Extract from the August 8, 2013, Full Board Meeting Minutes

***** The original minutes can be found on the Board's website, www.realestate.mt.gov*****

FULL BOARD MEETING MINUTES
of the
BOARD OF REALTY REGULATION
301 S Park Ave, 4th Floor Large Conference Room, Helena, MT
9:42 a.m. - 5:12 p.m.
Thursday, August 8, 2013

1. **Call To Order - Establish Quorum - Introduction of Board & Staff Members Present (00:00:00)**
   Mr. Abramson convened the meeting at 9:42 a.m.

   Board Members present:
   Mr. CE "Abe" Abramson, Chairperson
   Mr. Pat Goodover, Industry Member
   Mr. Larry Milless, Industry Member
   Ms. Shirley McDermott, Public Member
   Ms. Connie Wardell, Industry Member
   Ms. Cindy Willis, Industry Member

   Board Members present:
   Mr. Stephen Hess, Public Member

   Board Staff present:
   Ms. Maggie Connor, Board Management Bureau Chief
   Ms. Grace Berger, Executive Officer
   Mr. Gene Allison, Board Counsel
   Ms. Susan Asplund, Board Management

   Others present:
   Zane Sullivan, Peggy Trenk, Tia Robbin, Mary Grant, Riley Burnham, Pat Reardon, Mark Simonich, Ruth Link, Jaymie Bowditch, and Ryan Olsen.

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5. **Board Action (02:30:52)**

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   e. **Correspondence/Discussion Items**
      i. CD Trust Accounts **(6:13:11)**
      See Board Counsel's White Paper Research Regarding Certificates of Deposit in Trust Accounts.

      Motion (06:13:40): Mr. Goodover moved to re-affirm Board Counsel's position, in summary, trust funds cannot be in a Certificate of Deposit (CD). **(06:15:12)** The motion passed.

Re: White Paper Research Regarding Certificates of Deposit in Trust Accounts

To: Montana Board of Realty Regulation
From: M. Gene Allison, Board Counsel
Date: 07/02/2013

Currently, Montana law demands that trust funds be kept in a federally insured financial institution located within Montana and the account must be identified by the words "trust account". The trust account may be maintained in an interest-bearing account pursuant to a written agreement between the agent and the client. ARM 24.210.426 and 24.210.805. Reading all of the Board's laws and rules together, it is safe to say that the funds must be available on demand and must never be in jeopardy of loss. Consequently, the Board has previously taken the position that keeping trust funds in Certificates of Deposit would not satisfy Montana law regarding the liquidity of funds and protection of deposited principle.

Different Types of Certificates of Deposit (CDs)[1]

Certificates of Deposit (CDs) come in numerous forms and each of those may have different terms. The terms within general categories of CDs will vary from institution to institution. Essentially, each financial institution customizes their CDs. Therefore, it would be impossible to list the entirety of the forms and terms of all CDs. However, very broad explanations of some of the types of CDs can be attempted. The list is by no means exhaustive. In listing these broad categories, the writer attempts to alert the reader of the plethora of CD types and the pitfalls that may or may not occur when trust funds are invested in CDs. The reader should take into account the requirements for trust accounts including ready liquidity and threats to principle amounts. The reader should also consider the possibility of a broker exceeding the amount of personal funds which may be contained in trust accounts.

CD types may be distinguished based on a specific feature offered by the Certificate of Deposit account. Sometimes, the CD account type will be labeled by a name describing its main feature. There are many

[1] This portion of this discussion paraphrases and borrows heavily from a number of sources especially including: *Certificate of Deposit.co* http://www.certificateofdeposit.co/ Because much, if not most, of the information provided herein is not of this writer's creation and because the writer is not an expert in financial matters, the writer cannot guarantee the absolute accuracy of any of the statements made herein. Therefore, NOTHING HEREIN SHOULD BE TAKEN AS FINANCIAL ADVICE OR RELIED ON BY ANYONE WHO WISHES TO INVEST MONIES. Investors should consult their own financial advisor.

different types of CD accounts offered by the various financial institutions. Some of the most common and most popular account types include:

Traditional CDs

Certificates of deposits are often considered to be “time deposits”. A traditional or general type of CD are agreements with financial institutions whereby the investor agrees to let the institution hold the investor’s money for a set maturity date, which will vary depending on the individual CD’s term. The interest rates for CDs are typically higher than a standard savings account, but most traditional CD’s do not allow the funds to be withdrawn without penalty until the CD’s maturity term is reached (whereas most savings accounts allow penalty-free withdraws).

Usually, a Traditional CD deposit is insured by the Federal Deposit Insurance Corporation (FDIC) for up to $250,000 per depositor, per insured bank.

