaction deposit accounts as part of a cash management feature.

CDs are offered to both retail and institutional investors with maturities ranging from one month to twenty years. Generally, interest is paid either on a fixed rate, floating rate, or zero-coupon basis, though some CDs pay interest based on the performance of an index, such as the S&P 500® or other market measures. CDs are most commonly issued by utilizing DTC as sub-custodian. Banks issuing CDs establish the CDs on their books and records in the name of DTC as agent for its participants (the broker-dealer or bank offering the CDs to its customers) and issue a "Master Certificate of Deposit" ("Master Certificate") to DTC setting forth the terms of the CDs. CDs are typically issued in denominations of $1,000, and each Master Certificate states the number of CDs issued by the bank. Each $1,000 CD can be transferred, pledged or sold independently of any other CD evidenced by the Master Certificate.[235] CDs evidenced in this manner are "certificated securities" for purposes of Article 8.[236]

DTC maintains records of the CDs held by each DTC participant.[237] The DTC participants, in turn, maintain records of the CDs owned by their customers. By utilizing DTC as a sub-custodian, multiple broker-dealers can participate in the same CD offering. On occasion, when a single broker-dealer is offering CDs, a bank may establish CDs directly in the name of the broker-dealer and issue the

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[235] Unlike the description of brokered CDs that appears in certain regulatory materials, brokered CDs are not "participated out" by brokers. *See, e.g.*, FED. FIN. INSTS. EXAM'N COUNCIL, *supra* note 64, at RC-E-10. Such terminology implies the establishment of a single CD in which interests have been sold, rather than the establishment of individual CDs that are evidenced by a single master certificate.

[236] U.C.C. § 8-102(a)(4) (defining "certificated security")*; see also id.* § 8-102(a)(15) (defining "security"). CDs evidenced in this manner are "securities" because they are evidenced by a certificate, which is divisible into a series of obligations, and they are traded in securities markets or are mediums for investment.

[237] U.C.C. art. 8 Prefatory Note.

Master Certificate to the broker-dealer; DTC does not act as a sub-custodian in this arrangement.

In some arrangements, typically those that are offered by banks, a custodial bank, such as The Bank of New York Mellon, acts as a sub-custodian instead of DTC.[238] In these arrangements, no Master Certificate is issued and CDs are established with the depository bank in the name of the sub-custodian, which maintains both the records of the CDs issued by the depository bank, including their terms, on behalf of the depository bank and those of the CDs held by the banks or brokers on behalf of their customers. The banks or brokers then maintain records of the CDs owned by their customers. CDs evidenced in this manner are financial assets, but not securities, for purposes of Article 8.[239]

Though CDs were once the primary deposit product offered by brokers, sweep arrangements offered to broker-dealer and bank customers now dominate the market. As noted in the Introduction, in 2000 Merrill Lynch began offering customers an MMDA linked to a NOW account at its two affiliated banks as the primary sweep investment option for excess cash in customer brokerage accounts.[240] By automatically depositing—or "sweeping"—excess cash from interest and dividend payments and sales of securities in a customer's brokerage account, this service allows customers to earn interest on their cash pending an investment decision. In addition, customers at many brokerage firms can access their funds by check or debit card.[241]

The magnitude of excess customer cash at brokerage firms is illustrated by the fact that over $55 billion dollars were deposited in just one of Merrill Lynch's two affiliated banks within two years of the launch of the sweep program.[242] Within a few years, Lehman Brothers, Smith Barney, Charles Schwab, UBS, E*Trade, and

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[238] *See, e.g.*, *The Role of Custodians: How Client Assets Are Maintained & Safeguarded*, BANK OF N.Y. MELLON CORP., (2009), *available at* http://www.bnymellon.com/foresight/pdf/rolecustodians.pdf.

[239] U.C.C. § 8-102(a)(9) (defining "financial asset"); *see also* § 8-102(a)(15) (defining "security"). CDs evidenced in this manner are not "securities" because they are not evidenced by a certificate.

[240] *See* Winokur, *supra* note 10.

[241] *See, e.g.*, *Cash Management Account®*, MERRILL LYNCH WEALTH MANAGEMENT, http://wealthmanagement.ml.com/wm/pages/ArticleViewer.aspx?title=cash-management-account (last visited Nov. 28, 2012).

[242] *See supra* note 11 and accompanying text.

Morgan Stanley followed suit, resulting in the transfer of hundreds of billions of dollars from money market funds into the affiliated banks of each of these broker-dealers.[243] Broker-dealers that do not have affiliated banks also offer FDIC-insured sweep products to their customers, in some cases offering deposit accounts at ten to fifteen non-affiliated banks, each within the deposit insurance limit.[244] The amount of money in these sweep programs has increased significantly since the 2008 financial crisis, as customers have fled the stock market in search of FDIC insurance.[245]

In these sweep arrangements, the broker-dealer will typically establish a deposit account or accounts at one or more banks in its name and title the account or accounts in a manner that indicates that the broker-dealer is acting as agent and custodian for its customers.[246] The deposit accounts recorded on the books of the bank are frequently referred to as "omnibus" or "custodial" deposit accounts. If they are structured correctly, they represent multiple individual deposit accounts evidenced by the books and records of the broker-dealer. Some programs may utilize a bank as a sub-custodian in the same manner that DTC and sub-custodial banks are used in CD issuances, though this is not the most common method of evidencing account ownership. The deposit accounts offered through these sweep programs are financial assets, though not securities, for purposes of Article 8.[247]

Both CD programs and sweep programs are established by agreements between the broker or bank custodian, and the depository banks, setting forth the terms of the deposit accounts and the rights and responsibilities of each party and of the depositor with respect to

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[243] *See* Rob Blackwell, *Will Brokers' Sweeps Moves Speed Reform?*, AM. BANKER, May 2, 2002 (Washington), at 1; Walter Hamilton, *Brokers Shifting 'Sweep' Money*, L.A. TIMES, Aug. 1, 2005, at C1; Dan Jamieson, *Wirehouse Sweeps Raising Concerns*, INVESTMENT NEWS, Dec. 12, 2005 (News), at 2.

[244] *See, e.g.*, *CDARS Overview*, *supra* note 13.

[245] More recently, some banks have begun offering a sweep service to other banks seeking to offer deposit insurance above the $250,000 limit, but these programs are relatively new and represent substantially fewer deposits than broker-dealer sweep arrangements. *See, e.g.*, *ICS Overview*, PROMONTORY INTERFINANCIAL NETWORK, LLC, http://www.promnetwork.com/our-services/ics/overview.aspx (last visited Nov. 28, 2012).

