

**DEPOSIT PRODUCTS AND PAYMENT SYSTEMS
SUBCOMMITTEE**

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Presentation: “Hot Topics” update.

Legislative and regulatory reactions to recent events in the banking and financial world have been fast and furious, making it difficult sometimes to stay abreast of important new developments. This program will highlight some of these evolving topics, including:

- New insurance coverage issues for deposit and stored value products
- New rules to restrict unlawful Internet gambling
- New requirements and restrictions for overdraft protection products
- Other current developments

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**FRB AND TREASURY ADOPT REGULATION IMPLEMENTING BAN
ON FUNDING UNLAWFUL INTERNET GAMBLING**

The Federal Reserve Board (“FRB”) and the Department of Treasury (collectively, the “Agencies”) have jointly adopted identical regulations (12 CFR § 233.1, *et seq.*; 31 CFR § 132.1, *et seq.*) (collectively, the “Regulation”) implementing the Unlawful Internet Gambling Enforcement Act of 2006 (the “Act”). Compliance with the Regulation will become mandatory on December 1, 2009.

Background

The Act is Congress’ attempt to combat online gambling, after concluding that traditional law enforcement mechanisms were inadequate. It prohibits any person engaged in the business of betting or wagering from knowingly accepting “restricted transactions”, which are payments related to another person’s participation in unlawful Internet gambling. However, the Act does not clearly define what constitutes unlawful Internet gambling. Instead, it relies on underlying federal and state laws to determine what activities are legal and illegal. “Unlawful Internet gambling” is only generally defined under the Act as using the Internet to place, receive, or otherwise knowingly transmit a bet or wager that is unlawful under applicable federal or state law in the state where the bet or wager is initiated, received, or otherwise made.¹ The Act does not require the Agencies to specify what activities are prohibited, and the Regulation does not attempt to further define any gambling-related terms.

The Act establishes procedures by which federal and state government officials can shut down unlawful Internet gambling websites that they identify. But, ultimately, enforcement of the

¹ The Act exempts from the definition of “unlawful Internet gambling” intrastate transactions conducted exclusively within a state where the bet or wager is authorized, as well as for intratribal transactions and interstate horseracing transactions.

Act is left primarily to banks and other financial institutions, which are expected to prevent the processing of online wagers. Some commenters have observed that the Act is really an attempt to indirectly regulate offshore casinos that are outside the jurisdiction of American law enforcement by prohibiting U.S. banks from processing illegal online wagers.

Restricted Transactions

A “restricted transaction” is a transaction that involves any credit, funds, instrument or proceeds that the Act prohibits any person engaged in the gambling business from knowingly accepting in connection with another person’s participation in unlawful Internet gambling. The following types of transactions are potentially “restricted transactions:”

- Credit, or the proceeds of credit, extended to or on behalf of the person participating in unlawful Internet gambling (including credit extended through use of a credit card);
- An electronic funds transfer (“EFT”) or funds transmitted by or through a money transmitting business, or the proceeds of an EFT or money transmitting service, from or on behalf of such other persons; or
- Any check, draft, or similar instrument that is drawn by or on behalf of such other person and is drawn on or payable at or through any financial institution.

Under the Regulation, a “restricted transaction” only involves funds going to a commercial customer (*i.e.*, an Internet gambling business); it does not include funds going to a consumer (*i.e.*, a gambler).

Blocked Transactions: The Agencies anticipate that a restricted transaction will be blocked, or rejected, before or during transaction processing. Blocking is not intended to result

in the funds being frozen. Rather, the funds will remain in or be returned to the original account, where the accountholder can access them for other purposes.

Overblocking: The Act requires the Agencies to ensure that transactions associated with any legal gambling activity are not blocked or otherwise prohibited, and nothing in the Regulation is intended to suggest that participants should block gambling-related transactions that are not unlawful under the Act. Nevertheless, some financial transaction providers have suggested that they may avoid all Internet gambling-related transactions, including those that the Act does not prohibit.

The Agencies declined requests from commenters representing gambling interests to combat this attitude by taking some action to facilitate gambling transactions that are not prohibited by the Act. However, the Agencies have concluded that the Act does not authorize them to require a payment system to engage in any particular business line or process any particular transactions. Such a determination remains the provider's business decision.

Designated Payment System (“DPS”)

The Act requires the Agencies to identify those payment systems that could be used to facilitate restricted transactions. A designated payment system has primary responsibility for enforcing the Act by establishing policies and procedures that are reasonably designed to identify and block or otherwise prevent restricted transactions.

The Agencies have identified the following as designated payment systems that could be used in connection with restricted transactions:

1. Automated clearing house (“ACH”) systems;
2. Card systems (including credit, debit and prepaid cards or stored value products);

3. Check collection systems;
4. Money transmitting businesses, to the extent that they engage in the transmission of funds and permit customers to remotely initiate money transmission transactions; and
5. Wire transfer systems.

Exempt and Non-Exempt Participants: The Act authorizes the Agencies to exempt from the Regulation's requirements certain restricted transactions or designated payment systems if the Agencies find that it is impractical to identify and block such transactions. In recognition of the reality that most DPS participants do not have access to sufficient information to identify potentially problematic customers or transactions, the Regulation generally exempts all participants in a DPS *except* those that have contact with the commercial customer. With the exception of card systems (discussed below), only the DPS participant that has the customer relationship with the Internet gambling business has responsibility to prevent or prohibit restricted transactions from being credited to the gambling business's account. DPS participants that are not exempted (non-exempt participants) are described in more detail below.

