HUNTON & WILLIAMS

CLIENT ALERT

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FDIC Issues Final Rule on Treatment of Sweep Accounts in Bank Failures and Disclosure Requirements

By: Zonnie Breckinridge and Peter Weinstock[1]

As we reported in a previous alert, the FDIC published an interim rule in July of last year that addressed the treatment of deposit accounts, including sweep accounts, in bank failures. That rule has now been made final. It establishes the FDIC's practices for determining deposit account balances for insurance coverage purposes at a failed financial institution. The rule also requires banks and thrifts to notify their sweep account customers of the nature of their swept funds and how they would be treated if the institution were to fail. The rule will be effective 30 days after publication in the *Federal Register*, except for the disclosure to sweep account customers requirement, which will be effective July 1, 2009.

As noted in our earlier memo, in making deposit insurance determinations, the FDIC will base deposits of the failed institution on end-of-day ledger balances, using the institution's normal posting procedures, *except* as otherwise provided in the rule. With regard to sweep accounts, the final rule treats internal and external sweep accounts somewhat differently.

For internal sweeps, the FDIC will determine the ownership of the funds and the nature of the receivership claim based on the institution's records for that account as of the closing day end-of-day ledger balance. Thus, if the sweep account entails the daily transfer of funds from one account at the bank to another account at the bank, the FDIC will treat the account as it would have been reflected on the bank's books at the end of the day (as if the bank had not closed).

For sweeps from the bank to an external entity, the FDIC will treat swept funds consistent with their status as of the end-of-day ledger balances at both the closed bank and the external entity, *as long as the transfer is completed prior to the Applicable Cutoff Time.* The rule defines Applicable Cutoff Time as the earlier of either the failed bank's normal cutoff time for that particular type of transaction or the time established as a cut-off point by the FDIC after it has been appointed receiver. In other words, the FDIC would not complete an external sweep unless the funds had left the institution prior to the applicable cutoff point.

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For repurchase agreement sweep accounts, where, as a result of the sweep, the customer becomes either the legal owner of the identified assets subject to repurchase or obtains a perfected security interest in those assets, the FDIC will recognize the customer's ownership interest in the assets.

In promulgating the interim rule, the FDIC requested comments and received four comments on the interim rule, three from bank trade associations and one from a large commercial bank. All commenters urged the FDIC not to prescribe "specifically worded" disclosures because sweep arrangements and their processes vary considerably across institutions (although one commenter noted that at least some of its members felt that a "model disclosure" would be helpful). The commenters also requested that there be only a one-time disclosure to the customer in the sweep agreement.

In accordance with the majority of comments, the FDIC determined not to prescribe the exact language of the disclosure in the final rule. Moreover, the rule does not require that the institution modify its existing contracts with sweep customers. However, effective July 1, 2009, in all new sweep account contracts, in renewal contracts and within 60 days of July 1, 2009, *and at least annually thereafter*, institutions must prominently disclose in writing to sweep account customers whether their swept funds are deposits. In the case of external sweep arrangements, the required disclosure must indicate that if the institution failed, the funds might not be swept to the external source. In that situation, the disclosure must note how the funds would be treated. For example, in the case of an external money market mutual sweep, the disclosure must state that the funds would be treated as deposits and insured under applicable deposit insurance rules.

Where swept funds would not be deemed deposits upon the bank's failure, the institution must disclose the status such funds would have if the institution failed, i.e., whether general creditor status or secured creditor status.

Institutions may comply with the disclosure requirements through client letters, transaction confirmations or account statements. The requirement in the interim rule that these disclosures be included in all account statements was not part of the final rule. All disclosures must be consistent with how the bank reports the funds on its quarterly Call Report or Thrift Financial Report.

It should be noted that the disclosure requirements do not apply to sweeps in which the transfers are within a single account or subaccount, or the arrangement involves only deposit-to-deposit sweeps, such as zero-balance sweeps, unless the sweep results in a change in the status of the customer's account under the deposit insurance rules.

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