[246] *See, e.g.*, *CDARS Overview*, *supra* note 13.

[247] *See supra* note 239 (providing U.C.C. definitions of "security" and "financial asset").

the deposit accounts. These agreements are discussed in more detail below.

The Article 8 framework—which establishes the relationship between an entitlement holder, the securities intermediary and the issuer of the financial asset—is remarkably consistent with the FDIC's pass-through insurance framework; each relies upon recordation on the books of an issuer and maintenance of books and records by an intermediary.[248] It is important for the FDIC to understand the Article 8 framework and to reference it in policy pronouncements concerning investment-purpose custodial relationships. Doing so should result in the elimination of troubling references to "owning" funds in FDIC regulations and guidance.

V. Application of the Federal Securities Laws to Brokered Deposit Arrangements

In contrast to Article 8, which directly correlates to the FDIC's obligation to determine the relationships between parties, the federal securities laws do not define the relationships between parties to a transaction or expressly impose requirements on brokers in contracting with their customers, other than certain disclosure requirements.[249] Instead, these laws impose registration and disclosure obligations on issuers of securities to the public (the Securities Act of 1933 ("Securities Act")), persons offering securities brokerage and trading services to the public (the Exchange Act) and persons offering pooled investment vehicles to the public (the ICA). The purpose of these laws is investor protection, which is accomplished by, *inter alia*, imposing liability for failure to make full and complete disclosure concerning the offer and sale of a security and for engaging in fraudulent activity and, in many cases, requiring registration with the SEC.[250]

On more than one occasion, the FDIC has declined to confirm the availability of deposit insurance for deposit accounts that are part of an investment product that may be a security for purposes

[248] 12 C.F.R. § 330.5 (2012) (FDIC recordkeeping rules); U.C.C § 8-501 (1994) (U.C.C. requirements for the acquisition of a security entitlement).
[249] Barbara Black & Jill I. Gross, *Making It Up As They Go Along: The Role of Law in Securities Arbitration*, 23 CARDOZO L. REV. 991, 1006 (2002).
[250] *See The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity and Facilitates Capital Formation,* SEC, http://www.sec.gov/about/whatwedo.shtml (last visited Dec. 14, 2012).

of the federal securities laws.[251] In addition, FDIC regulations preclude deposit accounts held by registered investment companies, or companies that should be registered with the SEC under the ICA, from eligibility for pass-through insurance. Although there is no clear statement from the FDIC on how the federal securities laws relate, or should relate, to the availability of deposit insurance, the recent FDIC guidance on custodial accounts has moved the FDIC closer to the analytic framework used by the SEC to assess the risks posed by custodial relationships. References to creating a debtor-creditor relationship between a custodian and a principal and to commingled funds echo tests long applied by the SEC and the courts to implement the federal securities laws.

In order to effectuate the investor protection purposes of the federal securities laws, the courts and the SEC have developed tests to determine when an attribute related to an investment product is a security subject to the federal securities laws. At the heart of each of these tests is a determination that investors in the investment product are reliant upon the actions of a promoter, custodian or other person, or are at risk of loss due to the actions of such persons, and should be accorded the protections of the federal securities laws to ensure full disclosure of the risks prior to investment.

A. *Marine Bank v. Weaver*

The treatment of deposit accounts under the Securities Act and the Exchange Act illustrate how the courts determine when the protection of the federal securities laws should be available. Despite the fact that the definition of security in both statutes includes an "evidence of indebtedness," deposit accounts at banks are not securities for most purposes of the Securities Act and the Exchange Act. [252] Although this was assumed to be the case for many years, the

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[251] *See* 2011 Clark Letter, *supra* note 23, and Burdette Letter, *supra* note 23.

[252] Securities Act of 1933 § 2(a)(1), 15 U.S.C. §77b(a)(1) (2006) ("The term 'security' means any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest . . . transferable share, investment contract, voting-trust certificate, certificate of deposit for a security . . . or, in general, any interest or instrument commonly known as a 'security' . . . ."); Exchange Act of 1934 § 3(a)(10), 15 U.S.C. §78(c)(a)(10) ("The term 'security' means any note, stock, treasury stock, security future, security-based swap, bond, debenture, certificate of interest . . . transferable share, investment contract, voting-trust

status of deposit accounts at banks as falling outside the definition of the term "security" was finally confirmed by the U.S. Supreme Court in 1982 in *Marine Bank v. Weaver*.[253] In *Weaver*, the Court held that a bank CD was not a security for purposes of the anti-fraud provisions of the Exchange Act,[254] because depositors do not need the protection of the Exchange Act due to the ample protections provided by the federal banking laws, including reserve requirements, regular examinations, and FDIC insurance.[255] The holding in *Weaver* was seemingly endorsed by Congress shortly thereafter, when it amended the definition of a security in both the Securities Act and the Exchange Act,[256] and was reconfirmed by the Supreme Court in 1990.[257]

B. The *Howey* Test

The fact that a deposit account itself is not a security for purposes of the Securities Act and the Exchange Act[258] has not

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certificate, certificate of deposit for a security . . . or in general, any instrument commonly known as a 'security' . . . .").

[253] Marine Bank v. Weaver, 455 U.S. 551, 559 (1982). The *Weaver* ruling likely does not apply to deposit accounts at non-U.S. banks. *See* Reves v. Ernst & Young, 494 U.S. 56 (1990). *See also* Plaintiff's Memorandum of Law in Support of Motion for Ex Parte Temporary Restraining Order, Preliminary Injunction and Other Emergency Relief, SEC vs. Stanford Int'l Bank, Ltd., No. 3-09CV0298-L (N.D. Tex. Feb. 17, 2009), 2009 WL 412588.

[254] Section 10(b) of the Exchange Act prohibits the use of manipulative and deceptive devices in connection with the purchase or sale of a security in contravention of SEC rules and regulations. 15 U.S.C. § 78j(b).

[255] 455 U.S. at 558–59. *But see* Olson v. E.F. Hutton & Co., 957 F.2d 622 (8th Cir. 1992) (holding that the anti-fraud provisions of the Exchange Act could be applied to alleged fraud committed by a broker in the trading of CDs because the federal banking laws do not provide protection against the actions of a third party).

[256] *See* H. R. REP. NO. 97-626, pt. 1, at 10 (1982) (observing that the holding in *Weaver* conflicts with the SEC treatment of deposits as securities for the purposes of the Investment Company Act and adopting different language in amending that Act as compared to the amending language in the Securities Act and the Exchange Act).

[257] Reves v. Ernst & Young, 494 U.S. 56 (1990).