ACH Systems: All participants processing a transaction through an ACH system are exempt from the Regulation's requirements *except for:*

- the receiving depository financial institution ("RDFI") and any third party processor receiving the transaction on behalf of the receiver in an ACH credit transaction;
- the originating depository financial institution ("ODFI") and any third party processor initiating the transaction on behalf of the originator in an ACH debit transaction; and

- the receiving gateway operator and any third party processor that receives instructions for an ACH debit transaction directly from a foreign sender.

Check Collection Systems: All participants in collecting a check through a check collection system are exempt from the Regulation's requirements *except for* the depository bank (*i.e.*, the bank receiving the check deposit from the Internet gambling business).

Money Transmitting Businesses: All participants in a money transmitting business are exempt from the Regulation's requirements, *except for* the operator.

Wire Transfer Systems: All participants processing a wire transfer through a wire transfer system are exempt from the Regulation's requirements *except for* the beneficiary's bank (*i.e.*, the bank receiving the wire transfer on behalf of the gambling business).

There is no exemption for any participant in a card system; all card system participants are non-exempt participants that are subject to the Regulation. Among all the DPS categories, only a card system has merchant category and transaction codes that identify the payee's business line (*e.g.*, the gambling business) and how the transaction was initiated (such as via the Internet) that must accompany the merchant's card transaction authorization request. The Agencies concluded that, because these processes enable a card system participant to identify and block certain types of payments in real time during payment processing, that the entire system should be subject to the Regulation.

Required Policies and Procedures

Every non-exempt participant in a DPS must develop and implement written policies and procedures that are reasonably designed to identify and block or otherwise prevent or prohibit

restricted transactions. Generally, these policies and procedures should include (i) risk-based due diligence methods designed to ensure that a commercial customer does not originate or receive restricted transactions through the customer relationship; and (ii) procedures to be followed when the participant discovers that its customer has engaged in restricted transactions through its customer relationship.

The Regulation provides a general due diligence process for use by a non-exempt participant in assessing its commercial customer's risk of engaging in unlawful Internet gambling. It also provides more specific but non-exclusive examples of appropriate policies and procedures for each type of DPS.

The Agencies anticipate that a participant will choose to use a flexible, risk-based approach in its procedures, so that the level of due diligence performed will reflect the level of risk posed by the commercial customer. The most efficient way for a participant to implement the due diligence procedures is to incorporate them into existing account-opening procedures, such as, for depository banks, the customer identification procedures required under the Bank Secrecy Act's anti-money laundering program requirements.

No "Bad Guys" List: The Agencies considered, but ultimately rejected, the possibility of creating a list of businesses known to be engaged in unlawful Internet gambling. Such a list might have been used in a manner similar in effect to the way financial institutions use other government lists, such as the one administered by the Office of Foreign Assets Control, although in a different context. However, the Agencies concluded that compiling such a list would not be feasible because, without a clear definition of what is and is not lawful under the Act, the Agencies would have to formally interpret the various federal and state gambling laws in order to

determine whether the activities of each gambling-related business are unlawful under those statutes.

General Due Diligence Provisions: A non-exempt participant's due diligence procedures should incorporate the following steps:

1. At account opening, the participant must conduct due diligence of the commercial customer and its activities to the level appropriate to assess the risk of restricted transactions presented by the customer's business.
2. Based on its account-opening due diligence results, the participant should have a basic understanding of the new commercial customer's business and be able to determine the risk the commercial customer presents of engaging in an Internet gambling business.

Low-Risk Customers: The vast majority of commercial customers will have no involvement in the Internet gambling business. If, based on its initial due diligence, the participant determines that a prospective commercial customer presents only a minimal risk of engaging in an Internet gambling business, the participant may open the account without further due diligence.

No-Risk Customers: No due diligence is required in connection with certain low-risk commercial customers. These customers include banks and other financial institutions that are supervised by the federal functional regulators that are responsible for enforcing the Act, and other agencies, departments or divisions of federal or state government.

Foreign Respondents: A U.S. bank establishing a correspondent account for a foreign respondent should conduct appropriate, risk-based due diligence on the

foreign respondent as its commercial customer to determine the risk that it is engaging in an Internet gambling business. However, the Agencies do not expect a U.S. participant to conduct due diligence on its foreign respondent's commercial customers.

Money Transmitter Customers: A non-exempt bank participant with a commercial customer that is a money transmitting business should apply its due diligence procedures to that customer. The bank is not responsible for assessing the risk that the money transmitter's commercial customers will engage in an Internet gambling business. The money transmitting business is responsible for implementing its own policies and procedures with respect to its customers.

Higher Risk Customers: If, after conducting its due diligence, the participant suspects that its commercial customer may present more than a minimal risk of engaging in an Internet gambling (for example, the commercial customer offers contests or games over the Internet), the participant should ask the commercial customer for further documentation regarding the nature of its business. The customer may produce certification evidencing that it does not engage in an Internet gambling business in order to address factual questions about the customer's business.

If the participant determines that its commercial customer does engage in an Internet gambling business, the participant should obtain further documentation to evidence that the customer's gambling business is lawful. If the commercial customer has a license issued by an appropriate state or tribal authority that expressly authorizes the customer to engage in the Internet gambling activities, the participant can rely on that license as an indication that its customer's business is lawful. A commercial

customer that does not have a license may produce a legal opinion from its counsel which demonstrates that the commercial customer's Internet gambling business does not involve restricted transactions.

If the participant still has questions about the permissibility of the customer's activities, the participant should consult with the applicable licensing authority or have the customer obtain the authority's confirmation that its activities are legal and do not require the customer to maintain a license. Additionally, the participant's due diligence process may include a third party's certification that the commercial customer's systems for engaging in the Internet gambling business are reasonably designed to ensure that its business will remain within the licensed and otherwise legal limits with respect to age and location verification.