[258] Because the definitions of "security" in the Securities Act and the Exchange Act are substantially similar, the courts have treated the

prevented the courts and the SEC from finding an investment product that includes a deposit account to be a security.[259] In doing so, the courts and the SEC have relied upon tests developed to determine if an "investment contract" has been created. The term investment contract—included in the definition of security in both the Securities Act and the Exchange Act and utilized in some state "blue sky" laws prior to the adoption of the federal securities laws[260]—is not defined by Congress or in relevant legislative reports. The SEC has described an investment contract as a "general descriptive term that is a catch-all for unconventional investment arrangements."[261]

In *SEC v. W.J. Howey Co.*,[262] the U.S. Supreme Court held that for purposes of the Securities Act an investment contract is a "contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise."[263] In other words, a security need not be evidenced by a traditional note, stock or bond, and may instead be an investment scheme in which the managerial efforts of the scheme's promoter affect the realization of profit or loss by an investor.

The U.S. Court of Appeals for the Second Circuit applied the *Howey* test to a CD program offered by Merrill Lynch in *Gary Plastic Packaging Corp. v. Merrill Lynch*.[264] While acknowledging that the CDs offered by Merrill Lynch to its customers were not themselves securities under the ruling in *Weaver*, the court held that the CD program through which the CDs were offered was an

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definitions as if they were identical. *See, e.g.*, Landreth Timber Co. v. Landreth, 471 U.S. 681, 686 n.1 (1985).

[259] *See, e.g.*, Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 756 F.2d 230 (2d Cir. 1985); Merrill Lynch, Pierce, Fenner & Smith, Inc., SEC No-Action Letter, 1982 WL 30517, at *2 (Oct. 28, 1982) [hereinafter Merrill Letter].

[260] Securities Act of 1933, § 2(a)(1), 15 U.S.C. § 77b(a)(1) (2006); Exchange Act of 1934, § 3(a)(10), 15 U.S.C. § 78(c)(a)(10). The term originally appeared in the Arkansas securities statute. *See* JOSEPH C. LONG, 12 BLUE SKY LAW § 2:40 (2012).

[261] Brief for Petitioner at 9–10, SEC v. Edwards, 540 U.S. 389 (2004) (No. 02-1196).

[262] SEC v. W.J. Howey Co., 328 U.S. 293 (1946).

[263] *Id*. at 298–99.

[264] Gary Plastic Packaging Corp., 756 F.2d at 240–42.

investment contract, and therefore a security.[265] The purchasers of the CDs depended to a significant degree on the efforts of Merrill Lynch for profit, including Merrill Lynch's promise of above-market returns on the CDs, Merrill Lynch's undertaking to continuously monitor the credit quality of banks issuing CDs, and Merrill Lynch's implied promise to maintain a secondary market in the CDs for purposes of achieving trading profits.[266] The court concluded that if these alleged promises had been made, Merrill Lynch was an issuer of a security that should have been registered with the SEC, or offered pursuant to an exemption from registration, and that Merrill Lynch's financial ability to fulfill the terms of the investment should have been disclosed.[267]

C. The "Rights and Status" Test

As the securities industry moved from a system in which brokers held physical certificates for their customers to the indirect holdings system, the SEC developed a framework for determining whether a custodian is "essentially passive and that in all material respects the Beneficial Owner [of the investment] is the real party in interest."[268] The "rights and status" test is derived from the investment contract test articulated by the U.S. Supreme Court in *Howey* and endeavors to ascertain when an investor may be relying on a custodian for profit or is being put at risk by the custodian in a manner that is greater than mere custodial risk (i.e., the risk that the custodian will lose or steal the asset).

Under the rights and status test, the SEC considers the nature of the risks assumed by the custodian's customer to determine whether the customer holds the "rights and status" of ownership of the underlying asset.[269] The following is a list of factors, developed from SEC no-action letters, that the SEC employs in determining whether a custodian has issued a separate security by the failure to bestow the rights and status of ownership upon the customer.

- The customer has the right upon default to proceed directly against the issuer. In such event, the

[265] *Id*. at 242.
[266] *Id.*, at 240–41.
[267] *Id.* at 242.
[268] Apfel Letter, *supra* note 44, at *1 n.2.
[269] *Id*. at *1.

customer may proceed individually against the issuer and is not required to act in concert with other holders of the investment.[270]

- The custodian ensures that the customer receives all relevant communications from the issuer that a direct owner would receive.[271]
- The custodian acts in a purely ministerial capacity, and the asset is not considered an asset of the custodian in the event of the custodian's insolvency.[272]
- A customer has the benefits or risks that would be present if the customer had chosen to purchase the investment directly from the issuer, as opposed to going through the custodian.[273]
- Generally, there are no factors present that would require the customer to rely on the custodian to obtain the benefits of the investment.[274]

Since failure to meet the rights and status test has significant consequences, most, though not all, brokered deposit arrangements seek to meet its requirements. In doing so, brokers and banks rely in part upon the Article 8 framework that permits each customer's rights in one or more deposit accounts to be evidenced on the books and records of the broker or bank, with the rights of each customer in a deposit account separate from the rights of every other customer. The UCC provides each customer with the independent right to give

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[270] *See* Apfel Letter, *supra* note 44, at *1; M.L. Stern, SEC No-Action Letter, 1984 WL 45378, at *1 (May 21, 1984) [hereinafter M.L. Stern Letter].

[271] *See* Apfel Letter, *supra* note 44, at *1.

[272] *See id.* at *1; Pension Adm'rs, Inc., SEC No-Action Letter, 1989 WL 246535, at *1 (Oct. 18, 1989) [hereinafter Pension Letter]; M.L. Stern Letter, *supra* note 270, at *1; Merrill Letter, *supra* note 259, at *3.

[273] See Pension Letter, *supra* note 272, at *1; Rappaport & Segal, SEC No-Action Letter, 1988 WL 234391, at *2 (May 24, 1988) (denying no-action relief in connection with the custody of deposits where an unregulated entity played a role in handling customer funds, which exposed the customers to the "risk of loss separate from and in addition to that presented by the underlying investment itself").

[274] *See* Apfel Letter, *supra* note 44, at *1; Merrill Letter, *supra* note 259, at *2.

an entitlement order[275] and to pledge deposit accounts as security for a loan.[276] CDs evidenced by a negotiable Master Certificate held at DTC can be traded by each customer in secondary markets maintained by brokers and moved from one DTC participant to another if a customer chooses to change custodians.

In addition to Article 8, compliance with the rights and status test is accomplished through the documentation used to offer a bank's deposit accounts to the public.

D. Brokered Deposit Documentation

Brokers and banks that offer deposit accounts at depository banks to their customers typically enter into an agreement with each depository bank that is essentially an agreement to underwrite the depository bank's deposit obligations. Indeed, the offer, sale, and, when applicable, trading of bank deposit accounts (exclusively CDs) generally occur from a fixed-income origination group within the capital markets division of a broker-dealer or a similar group at a bank. The depository bank provides representations and warranties that it is legally competent to establish and offer the deposit accounts and that its deposit accounts are eligible for FDIC insurance. In the case of CDs, the agreements set forth a protocol for establishing the terms of the CDs (maturity, interest rate, etc.), the offering period, and the number of CDs to be offered. In the case of MMDAs and transaction accounts, the agreements set forth the basis for determining the daily interest rate and any minimum or maximum deposit account balance requirements. For all products, the operational procedures for settling the transactions, either through DTC or another sub-custodian, or directly between the broker and the depository bank, are set forth in the agreement.

The agreements also provide the basis for the "rights and status" of customers by requiring depository banks to provide notice to the custodian or sub-custodian, as applicable, of any material changes affecting a customer's deposit account, and by the agreement of the custodian to provide such notice to their customers.[277] Notices are generally intended to parallel the notices a

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[275] U.C.C. § 8-505(b) (1994).
[276] *Id.* §9-108(d) (2001).
[277] *See, e.g.*, CDARS DEPOSIT PLACEMENT AGREEMENT, *available at* https://www.saukvalleybank.com/pdf/CDARS-Deposit-Placement-Agreement.pdf.

bank would send to depositors with direct depository relationships in the event of a material change in the depositor's account.

The standard agreements also provide a mechanism for customers to enforce their rights in their deposit accounts directly against a bank. The agreements require a depository bank to establish a customer's deposit account or accounts directly on its books in the event that the customer chooses to terminate the custodial relationship with the broker.[278] In such a case, the customer can enforce his or her rights in the deposit account or accounts directly against the bank.[279]

While the need for customers to enforce their rights in deposit accounts directly against a bank is rare, two situations illustrate the importance of this right. Some savings banks or their holding companies are organized in "mutual" form, meaning that depositors have certain rights normally associated with shareholders, including the right to vote at annual meetings. In addition, if a savings bank or its holding company converts to stock form, depositors typically have the right to purchase stock.[280] Absent guidance from the federal banking regulators that deposit accounts held through a custodial relationship are not eligible to exercise voting and conversion rights,[281] the standard industry agreements would require the savings bank to notify depositors through their custodians concerning meetings and proposed conversions and afford the depositors the ability to exercise their rights, either through their custodians or directly. Under the SEC's rights and status test, the loss of these rights simply because the deposit accounts are held through a custodial relationship would result in the issuance of a security by

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[278] *Id.*

[279] As a general matter, federal banking regulators permit, and in some cases require, deposit accounts held through a broker or bank to be treated as individual deposit accounts. In addition to insurance of individual deposit account holders on a pass-through basis by the FDIC, the Board requires transaction restrictions on savings deposits to be enforced by the broker or bank against individual holders of savings deposits, and has rejected at least one effort to have a custodian deemed the owner of CDs for purposes of minimum deposit requirements. *See* Letter from Oliver Ireland to Philip E. Taken, *supra* note 5; Letter from William W. Wiles to Roger M. Zaitzeff, *supra* note 5.

[280] Dwight C. Smith, III, *Proposed OTS Rules on Stock Conversions and Mutual Holding Companies*, 4 M & A L. 15 (July/Aug. 2000).

[281] The author is not aware of any such guidance.

the custodian.[282]

Another example is the transfer by a healthy bank of its deposit accounts, usually CDs, to another healthy bank. This typically occurs when a bank needs to relieve itself of excess deposit obligations. A deposit account is a contract between a depositor and the bank and is governed by state contract law. Under the basic principles of contract, an obligor on a contract—in this case, the bank—cannot be relieved of an obligation without consent of the obligee—the depositor.[283] This contractual relationship does not change because the depositor acts through an agent and has not been preempted by the federal banking regulators.[284] It is, therefore, common practice for the transferring bank to provide notice of the proposed transfer to holders of CDs through their custodian and to offer the holders an opportunity to maintain their CDs with the transferor or to exercise early withdrawal without penalty. In this manner, CD holders are permitted the opportunity to individually exercise their rights in their CDs.

It is common for deposit brokers offering deposit accounts to their customers to provide customers with a disclosure document describing the deposit accounts and addressing issues raised in the *Gary Plastic* case and by the SEC in its no action letters. Typical disclosure documents state that the broker makes no representations concerning the interest rates on deposit accounts, which may be higher or lower than those available directly from the depository bank. Customers are informed that the deposit accounts are obligations of the depository bank, not the broker, and that the broker makes no representations about the bank's credit. If a secondary market in CDs is offered by the broker or bank, the customer is informed that the market may be discontinued at any time. Customers are also informed of their right to terminate the custodial relationship and establish their deposit account or accounts directly with a bank.

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[282] *See* U.C.C. §8-501 cmt. 1 (1994).

[283] *See* RESTATEMENT (SECOND) OF CONTRACTS §§ 273–287 (1981).

[284] While the Bank Merger Act, 12 U.S.C. § 1828(c)(2) (2006), requires a bank to seek the approval of its primary federal banking regulator before assuming the deposit liabilities of another bank, federal law does not govern the relationship between a depositor and a bank. *See, e.g.*, Letter from Julie L. Williams to Fred H. Miller, *supra* note 66.

E. The Investment Company Act of 1940

FDIC regulations deny pass-through insurance for deposit accounts held through arrangements that have registered, or should register, as investment companies pursuant to Section 8 of the ICA.[285] Under the ICA, an investment company is any person, including a company, that (1) issues securities and (2) invests the proceeds primarily in securities.[286] A "company" includes a fund or any organized group of persons, whether incorporated or not.[287] The definition of "security" in the ICA is similar to the definition in the Securities Act and the Exchange Act, but the SEC has taken the position that bank deposit accounts are "securities" for purposes of the ICA definition, and that position has not been formally challenged.[288] Therefore, if a "company" issues a security—as determined either under the *Howey* test or the rights and status test—and invests the proceeds in deposit accounts, the entity may have become an investment company.