A participant may also obtain its commercial customer's written commitment to notify the participant of any changes in its legal authorization to engage in its Internet gambling business.

3. Finally, a non-exempt participant must communicate to all of its commercial customers that restricted transactions are prohibited. This notification may be provided by means of a term in its commercial customer agreement, a simple notice sent to the customer, or through some other method.

Non-Exclusive Examples: The Regulation provides non-exclusive examples of compliant due diligence policies and procedures for each type of DPS except wire transfer systems.

The examples for participants in an ACH and check collection systems (the two activities in which banks are most likely to be involved) are helpful. As an ODFI in an ACH debit

transaction, an RDFI in an ACH credit transaction or as a depository bank, the bank should incorporate appropriate procedures into its account-opening process to be utilized then the bank knows that the customer is engaged in an Internet gambling business. Finally, the bank must implement procedures to follow if the bank has actual knowledge that the commercial customer has engaged in restricted transactions (through ACH debit or credit transactions, as applicable, or deposited checks). For an ODFI or RDFI, these procedures must address the circumstances under which the bank will prevent the customer from originating further ACH debit transactions or receiving ACH credit transactions and the circumstances under which the customer's account should be closed. A depository bank's procedures must specify the circumstances under which it should deny check collection services to the customer and when the customer's account should be closed.

Conclusion

The Act's lack of specificity regarding what activities constitute unlawful Internet gambling reflects the difficulty involved in any attempt to effectively regulate such gambling activities. The absence of a statutory definition of what the Act prohibits and the unique nature of Internet gambling made the task of drafting the Regulation inherently difficult for the Agencies. Whether the Regulation will have any meaningful impact on unlawful Internet gambling activities remains to be seen.

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**REVISIONS TO DEPOSIT INSURANCE COVERAGE
October and November 2008**

I. BACKGROUND

1. WHAT'S GOING ON?

The Federal Deposit Insurance Corporation has made several significant changes to deposit insurance coverage amounts and requirements. Some of these requirements are temporary in nature, while others are permanent. This summary describes these changes, and highlights some areas of compliance concerns for banks.

2. WHAT ARE THE CHANGES?

The changes include:

- (a) A temporary increase in the Standard Maximum Deposit Insurance Amount ("SMDIA") from \$100,000 to \$250,000.
- (b) A temporary removal of the SMDIA coverage cap for certain accounts.
- (c) Simplification of the coverage requirements for revocable trust and mortgage servicer accounts;

- (d) Revisions to the FDIC's practices for determining deposit and other liability account balances at failed institutions;
- (e) New requirements for certain large depository institutions to modernize the insurance claims process and make it easier for the FDIC to calculate deposit insurance coverage quickly, and provide depositors faster access to their funds after a large bank failure; and
- (f) Issuance of a new version of FDIC General Counsel Opinion No. 8, which declares funds held by banks in connection with stored-value products to be "deposits" under the Federal Deposit Insurance Act.

3. WHEN ARE THE CHANGES EFFECTIVE?

All of the changes discussed in this summary are currently effective. However, several of the changes are temporary and are scheduled to sunset on December 31, 2009.

II. INCREASES IN DEPOSIT INSURANCE

1. TEMPORARY INCREASE IN SMDIA.

Section 136 of the Emergency Economic Stabilization Act of 2008ⁱ (the "Stabilization Act") temporarily increased the SMDIA from \$100,000 to \$250,000 per depositor. This change was effective upon passage of the Stabilization Act on October 3, 2008. It will sunset on December 31, 2009.

The FDIC codified this increase through an Interim Rule issued on October 17, 2008. The FDIC will accept comments on this Interim Rule through December 16, 2008.ⁱⁱ

This revision is a "find and replace" amendment. Aside from the SMDIA increase, it makes no other changes to underlying deposit insurance coverage requirements. Therefore, for purposes of calculating insurance coverage for bank customers, the analysis

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is exactly the same as before, with the SMDIA increased from \$100,000 to \$250,000. The FDIC has updated its Electronic Deposit Insurance Estimator ("EDIE") to use the higher SMDIA.

2. MODEL LANGUAGE.

Many customer-facing communications (including deposit insurance brochures and teller window signs) specifically reference the \$100,000 SMDIA. To address this, the FDIC has immediately approved the following language to clarify these materials:

*On October 3, 2008, FDIC deposit insurance temporarily increased from \$100,000 to \$250,000 per depositor through December 31, 2009.*ⁱⁱⁱ

3. TEMPORARY LIQUIDITY GUARANTEE PROGRAM.

On October 14, 2008, as part of its Temporary Liquidity Guaranty Program^{iv} (the "Liquidity Program"), the FDIC temporarily increased the SMDIA on non-interest bearing transaction accounts.^v

The FDIC has issued a Final Rule codifying the Liquidity Program Requirements as a new Part 370 of the FDIC regulations (12 C.F.R. Part 370).^{vi} The deposit insurance requirements of the Liquidity Program as codified in the Final Rule have several important components:

- (a) Generally. Effective October 14, 2008, all balances in non-interest bearing transaction accounts are fully insured, without regard to the SMDIA cap. This additional coverage is provided to insured depository institutions free-of-charge until November 12, 2008.
- (b) IOLTAs and Low Interest NOW Accounts. Based on comments received, the Final Rule includes both (i) Interest on Lawyers Trust Accounts ("IOLTAs") and (ii) Negotiable Order of Withdrawal ("NOW") accounts with interest rates $\leq 0.50\%$ in the definition of non-interest bearing transaction accounts. Under the Liquidity Program these accounts are fully insured, without regard to the SMDIA.^{vii}
- (c) One-Time Opt-Out. Unless the insured depository institution opts-out of the Liquidity Program by **December 5, 2008**, it will remain enrolled until December 31, 2009. Unless the institution opts out, it will pay a special assessment for the additional deposit insurance equal to 10-basis points on deposit amounts over \$250,000 in non-interest bearing transaction accounts, IOLTAs and NOW accounts. This assessment will be retroactive to November 13, 2008. The regulators will be revising call reports/TFRs to facilitate this calculation. The FDIC will publish on its web site a list of the entities that have opted-out of the unlimited coverage.
- (d) Multi-Bank Holding Companies. The Liquidity Program will require all insured depository institutions within a bank holding company structure to make the same election regarding continued participation. If any institution within a holding company opts out, the FDIC will take the position that all insured institutions within the holding company have opted-out.^{viii}
- (e) Sweeps and Reclassification Programs. Many institutions offer sweep programs which transfer

funds from transaction accounts to other types of deposit or nondeposit products on an overnight basis. Similarly, institutions may use account reclassification programs (i.e., programs that sweep funds from transaction accounts to savings accounts) for reserve management purposes. The Liquidity Program relies on FDIC rules regarding failed institutions (discussed in Part V of this Summary) to determine whether funds are in a non-interest bearing account. As a general rule, the FDIC will treat the funds as being in the account to which they are swept/reclassified. However, the FDIC will make an exception for transfers of funds from a non-interest bearing transaction account to a non-interest bearing savings product. The FDIC will consider these funds as being in the non-interest bearing transaction account and eligible for full coverage under the Liquidity Program.^{ix}

- (f) Disclosure Obligations. Effective **December 19, 2008**, the Final Rule requires two (2) types of disclosures.^x

- i. Lobby Notice Regarding Participation in Liquidity Program. Institutions offering non-interest bearing transaction accounts must post a prominent and readily understandable notice in the lobby of all branch locations (and on its website if it offers Internet deposit services) indicating whether it is participating in the transaction account guarantee portion of the Liquidity Program.^{xi} The FDIC has provided two sample notices, and has indicated that institutions may supplement this content. The sample notices are:

Sample For Participating Institutions
[Institution Name] is participating in the FDIC's Transaction Account Guarantee Program. Under that program, through December 31, 2009, all noninterest-bearing transaction accounts are fully guaranteed by the FDIC for the entire amount in the account. Coverage under the Transaction Account Guarantee Program is in addition to and separate from the coverage available under the FDIC's general deposit insurance rules.

Sample For Non-Participating Institutions
[Institution Name] has chosen not to participate in the FDIC's Transaction Account Guarantee Program. Customer of [Institution Name] with noninterest-bearing transaction accounts will continue to be insured through December 31, 2009

for up to \$ 250,000 under the FDIC's general deposit insurance rules.

- ii. Disclosures to Sweep and Reclassification Customers. If the institution uses sweep arrangements to transfer funds (or otherwise reclassifies deposit accounts) to accounts that are not fully insured under the Liquidity Program, the institution must disclose this fact to impacted customers, and inform them that these actions void the full coverage of these deposits with respect to the swept, transferred or reclassified funds. Due to the wide variety in these types of programs, the Final Rule does not provide model language for this disclosure.
- (g) Sunset. The extended insurance coverage offered under the Liquidity Program is scheduled to sunset on December 31, 2009.

4. PRACTICAL CONSIDERATIONS.

The increases in deposit insurance coverage raise several practical considerations, including:

- (a) Model Language Inconsistency? The FDIC has issued two (2) sets of model language. The first (provided in Part II(2), above), deals with the increase in the SMDIA for all accounts. The second (provided in Part II(3)(f)) is found in the Final Rule and announces whether the institution is participating in the Liquidity Program. However, these provisions do not adequately cross-reference each other (particularly if the institution has not opted-out of the Liquidity Program). Institutions may want to consider adding language to clarify that if the institution has not opted out that non-interest bearing transaction accounts are fully covered, and that all other accounts are insured to the new SMDIA of \$ 250,000.
- (b) EDIE. The FDIC's Electronic Insurance Deposit Estimator has not been updated to reflect the additional insurance coverage under the Liquidity Program.
- (c) Massachusetts Banks Participating in DIF. Many Massachusetts banks participate in the

Deposit Insurance Fund ("DIF"). Because the DIF fully insures amounts above the SMDIA, there appears to be no benefit to these institutions for the increased insurance coverage for non-interest bearing transaction accounts under the Liquidity Program. The FDIC acknowledged this in the Final Rule, granting an allowance for institutions to supplement the model lobby notices. Massachusetts banks participating in DIF can explain their decision to opt out in such supplementary content.

- (d) Government/Municipal Deposits. Financial institutions holding municipal and state government deposits accounts are generally required by state law to provide adequate protection (e.g., collateral) for any uninsured deposit amounts. Due to the additional insurance coverage on non-interest bearing transaction accounts, depository institutions may wish to consider the degree to which such accounts need additional protection.
- (e) Reclassification Programs. Banks that have reclassification programs for reserve management purposes should revisit the manner in which those programs operate. Funds swept to anything other than a non-interest bearing savings account (or a NOW account earning less than 0.50% interest until the end of the Liquidity Program) will void the full coverage otherwise available to the non-interest bearing transaction account from which the funds are swept. Given the disclosure requirements imposed by the Final Rule, this may have a bearing on how banks manage these types of programs.
- (f) Disclosure Obligations. The lobby signage requirements imposed under the Liquidity Program, along with peer advertising, may weigh on a bank's opt out decision. These factors, along with the manner in which reclassification programs operate, should be considered together when making a determination of whether or not to opt out of the additional coverage offered by the Liquidity Program.