Applying the *Howey* test, the SEC staff denied a no-action request from Kemper Financial Services, Inc. with respect to a program in which Kemper, a registered broker, would place customer funds in MMDAs at different banks in its discretion.[289] In the letter, the SEC staff concluded that Kemper would be the issuer of a separate security because, *inter alia*, it (1) selected the banks in the program; (2) negotiated supposedly superior rates on the MMDAs; (3) determined the amount of funds to be placed at each institution based on its analysis of the institution's financial condition; (4) moved customer funds among institutions based on its determination of the best interests of the program; (5) did not inform customers of the identity of the institutions into which funds were deposited until after the funds were deposited; and (6) prohibited customers from dealing directly with the depository institutions without closing the MMDA involved and receiving a refund of the deposit amounts.[290] Though the SEC staff used the *Howey* test to conclude that the program through which the MMDAs were offered was a separate security, the rights and status test would support the same conclusion.

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[285] *See* 12 C.F.R. § 330.11(a)(2) (2012).
[286] 15 U.S.C. § 80a-3(a)(1); *see also id.* § 80a-2(a).
[287] 15 U.S.C. § 80a-2(a)(8).
[288] *Id.* § 80a-2(a)(36).
[289] *See* Kemper Letter, *supra* note 27, at *1.
[290] *Id.* at *2–3.

In denying no-action relief to Kemper, the SEC staff did not indicate whether a program sharing some, though not all, of these factors would be considered an investment company. Because a program inadvertently structured as an investment company should be registered with the SEC, rendering the underlying deposit accounts ineligible for pass-through insurance,[291] most, though surprisingly not all, brokered deposit arrangements are structured to address the issues cited by the SEC staff.

It is generally easier to structure a CD program to avoid characterization as an investment company because CDs are term instruments typically selected by the investor and, once invested in CDs, an investor's funds are not moved between banks. The nature of multi-bank sweep arrangements, in contrast, requires greater vigilance on the part of the broker or bank structuring the program.[292] It is tempting, from both an operational and marketing perspective, for brokers or banks to structure programs that promote the interest rate available through the program, exercise discretion in moving funds between banks, and deny customers the right to deal directly with participating depository institutions.[293]

Mainstream multi-bank sweep arrangements address the issues in the Kemper Letter by utilizing the type of agreements and disclosure documents outlined above. In addition, in order to deflect concerns about the exercise of investment discretion, many sponsors, though not all, provide a list of banks at which a customer's funds can be placed and deposit the funds up to the FDIC insurance limit in each bank in the order in which the banks are set forth on the list. Customers are provided with the ability to designate a bank or banks as ineligible to receive the customers' funds, and customers are generally provided with advance notice of changes to the list.

It is reasonable to assume that the aim of the FDIC's 1977 amendment prohibiting the pass through of deposit insurance for deposit accounts held through arrangements registered, or required to be registered, as investment companies,[294] was to avoid conferring an

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291 *See* 15 U.S.C. §§ 80a-2(a)(36), 80a-3(a)(1) (2006).
292 *See supra* text accompanying notes 10–12, discussing sweep arrangements.
293 *See, e.g.*, Kemper Letter, *supra* note 27, at *2–3 (describing how Kemper negotiated favorable interest rates, moved funds between banks, and prevented customers from dealing directly with the banks that held their funds).
294 *See* 12 C.F.R. § 330.11(a)(2) (2012).

additional competitive advantage in the form of pass-through deposit insurance upon registered money market funds already enjoying unregulated rates. Since deposit account sweep programs were not introduced until the 1980s, and did not reach significant scale until after 2000, it is unlikely that the FDIC has considered the consequences of denying insurance to investors having funds placed through a program that should be registered with the SEC. Ironically, using the ICA as a basis for denying investors FDIC insurance conflicts with the mission of both the FDIC and the SEC to protect the investing public.

VI. Conclusions

As outlined in the preceding pages, the FDIC's policies with respect to pass-through insurance leave something to be desired in terms of clarity. The problems include the following:

- The regulations contain superfluous provisions that detract from efforts at meaningful interpretation.
- Both the regulations and interpretations of the regulations use the term "owner of funds," and various interpretive letters use the term "title to funds." These are meaningless terms that have prevented the development of a body of interpretive guidance based upon an analysis of the underlying legal relationship between the parties to various types of custodial relationships. This has prevented the development of guidance based upon the nature of the claim that a principal has against the custodian and, with respect to investment-purpose custodial relationships, incorporation of Article 8 concepts.
- FDIC regulations permit funds of multiple principals that have been "commingled" by a custodian in a deposit account at one or more banks to be insured on a *pro rata* basis. No publicly available interpretive guidance exists on what the FDIC means by commingled funds and what types of custodial relationships to which this provision applies. Indeed, this section of the FDIC regulations is not cited in

any published guidance, and is ignored in the recent guidance.

- Despite adopting regulations that prohibit pass-through insurance for deposit accounts held through arrangements that should be registered as investment companies with the SEC and demonstrating a reluctance to confirm the availability of deposit insurance for deposit accounts that may be included as part of a "security," the FDIC has never referenced relevant SEC or judicial guidance or explained the policy behind this denial of insurance.

One explanation for these deficiencies may lie in the process for granting interpretive guidance applicable to specific factual circumstances, which if not properly managed, can result in *ad hoc* policy-making. And, to be fair to the FDIC Legal Division, legal practitioners have no motivation to seek a comprehensive review of pass-through insurance policies. The practitioner's primary objective is to obtain confirmation of FDIC insurance of deposit accounts in a specific factual situation, not to prompt policy re-consideration or question previous staff pronouncements, particularly when there is no evidence of FDIC enforcement of its pass-through insurance policies.

Nevertheless, reliance on non-enforcement is not a healthy basis for providing confidence to the marketplace unless the FDIC's articulated policy is non-enforcement. Since there is no evidence that an official non-enforcement policy exists, the current state of play leaves unwary depositors at risk of being denied insurance coverage due to the enforcement of policies they do not know exist.

A. Competing Policy Goals

Since the rejection by Congress in 1991 of proposals to eliminate pass-through deposit insurance for deposits placed by deposit brokers, the availability of pass-through insurance has not been questioned. However, the 1991 debate focused on the risks of allowing the pass-through insurance of brokered deposits to facilitate the rapid growth of assets by banks, not on the wisdom of pass-through insurance in the context of various custodial arrangements. There has been no public debate on the current application of pass-through insurance policies and the potential consequences of punishing depositors who have deposit accounts held by a custodian.