III. REVOCABLE TRUST RULES SIMPLIFICATION

1. REVOCABLE TRUSTS -- BACKGROUND.

Revocable trust accounts generally fall into two categories:

- (a) Informal Trusts. Informal trust accounts, which are generally referred to as "totten trusts," "payable on death" (or "POD") accounts, or "in trust for" (or "ITF") accounts. These accounts are governed by the terms and conditions of the

deposit account agreement, and do not require a formal trust agreement.

- (b) Living Trusts. The second type of revocable trust account involves a formal trust documents created for estate planning purposes. Trusts falling into this category are generally referred to as “living trusts,” although they may also go by a variety of other names.

Under prior FDIC rules, revocable trust accounts were subject to certain requirements to qualify for separate deposit insurance coverage. Failure to fulfill these requirements resulted in the amount on deposit being insured under the individual ownership category.

2. INTERIM FINAL RULE.

On September 30, 2008, the FDIC issued an Interim Final Rule^{xiii} to amend the revocable trust account coverage requirements:

- (a) Qualifying Beneficiary Requirements: Under the prior rule, the beneficiaries named on a revocable trust needed to be the spouse, children, grandchildren, parents and siblings of the account owner. The Interim Final Rule removes this requirement. All that is required under the new rule is that the beneficiary be a natural person, charity, or non-profit.
- (b) Determination of Beneficiary Interests: Coverage calculations under the prior rule were often complicated if the beneficial interests were unequal, which often occurred with living trusts. The Interim Final Rule simplifies this in two ways:
- i. Accounts < \$500,000. The Interim Final Rule removes beneficial interest calculations altogether for accounts with up to \$ 500,000. In this case, coverage is determined by multiplying the number of beneficiaries by the SMDIA.^{xiii}
 - ii. Accounts > \$500,000. To maintain limits on the maximum amount of coverage under this category, the Interim Final Rule establishes a separate coverage calculation for accounts with more than \$500,000 with more than five (5) beneficiaries. In this case, coverage is the

greater of \$500,000 or the sum of all beneficial interests in the account (capped at the SMDIA per beneficiary).

- (c) Coverage of Life Estate Interests: In certain instances, a revocable trust account will provide for a life estate interest in one or more parties (e.g., a spouse creating a trust account and granting a life estate to his/her spouse), with the remainder in the account to certain beneficiaries (or “remainder-men”). The prior rules provided an equal interest in the trust assets to each life-estate holder and remainder-man for deposit insurance purposes. The Interim Final Rule simplifies this by covering each life estate interest up to the SMDIA.
- (d) Coverage of Revocable Living Trusts Converting to Irrevocable Trusts: Under the prior rules, when a party owning a living trust account died the trust would become irrevocable, and then be governed by separate deposit insurance rules. These rules would often decrease coverage, as they would be based on the non-contingent interest of each trust beneficiary. The Interim Final Rule does away with this coverage change, and instead keeps the coverage calculation under the revocable account rules even once the account becomes irrevocable.

3. NO OTHER CHANGES MADE.

Aside from these revisions, no other substantive changes were made to the revocable account rules. In particular, the requirement that the intention to transfer the funds in the account to the beneficiary(ies) upon the death of the account owner(s) be clearly manifested in the title of the account, as well as the requirement to name the beneficiary(ies) in the books and records of the financial institution, remain in effect.

4. REQUEST FOR COMMENTS.

Although the Interim Final Rule is currently effective, the FDIC has requested comments and established a comment period. Any comments regarding the Interim Final Rule must be received prior to the close of business on December 1, 2008.

IV. MORTGAGE SERVICER RULES SIMPLIFICATION

I. WHAT'S GOING ON?

On October 10, 2008,^{xiv} the FDIC simplified its rules regarding deposit insurance coverage on mortgage servicer accounts. These changes are permanent, and

were effective immediately. The FDIC codified these changes through an Interim Rule issued on October 17, 2008.^{xv} The FDIC is seeking comment on the Interim Rule by December 16, 2008.

2. PRIOR RULE.

Under the prior rule, accounts maintained by a mortgage servicer containing the principal and interest payments of borrowers were insured on the ownership interest of each lender (or investor) in the account. Due to the increasing complexity of secondary market transactions (e.g., securitizations), it has become very complex and time-consuming to determine deposit insurance coverage.

3. NEW RULE.

Under the Interim Rule, coverage is provided to lenders and investors as a collective group. Coverage is based on the cumulative amount of principal and interest payments in the account by each borrower, up to the SMDIA.

4. NO AGGREGATION.

Insurance coverage under the new rule is not aggregated with other accounts held by the

borrower(s) at the institution holding the mortgage servicer accounts. As a result, the new rule will not affect the coverage of a borrower in connection with other accounts s/he may hold at the institution maintaining the mortgage servicer account.

5. NO CHANGE FOR TAXES/INSURANCE.

The Interim Rule only changes the calculation coverage for principal and interest payments held by mortgage servicers. It does not change the rules for tax and insurance amounts held by a servicer in a custodial or fiduciary capacity.

These funds will continue to be insured on a pass-through basis as the funds of the borrower(s). The distinction drawn in the Interim Rule is that while principal and interest payments “belong” to the lender (or investor), tax and insurance payments belong to the borrower until the servicer remits such payments.

V. NEW RULES FOR ACCOUNT PROCESSING UPON BANK FAILURE

1. BACKGROUND.

In July of 2008,^{xvi} the FDIC adopted an Interim Rule that established its practice for determining deposit balances at failed institutions. This Interim Rule became effective August 18, 2008.

2. GOVERNING PRINCIPLES.

The Interim Rule establishes the following principles that will be followed in the event of a bank failure:

- (a) End of Day Ledger Balances. The FDIC will treat deposits in accordance with their underlying obligations based on the end-of-day ledger balance for the account. The balance will generally take into account the depository institution’s normal posting and cutoff procedures.
- (b) Cease Liabilities. As receiver of a failed institution, the FDIC will attempt to stop inbound and outbound transfers of new liabilities (or the extinguishing of existing liabilities) for the institution.
- (c) FDIC Cutoff Point. To accomplish this goal, the rule allows the FDIC to establish an “FDIC Cutoff Point”. This is a point in time at which these transfers will be stopped. If the institution’s ordinary cutoff time for transactions is after the FDIC Cutoff Point, the FDIC Cutoff Point will be used instead.

3. DETERMINING ACCOUNT BALANCES.

To determine account balances in accordance with these principles, the FDIC will use the balance in accounts at the close of the business day. These balances may be adjusted for funds received by, or removed from, the failed institution after the FDIC Cutoff Point. Calculation of this balance is subject to the following provisions:

- (a) Posted Uncollected Checks. Checks posted to the account at the close of business will be included in the account balance. This amount will then be subject to adjustment for uncollectible items that will be handled by the FDIC in its role as receiver of the failed institution.
- (b) Sweeps. Sweeps of funds to internal non-deposit investment accounts that are scheduled to take place before the final calculation of the institution’s end-of-day balances will be allowed in accordance with the institution’s standard cutoff time – even if that occurs after the FDIC Cutoff Point. However, sweeps to third party accounts that do not occur prior to the FDIC Cutoff Point will not be allowed and funds will remain in the account and be included in its end-of-day balance for deposit insurance calculation purposes.

4. PRACTICAL IMPLICATIONS.

The Interim Rule has significant practical implications for holders of sweep accounts. Depending on whether the nature of the sweep is internal or external, the FDIC may allow funds to be swept out of the account into a non-deposit investment product that is not covered by deposit insurance. This would leave no (or very few) funds in the account covered account at the time account balance calculations are made.

5. SWEEP ACCOUNT DISCLOSURES.

To address these new rules, institutions will have to ensure that all sweep account contracts and statements must prominently disclose whether swept funds are deposits under the Federal Deposit Insurance Act.^{xvii} If they are not, then the disclosure must also note the status the funds would have if the institution failed (for example: general creditor status, or secured creditor status).

Institutions offering sweep products must be prepared to make this disclosure by July 1, 2009.

VI. NEW REQUIREMENTS FOR LARGE BANKS

1. WHAT'S GOING ON?

On July 17, 2008,^{xviii} the FDIC adopted a Final Rule to modernize its business processes and procedures for determining insurance coverage in the event of a failure of a large insured depository institution.

2. WHAT INSTITUTIONS ARE COVERED BY THE NEW RULE?

- (a) General. The new rule applies to any insured depository institution (a "Covered Institution") with at least \$2 billion in domestic deposits and either:
- More than 250,000 deposit accounts; or
 - More than \$20 billion in total assets (regardless of the number of deposit accounts).^{xix}

The FDIC estimates that 159 financial institutions will be Covered Institutions under the new rule.

- (b) Requests for Exemption. Covered Institutions may apply to the FDIC for an exemption from the requirements of the new rule if they have a high concentration of deposits incidental to credit card operations.

3. WHAT DOES THE NEW RULE REQUIRE COVERED INSTITUTIONS TO DO?

While the requirements of the new rule are too lengthy for full explanation in this Summary, the new rule requires Covered Institutions to adopt mechanisms that would, in the event of a failure:

- Allow automatic posting of provisional holds on large deposit accounts in any percentage specified by the FDIC on the day of failure;

- Allow automatic removal of provisional holds and posting of the results of insurance determinations as specified by the FDIC;
- Provide the FDIC with deposit account data in a standard format; and
- Provide assistance to the FDIC in testing the systems required by the new rule.

4. WHEN IS THE NEW RULE EFFECTIVE?

- (a) General Rule. The new rule became effective on August 18, 2008. Covered Institutions have 18 months from the effective date (i.e., until February 18, 2010) to comply with the requirements of the new rule.
- (b) Delayed Compliance Date. The rule provides additional time for mandatory compliance in certain circumstances, including:
- If a financial institution becomes a Covered Institution after the effective date, it must comply with the requirements of the new rule no later than 18 months after the end of the second calendar quarter for which it meets the criteria for a Covered Institution.
 - Similarly, if two or more institutions merge and the resulting institution is a Covered Institution, the resulting institution must comply with the requirements of the new rule no later than 18 months after the effective date of the merger.
- (c) Accelerated Compliance Date. The FDIC reserves the right to accelerate the 18-month mandatory compliance deadline for any Covered Institution which:
- has a composite rating of 3, 4 or 5;

- is undercapitalized; or
- is determined to be experiencing a significant deterioration of capital, significant funding difficulties, or liquidity stress.

- (d) Requests for Extension of Deadline. Covered Institutions may apply to the FDIC for an extension of the mandatory compliance date.

VII. FDIC INSURANCE FOR STORED VALUE PRODUCTS

1. WHAT'S GOING ON?

On November 13, 2008, the FDIC issued a new version of General Counsel Opinion No. 8, which replaces the prior version issued in 1996.^{xx}

2. WHAT DOES THE NEW OPINION SAY?

The new Opinion No. 8 declares that all funds underlying stored-value products -- such as gift cards, payroll cards, prepaid cards, and government benefit cards -- and other nontraditional access mechanisms are "deposits" under the Federal Deposit Insurance Act ("FDIA") if the funds are placed with an insured depository institution.