Deposit insurance is intended to instill confidence in depositors by assuring them that their deposits are safe regardless of the financial condition of their bank. The FDIC's historic generosity in insuring virtually all depositors, and the speed and efficiency with which it resolves failed banks, have allowed the FDIC to admirably satisfy the primary purpose of deposit insurance. Though not unheard of, deposit runs on banks are virtually non-existent in the United States.[295]

Although the issues surrounding the technical requirements of pass-through insurance have not been debated, there has been an active policy debate for decades over the coverage of uninsured depositors at failed banks. Dating back to at least the 1950s, policy-makers and commentators have questioned whether such *de facto* universal coverage eliminates the risk to depositors necessary for the market to impose discipline upon bank management.[296] Arguably, fully-protected depositors face no risk and have no incentive to monitor a bank's financial condition or to withdraw their funds if a bank becomes financially weak. However, creating risk by strictly enforcing deposit insurance limits creates a tension with the need to reassure the public about the safety of their deposits.

Policymakers, including both the federal banking regulators and Congress, have sent mixed signals about enforcing insurance limits. In FDICIA, Congress amended the FDIA to require the FDIC to follow a policy of Least Cost Resolution, or "LCR." This amendment was prompted by repeated instances in which the FDIC paid off all depositors, whether insured or uninsured, at a failed bank. As stated in the 1991 report by the Treasury Department:

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[295] In July of 2008, there was what some described as a "mini-run" on IndyMac Bank FSB prior to its closure by the OTS and the FDIC on July 11, 2008. *See* Joe Adler, *FDIC Defends Handling of IndyMac Run*, AM. BANKER, July 18, 2008, http://www.americanbanker.com/issues/173_140/-358143-1.html.

[296] *See* George Hanc, *Deposit Insurance Reform: State of the Debate*, 12 FDIC BANKING REVIEW, no.3, 1999, *available at* http://www.fdic.gov/bank/analytical/banking/1999dec/1_v12n3.pdf. *See also* Carter H. Golembe, Comments on Deposit Insurance and Financial Modernization, *in* CONFIDENCE FOR THE FUTURE: AN FDIC SYMPOSIUM, JANUARY 25, 1998, at 37, *available at* http://www.fdic.gov/deposit/insurance/symposium/fdic15.PDF.

> Yet, the preferred FDIC practice in recent years has been to fully protect uninsured depositors. This is not merely true of so-called "too big to fail" situations . . . . FDIC policy has resulted in the protection of over ninety-nine percent of uninsured deposits during the record period of bank failures occurring since 1985.[297]

LCR requires the FDIC to choose a resolution alternative resulting in the least cost to the insurance fund. FDICIA further states that after December 31, 1994, the FDIC may not take any action that would increase losses to the insurance fund by protecting uninsured depositors.[298]

There is a "systemic risk" exception to this statutory policy. Upon a written recommendation from not less than two-thirds of the Board of Directors of the FDIC, not less than two-thirds of the Board of Governors of the Federal Reserve System, and the Secretary of the Treasury, in consultation with the President, an exception can be made to the LCR policy if liquidation of an insolvent bank could cause serious adverse effects on economic conditions or financial stability.[299] Ironically, this provision was most recently used by federal regulators to provide unlimited deposit insurance for all transaction deposit accounts at all banks through the Transaction Account Guarantee Program ("TAGP"),[300] even though a credible reading of the statute is that the exception was intended to be invoked only on a case-by-case, or bank-by-bank, basis.[301]

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[297] *See* U.S. DEP'T OF THE TREASURY, *supra* note 159, at 18.
[298] 12 U.S.C. § 1823(c)(4)(E) (2006).
[299] *Id.* § 1823 (c)(4)(G) (Supp. V 2011).
[300] *See* Temporary Liquidity Program, Final Rule, 73 Fed. Reg. 72,244 (Nov. 26, 2008).
[301] At the time that TAGP was implemented in October 2008, there were concerns that the systemic risk exception had been improperly interpreted. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-10-100, REGULATORS' USE OF SYSTEMIC RISK EXCEPTION RAISES MORAL HAZARD CONCERNS AND OPPORTUNITIES EXIST TO CLARIFY THE PROVISION (2010). The Government Accountability Office concluded that there was sufficient basis for the regulators to rely upon the systemic risk exception but recommended that Congress clarify the provision. In Dodd-Frank, Congress clarified the provision by specifying that the FDIC could invoke it only for the purpose of "winding up the insured depository institution for which [the FDIC] had been appointed receiver." 12 U.S.C. § 1823 (c)(4)(G)(i).

Congress has also acted to undermine the discipline of enforcing insurance limits or, depending on one's perspective, to instill confidence in depositors. In the Dodd-Frank Act, Congress included provisions to (1) permanently increase deposit insurance coverage from $100,000 to $250,000 per depositor in each insurable capacity; (2) retroactively apply the new limit to bank failures after January 1, 2008 and before October 3, 2008; and (3) extend the FDIC's TAGP, with some modification, through 2012.[302]

Given the unwillingness of policy makers to enforce widely-publicized insurance limits, even in the face of a declared policy to do so, what is the likelihood that the FDIC will begin denying insurance to depositors who have had their deposits placed by an intermediary that has not complied with the FDIC's technical requirements for pass-through insurance? And how will the FDIC make such determinations in the brief time period it has informally established to provide depositors with access to their deposit accounts?

The FDIC is confronted with the choice of either (1) conceding that it will not, or cannot, enforce its technical requirements and revising them accordingly; or (2) taking steps to make the policies meaningful by instituting procedures for reconciling staff interpretive guidance, publishing the guidance, and enforcing the policies embodied in the guidance.

B. Simplify and Clarify

Simplifying and clarifying the regulations would be a good starting point. The FDIA clearly states that all deposits held by one person for the benefit of another person are eligible for insurance, providing the broadest possible grant of insurance to deposit accounts held by an agent or custodian. This statutory mandate should not be diminished by unnecessary and imprecise eligibility requirements.

The FDIC should eliminate Regulation 330.7 (Accounts held by an agent, nominee, guardian, custodian or conservator), which adds nothing to the implementation of pass-through insurance, and merely confuses the broader pass-through procedures set forth in

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[302] 12 U.S.C. §§ 1821(a)(1)(B), 1821(a)(1)(E). The retroactivity of the new deposit insurance limit effectively permitted many otherwise uninsured depositors of the failed IndyMac Bank FSB (one of the largest bank failures in U.S. history) to be paid off.

Regulation 330.5 (Recognition of deposit ownership and fiduciary relationships). References to "ownership of funds," a meaningless concept, should be eliminated. In its place, the FDIC should substitute the concept of a claim by a principal against a custodian based on the nature of the custodial relationship—including the agreement between the principal and the custodian, and the custodian's records. In this regard, the FDIC should incorporate the Article 8 approach with respect to a claim against a custodian into its policies for insuring investment-purpose custodial relationships.