As a result, effective immediately such funds are FDIC insured, and banks will be assessed insurance premiums on such fund balances. The Opinion also states that if such funds are held in a pooled account, insurance coverage will be determined under the FDIC's pass-through insurance rules (12 C.F.R. Section 330.5).

3. WHAT SHOULD YOU DO?

Given the immediate effect of the Opinion, banks which offer stored-value products should review (and, if necessary, revise) product documentation to ensure that any statements concerning FDIC insurance coverage in such documents are accurate.

4. WHAT ARE THE IMPLICATIONS OF THIS NEW OPINION?

While the new Opinion is a significant development, the conclusion that such funds are "deposits" under the FDIA may have even more significant unintended consequences. While no conclusions on the following issues have been reached, some questions to consider include:

- The definition of "deposit" in the FDIA is virtually identical to the definition of "deposit" in Federal Reserve Board Regulation D. Now that funds underlying stored-value products have been declared "deposits" for purposes of the FDIA, one might reasonably conclude that such

funds may also be "deposits" under Regulation D, and (depending on the structure of the stored value product) may be "demand deposits" and "transaction accounts" under Regulation D. If so, in addition to paying FDIC insurance premiums, a bank holding such funds would need to pay reserves on those funds, and follow other requirements of Regulation D.

- Similarly, under the Electronic Fund Transfer Act and Federal Reserve Board Regulation E, an "account" is defined to include a "demand deposit" or other "consumer asset account." These terms are not defined in the EFTA and Regulation E, and it may be reasonable to conclude that the Federal Reserve Board (or a court) would look to Regulation D for definitions of these terms. Currently, Regulation E applies to payroll cards, but is expressly inapplicable to other stored value products. One might wonder whether the Federal Reserve Board will reconsider this limitation on the scope of Regulation E. If so, stored-value products may need to comply with Regulation E requirements, including delivery of initial disclosures and periodic statements, error-resolution processing, and limitations on liability for unauthorized use.
- Under the Expedited Funds Availability Act and Federal Reserve Board Regulation CC, "account" is defined by express cross-reference to Regulation D. As a result, if the stored value funds are considered a "transaction account" under Regulation D, a bank holding such funds would be required to provide funds availability disclosures (e.g., for reloadable card products) and comply with other requirements of Regulation CC.
- Under the Truth-in-Savings Act and Federal Reserve Board Regulation DD, "account" is defined as a "deposit account," including a time account, demand account, savings account and NOW account. None of these terms is defined in Regulation DD and again, it may be reasonable

to conclude that the Federal Reserve Board or a court would look to Regulation D for definitions of these terms. If so, a bank holding stored value funds may be required to provide Regulation DD disclosures for stored value products.

- Under the USA PATRIOT Act “Customer Identification Program” rules, “account” includes a “deposit account,” including transaction accounts and asset accounts. Again, none of these terms is defined in the CIP rules, and it may be reasonable to conclude that regulators would look to Regulation D for definitions for these terms. If so, a bank may need to apply CIP procedures to its stored value products. One difficult question would be whether the bank’s CIP efforts could be limited to the purchaser of the product (i.e., the source of the funds), or would also need to apply to the holder of the access device.

These are just a sampling of the questions raised by new FDIC General Counsel Opinion No. 8. Other issues may include:

- Gramm-Leach-Bliley/Regulation P privacy requirements;
- identity theft “Red Flag” and address mismatch requirements;
- state and federal branch and deposit production office issues (if bank deposits are accepted at locations other than approved branches or DPOs); and
- state laws addressing escheatment of deposits and liens on/attachment of deposits.

VIII. WHAT SHOULD YOU DO?

1. SHOULD YOU OPT OUT OF LIQUIDITY PROGRAM?

A decision must be made very soon about whether you will opt-out of the Liquidity Program. Your institution will only have until **December 5, 2008**, to do so. The FDIC has published a [Sample Opt Out Form](#), the final version of which will be available on the [FDICconnect](#) site beginning on November 12, 2008.^{xxi}

2. REVIEW AND UPDATE MATERIALS.

Many customer-facing materials (including FDIC brochures and teller signage) specifically reference the \$100,000 SMDIA. Some of these materials may also reference the rules regarding revocable trust and mortgage servicer accounts. These materials should be either (a) discarded (if they are FDIC-produced) or (b) updated if they are internally-produced.

If you elect to update these materials, and you either (a) elect to make these changes prior to December 5, 2008, or (b) do not opt-out of the Liquidity Program, then you may need to revise the model language provided by the FDIC.

While the FDIC has not officially revised the model language for the increase in the SMDIA, the following modification may suffice:

On October 3, 2008, FDIC deposit insurance temporarily increased from \$100,000 to

\$250,000 per depositor through December 31, 2009.

As of October 14, 2008, all non-interest bearing transaction deposit accounts at an FDIC-insured institution, including all personal and business checking deposit accounts that do not earn interest, IOLTAs, and NOW accounts earning interest at a rate of 0.50% or less are fully insured for the entire amount in the deposit account. This unlimited insurance coverage is temporary and will remain in effect for participating institutions until December 31, 2009.

3. REVIEW AND UPDATE PROCEDURES.

Any procedures – particularly those for customer service personnel – discussing FDIC deposit insurance coverage amounts should also be reviewed and be updated to reflect the new coverage amounts and simplified requirements.

4. REVIEW RECLASSIFICATION PROGRAMS.

Many banks have established money market deposit sub-accounts for their transaction accounts, and have implemented automatic transfers from the transaction accounts to the MMDA sub-accounts. These “reclassification” programs are intended to reduce reserve requirements on transaction account balances. While customers must receive disclosures about such programs, the accounts function as a

single transaction account from the customer's perspective.

If an institution has implemented a reclassification program to minimize reserve requirements, such programs may have an impact on insurance coverage of the institution's transaction accounts. To the extent that funds are moved from non-interest bearing transaction accounts to anything other than a non-interest bearing savings account, the transaction account is not eligible for the unlimited insurance coverage under the Liquidity Program. Institutions need to be careful to provide appropriate disclosure to customers concerning the insurance coverage for such accounts.

5. CREATE OR ACQUIRE LOBBY SIGNAGE.

Institutions must either create or acquire lobby signage to comply with the disclosure requirements effective December 19, 2008.

6. REVIEW SWEEP ARRANGEMENTS.

Institutions should review any sweep arrangements they make available to depositors. Institutions may receive questions from customers regarding their coverage in the event of a potential failure. Additionally, institutions should also prepare for the new disclosure requirements for sweep arrangements that will become effective on July 1, 2009.

Because of its generality, the information provided in this summary may not be applicable to all situations and should not be acted upon without specific advice from legal counsel. If you have any questions concerning this summary or how it applies to any particular entity or circumstance, please contact either Ryan Stinneford by phone at (207) 791-1154 or by email at Rstinneford@pierceatwood.com, or Tom Quinn by phone at (857) 277-6903, or by email at Tquinn@Pierceatwood.com.

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END NOTES

ⁱ See: [Pub. L. 110-343](#).

ⁱⁱ See: [FIL 111-2008](#). This change was done by amending the SMDIA definition in the FDIC deposit insurance regulations (12 C.F.R. § 330.1(n)). Discussion of this revision is found at [73 Fed. Reg. 61658 \(October 17, 2008\)](#).

ⁱⁱⁱ See: [FIL 102-2008](#).

^{iv} See: [FIL 103-2008](#). The temporary increase in the coverage of non-interest bearing transaction accounts is one component of the Liquidity Program. In addition, for institutions participating in the program, the FDIC will guarantee certain newly issued senior unsecured debt issued by participating institutions on or after October 14, 2008, and before June 30, 2009. The FDIC has indicated that institutions may opt-out of one or both components of the Liquidity Program. See also: [Liquidity Program FAQ](#) and [FIL 125-2008](#).

^v “Transaction accounts” are defined in Federal Reserve Board Regulation D (“Reg D”) as “a deposit or account from which the depositor or account holder is permitted to make transfers or withdrawals by negotiable or transferable instrument, payment orders of withdrawal, telephone transfers, or other similar device for the purpose of making payments or transfers to third persons or others or from which the depositor may make third party payments at an automated teller machine (“ATM”) or a remote service unit, or other electronic device, including by debit card.” Reg D § 204.2(e). The most common type of transaction accounts are checking accounts. Money market deposit accounts and savings deposit accounts are excluded from the definition. See: 12 C.F.R. § 370.2(h).

^{vi} See: [FIL 132-2008](#) and [73 Fed. Reg. 72244 \(November 26, 2008\)](#). The Interim Rule was discussed in [FIL 110-2008](#), and published in the Federal Register at [73 Fed. Reg. 64179 \(October 29, 2008\)](#). The comment period on the Liquidity Program requirements closed on November 13, 2008.

^{vii} See: 12 C.F.R. § 370.2(h)(3). NOW accounts with interest rates above 0.50% may receive full coverage if the institution reduces the interest rate on the account to 0.50% and commits to maintain the rate at no more than this amount through December 31, 2009.

^{viii} See: 12 C.F.R. § 370.5(e).

^{ix} See: 12 C.F.R. §§ 370.4(c) and 370.7(c).

^x See: 12 C.F.R. § 370.5(h)(5). The disclosure obligation is effective December 19, 2008. However, prior to that time the FDIC has indicated that institutions should attempt to make the substance of these disclosures in a “commercially reasonable manner.”

^{xi} If the institution does not offer non-interest bearing transaction accounts, it does need to post this notice. See: [73 Fed. Reg. 72244, 72259](#).

^{xii} See: [73 Fed. Reg. 56706 \(September 30, 2008\)](#).

^{xiii} Because the Interim Final Rule was issued prior to the increase in the maximum deposit insurance amount, its calculation is based on a SMDIA of \$100,000. The Interim Final Rule is currently being redrafted to account for the increase in the SMDIA from \$100,000 to \$250,000.

^{xiv} See: [Press Release 97-2008](#).

^{xv} See: [FIL 111-2008](#). The amendment to the FDIC deposit insurance regulation governing mortgage servicer coverage requirements (12 C.F.R. § 330.7(d)) is found at [73 Fed. Reg. 61658 \(October 17, 2008\)](#).

^{xvi} See: [73 Fed. Reg. 41170 \(July 17, 2008\)](#). The Interim Rule is also discussed in our [October 10, 2008, Financial Services Alert](#).

^{xvii} In particular, under 12 U.S.C. § 1813(l).

^{xviii} See: [73 Fed. Reg. 41180 \(July 17, 2008\)](#).

^{xix} The dollar amount of domestic deposits, number of deposit accounts and dollar amount of total assets for each institution are determined by reference to the institution’s Report of Condition and Income (Call Report) if the

institution is an insured bank, or Thrift Financial Report (TFR) if the institution is an insured savings association.
See: 73 Fed. Reg. 41188, fn. 24.

^{xx} *See:* FIL 129-2008.

^{xxi} *See:* Liquidity Program FAQ and FIL 125-2008.