The FDIC should acknowledge that all deposited funds at a bank are, by definition, commingled. Instead of focusing on commingled funds, the FDIC should identify the types of custodial relationships, e.g., investment-purpose and safekeeping (escrow), and the nature of the claim the principal has against the custodian. Under Article 8, a principal has a security entitlement to a specific deposit account at a specific bank. In this case, there is no commingling of the rights of the principals as each principal can enforce his or her rights separately from any other principal. In certain escrow arrangements, the principals may have specified that the escrow agent deposit the funds in a specific bank. Even though the agent may also have deposited funds from other arrangements into the same deposit account at the same bank, thus commingling funds according to current FDIC guidance, each principal has a conditional claim to a specified amount of the total balance of a specific deposit account at a specific bank based upon the contract with the escrow agent and the agent's records. There is no commingling of contractual rights.

When the principals to an escrow arrangement do not know where funds are deposited, they merely have a claim against the escrow agent for payment, not against a specific deposit account at a specific bank. In this case, the commingling is on the books of the escrow agent. Here, the FDIC needs to determine whether the agent can allocate specific parties to specific banks, and then defer to the agent's records or require the agent to aggregate all claims against the agent and allocate the claims proportionately to all banks at which the agent has deposited funds.

The FDIC should also consider revising its regulations concerning the availability of pass-through insurance for deposit accounts held by investment companies. It is a defensible policy decision to deny pass-through insurance to shareholders of money market mutual funds that have registered with the SEC pursuant to the ICA. These funds offer a cash-equivalent investment option for which there is no policy reason to add the benefit of FDIC pass-through insurance. The same reasoning would apply to registered stock and bond funds. In fact, these funds are precisely the type of sophisticated investors that should be exposed to the risk of holding uninsured deposits.

In contrast, there is no apparent purpose served by denying pass-through insurance to arrangements that should be registered with the SEC but—because of either sponsor ignorance or lack of enforcement by the SEC—have not registered. The easiest resolution of this issue is to leave enforcement of the ICA to the SEC; if the SEC has not required an arrangement to register as an investment company, the FDIC should allow pass-through insurance.

Simplifying its regulations, eliminating unnecessary restrictions, and clearly articulating its policies for determining the availability of pass-through insurance, would greatly reduce the FDIC's burden of enforcing technical requirements and the risk of surprise to depositors if insurance is denied. In addition, in the absence of evidence of fraud on the part of the principals to custodial relationships, the FDIC should defer to the records of the custodian, particularly if the custodian is an entity, such as a bank or a broker, whose custodial activities are regulated by a federal regulatory agency. In effect, this is the *de facto* policy in place today when a bank fails.

C. Capital Markets Regulator

If, after careful and, hopefully, public review of its policies, the FDIC determines that it wants to retain significant parts of its current approach—particularly prohibiting pass-through insurance for arrangements that should be registered with the SEC or applying criteria similar to criteria used to determine whether a security has been created—the FDIC needs to acknowledge that it is a capital markets regulator and revise its approach to interpretive guidance accordingly.

It has not been realistic for many years to base bank regulation on the premise that banks fund themselves solely through walk-in-the-door deposit funding. As of March 31, 2011, 42.4% of banks accepted deposits from deposit brokers,[303] a number that does

[303] FDIC, *supra* note 174, at 116. This does not include deposits obtained by banks via the internet or through listing services.

not include banks accepting deposits from intermediaries that are exempt from the definition of deposit broker. In addition, banks use other "non-brokered" means to attract deposits, such as the internet and so-called deposit listing services,[304] each of which allows a bank to advertise interest rates on deposit accounts in order to attract funding from depositors around the country.

Deposit accounts have also assumed more complex features over the last twenty years. Call features on CDs were introduced into the brokered deposit market in the 1990s, permitting banks to issue long-term CDs that can be called by the bank if prevailing interest rates go down. Many callable CDs have utilized interest rates that move, or "step," up or down on pre-determined dates. And, as noted *supra*, the FDIC in the 1980s confirmed that banks can utilize virtually any benchmark to determine interest on a deposit account. This has led to an active market in CDs that pay interest based on all manner of financial indices, including indices as obscure as the "steepener" index.[305]

It is also worth noting that a substantial secondary trading market exists for CDs held through DTC. Individual brokers may make a market for the benefit of their customers. In addition, a robust inter-broker market exists, with quotes posted on at least four electronic trading networks.[306] The secondary trading in CDs permits banks to issue longer-term CDs with limited early withdrawal provisions because CD holders can liquidate their CDs in the secondary market prior to maturity.

Issues presented by this large, deep, and complex public market in bank deposit products, a market whose viability depends upon the availability of FDIC insurance, have largely been ignored by the FDIC. For example, despite the fact that FDIC staff for at least a decade has consistently provided informal guidance that a CD with an early withdrawal penalty based upon the market price of the

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[304] *See, e.g.*, Letter from Christopher L. Hencke, Counsel, FDIC, to Unidentified Party (July 28, 2004) *available at* http://www.fdic.gov/regulations/laws/rules/4000-10280.html; Letter from Valerie J. Best, Counsel, FDIC, to Unidentified Party (July 24, 1992), *available at* http://www.fdic.gov/regulations/laws/rules/4000-7410.html.

[305] The "steepener" index measures the difference between the thirty-year Constant Maturity Swap Rate and the two-year Constant Maturity Swap Rate.

[306] These include Knight BondPoint, Tradeweb, TheMuniCenter, and the Bloomberg Trade Order Management System.

CD is not a "deposit" for FDIC insurance purposes,[307] no written guidance has been issued. Hundreds of millions of dollars of CDs with these features have been issued.

What does the FDIC need to do? The first step is acknowledging the problem.

Compare the FDIC's policies with respect to published guidance with the SEC's policies. The FDIC website contains the following policy statement:

> As a public service, and in an effort to help bankers, lawyers, and others having an interest in federal banking law to better understand the statutes and regulations administered by the Federal Deposit Insurance Corporation (including the FDIC's rules for determining deposit insurance coverage), the FDIC's legal staff has selected for publication a representative sampling of FDIC staff legal advisory opinions, interpretive letters, and general informational letters. The FDIC has not attempted to identify or publish all, or even most, letters on a particular subject, and there may well be other letters that have not been selected for publication. Similarly, the FDIC does not plan to review letters, once they have been published, for the purpose of flagging or removing those that may have become outdated, superseded or discredited, or that may have been revised, modified, revoked or suspended.
>
> The letters express the views and opinions of individual FDIC staff lawyers and are not binding on the FDIC, its Board of Directors, or any board member; any representation to the contrary is expressly disclaimed. The letters should only be considered advisory in nature, and the reader bears the responsibility for relying on them.[308]

In contrast, the SEC uses no-action letters as a vehicle for interpretive guidance intended to clarify its statutes and rules. These

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[307] *See supra* note 78.

[308] *FDIC Law, Regulations, Related Acts – Advisory Opinions*, FDIC, http://www.fdic.gov/regulations/laws/rules/4000-300.html (last updated Dec. 3, 2009).

letters are recognized by many issuers, securities law practitioners, and other members of the public, as “the most comprehensive secondary source on the application of [the federal securities] laws,”[309] and are often “the sole body of precedent” on particular provisions of the securities laws.[310] Securities practitioners consider them “a source of de facto law.”[311]

Beginning in 1970, the SEC made no-action letters, interpretive letters, and staff responses available for public inspection and copying thirty days after the staff has given or sent its response to the requestor.[312] In 1988, the SEC further amended its rules to provide for expedited publication of no-action and interpretive letters except in cases in which it has granted confidential treatment.[313] No-action and interpretive letters issued on or after January 1, 1993 are available on the SEC's website.[314] Earlier letters are available via commercial research databases and may also be obtained by submitting a Freedom of Information Act request to the SEC.

Just as troubling as the FDIC's publication policies is its approach to formulating guidance. There is a tendency on the part of the FDIC to vacillate between extremes. In certain cases it articulates broad, vague standards whose application is not self-evident. In other cases it makes a determination on a specific set of facts without relating it to a broader legal principle.

An example of the first is the statement that a custodial relationship is not *bona fide* if it is a debtor-creditor relationship.

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309 *Expedited Publication of Interpretative, No-Action and Certain Exemption Letters, Securities Act Release No. 6764*, [1987–1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,228, at 89,053, 89,054 (Apr. 7, 1988) [hereinafter *Expedited Publication Release*].

310 Thomas P. Lemke, *The SEC No-Action Letter Process*, 42 BUS. LAW. 1019, 1019 (1987).

311 Donna M. Nagy, *Judicial Reliance on Regulatory Interpretations in SEC No-Action Letters: Current Problems and a Proposed Framework*, 83 CORNELL L. REV. 921, 924–25 (1998).

312 *Adoption of Section 200.81, Concerning Public Availability of Requests for No-Action and Interpretative Letters and the Responses Thereto by the Commission's Staff, and amendment of Section 200.80, Securities Act Release No. 5098* [1970–1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,921 at 80,051 (Oct. 29. 1970).

313 *Expedited Publication Release*, *supra* note 309, at 89,383.

314 *Staff No Action, Interpretive and Exemptive Letters*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/interps/noaction.shtml (last visited June 27, 2012).

What does this mean, and how does the FDIC intend to apply it? According to the available guidance, a debtor-creditor relationship can occur when the custodian has changed the terms of the deposit accounts. But is it accurate to characterize such activity by a custodian as creating a debtor-creditor relationship? This should more appropriately be viewed as an obligation by the custodian that is separate and distinct from the deposit accounts it is holding for its principal. The entire deposit account should not be disqualified from insurance because of such a separate obligation.

Under what circumstances could a custodian change the terms of the deposit account it is holding for its principal? One possibility is that the custodian does not place the principal's funds in any deposit account, but uses the funds for its own purposes. Another possibility is that the custodian places the funds in a type of deposit account different from the principal's instructions (e.g., an MMDA rather than a CD). Neither of these actions creates a debtor-creditor relationship because in neither case has the principal extended credit to the custodian. In the first instance, the custodian has engaged in fraud and the principal has a claim against the custodian under the appropriate state or federal laws. In the second, the custodian has violated its obligations as an agent. However, deposit accounts have been established using the principal's funds, and there is no reason they should not be insured.

A better result in these circumstances would be to apply the concept of a "constructive trust" to the custodial arrangement. A constructive trust is an equitable remedy that may be applied where an agent has breached its duties to its principal and the assets of the principal need to be preserved.[315] In the examples described above, the FDIC would utilize this doctrine to provide pass-through insurance for the deposit accounts actually established by the custodian with the principal's funds, rather than punishing the principal by denying insurance.

Another possibility is that the custodian has subsidized the interest rate on the deposit account as an inducement for the principal to establish a relationship with the custodian. If the custodian agrees to pay the bank the difference between the rate disclosed to the principal by the custodian and the rate the bank is willing to pay, clearly the custodian has become an obligor on a portion of the interest rate and its default on its obligation will affect the customer if the bank is unwilling to pay the subsidized rate. However, it is

[315] *See* 106 N.Y. JUR. 2D TRUSTS § 177 (2012).

unclear why the entire deposit account would be disqualified from pass-through insurance because a portion of the promised rate is an obligation of the custodian.

The FDIA requires the FDIC to insure the deposits of a depositor that have been established for the depositor's benefit by another person. This is a straightforward obligation to insure any deposit accounts established by a custodian using the funds of a principal entrusted to it for investment or safekeeping. Any reading of the statute that attempts to deny insurance of deposited funds based upon extraneous conduct of the custodian would appear to be beyond the scope of the FDIC's authority.

The analysis used by the SEC and the courts both under the rights and status test and the *Howey* test[316] would assist the FDIC in determining what, if any, obligations of a custodian to its principal in an investment-purpose relationship affect the principal's underlying investment. By determining whether the principal has the rights and status of ownership in the deposit account, the FDIC can differentiate claims to specific deposit accounts at specific banks from claims solely against the custodian. This would permit the FDIC to identify insurable deposits versus uninsurable separate obligations of the custodian.

In addition, so long as FDIC regulations prohibit pass-through insurance for deposit accounts held through arrangements that should be registered as investment companies with the SEC under the ICA, the analysis used by the SEC and the courts would permit the FDIC staff to identify potential federal securities law issues and refer them to the SEC for resolution.

At the other end of the spectrum, the FDIC's approach to escrow accounts has been piecemeal and lacking in any guiding principle. There has been no FDIC analysis of the nature of escrow arrangements, the result of which is a case-by-case approach for determining the "title to funds" and a reliance on state court decisions based on suspect theories of ownership. A better approach is for the FDIC to acknowledge the hybrid nature of the escrow "agency" and articulate a policy that reflects the fact that multiple parties have a claim against an escrow agent, and each claim is conditional. A more satisfying result would be to treat these arrangements as a type of joint account, thereby ensuring the greatest possible insurance coverage. Any policy in this area could be

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[316] *See supra* text accompanying notes 258–267.

accomplished using the FDIC's regulations permitting it to devise a uniform approach to insurance coverage.