Insured CDs

Typically, investors who invest in CDs have a guaranteed return of the principle that they invest, as long as they keep the money in CDs according to the terms. But financial institutions can fail. Therefore, many financial institutions carry insurance on monies deposited with them. The FDIC or the NCUA insures investors who invest their money in certain financial institutions. If the financial institution insures their money, investors are guaranteed to receive their original investment money back (up to the insured amount of money). Most insured banks offer protection of up to $250,000 on the amount of the deposit. Further, if there are additional depositors on the account, each depositor receive the same amount of protection. <u>It is extremely important to note that not all banks and credit unions carry insurance protection, especially credit unions</u>. If an investor’s financial institution is not insured, the investor can stand to lose money – including principal - during financial hardships.

Significantly, <u>deposits over the insured limit are not covered</u>. The FDIC limit is up to $250,000 at most financial institutions that provide this coverage but the amount may vary greatly by financial institution. It may be much less than $250,000. Regardless, any amount over the insured limit is <u>not</u> covered if something happens to the bank. Thus, investors stand to lose principle if the principle is over the insured amount.

Some financial institutions do offer additional insurance protection outside of FDIC. First Internet Securities Network (FISN) offers protection for FDIC insured CDs. Investors can receive up to $500,000 worth of protection if the financial institution fails for any reason. Investors cannot get FISN protection unless their accounts are already FDIC insured.

Callable CDs

With Callable CDs, the investor agrees to invest the money for a fixed amount of time with a specified interest rate for the return. The difference between traditional CDs and callable CDs is that the issuer may redeem callable CDs before the maturity date. If the financial institution calls the CDs, the investors still retain all of the original principle. However, there are early withdrawal penalties and longer terms for callable CDs. If investors take out their money before the maturity date, they stand to lose a large amount of interest. Banks change as much as a 25% early withdrawal penalty to investors.

Bump-Up CDs

Bump up CDs are different from traditional CDs in that investors have the option to bump up their CD interest rates when the market rates increase. Most banks only allow one bump-up option for the duration of the CDs. However, some banks will allow up to two bump-ups. Many financial institutions offer a fixed amount of time to use the bump-up option and the option may be lost forever if investors do not use the bump-up within the specified period. The bump-up option does not increase the maturity term. If investors use their bump-up options they still retain the original maturity date of their CDs. If the interest rates decrease instead of increase, investors keep their original investment amount.

Negotiable CDs

Negotiable CDs require investors to invest large sums of money – typically the investment is a minimum of $100,000. Negotiable CDs are similar to traditional CDs in that they both have predetermined terms, and money cannot be withdrawn until the predetermined maturity date. Financial institutions generally offer negotiable CDs on a short-term basis of one year or less. Once an investor invests money into Negotiable CDs, they will at least regain their original investment and some interest. Therefore, investors are guaranteed some return. What makes Negotiable CDs 'negotiable' is that Negotiable CDs may be sold.

Non-Negotiable CDs

Investors in Non-negotiable CDs must first select: a certain amount of money to invest; terms; and interest rates. Thereafter, investors open the CD account according to the agreement. Unlike Negotiable CDs, Non-negotiable CDs cannot be transferred, sold, bought, or exchanged. Investors are able to withdraw the money early from Non-negotiable CDs, but they have to pay penalties to do so. Some issuers charge 3 to 6 months of interest to withdraw funds from CDs.

If the investor leaves the money in the account according to its terms, the investor will leave with at least the principle amount that they invested plus some interest. Even with low interest rates, investors gain money while their money sits in non-negotiable CDs. However, once investors put their money into non-negotiable CDs, they must hold the investment until the maturity date. There is no option to sell, buy, transfer, or exchange non-negotiable CDs. Since investors cannot sell, buy, transfer, or exchange non-negotiable CDs, they may be left with no choice but to withdraw the funds early if they need the funds. There may be penalty fees for early withdrawal. Fees can add up to as much as 3 to 6 months of interest.

Auto-Renew CDs

Auto-renew CDs work similar to traditional CDs. An Investor who opens any CD account agrees to certain terms, rates, and conditions. Once the investment reaches the maturity date, investors must decide whether to re-invest in the same CDs, pull out the money, or invest in other CDs.

Some CDs come with an auto-renew feature that reinvests the money in the same type of CD, usually for the same terms. Investors open CD accounts for agreed terms and rates.

The difference in auto-renew accounts occurs as the CDs approach the maturity dates. Auto-renew CDs allow the issuer to reinvest the money. Issuers are supposed to contact investors 30 days before the maturity date reaches, or 20 days before the end of the grace period. If investors do not express their wishes to withdraw the money or reinvest in other CD options, issuers automatically renew the CDs as they wish.

Investors have a grace period before the auto-renewal. The grace period (usually 7 to 10 days after the maturity date) is a window of time to decide if they are still interested in renewing the CDs, or if they want to try other investment options. If investors do not respond to contacts before or during the grace period, the CD issuers have control over the decision. Issuers at financial institutions do not always make the choice to reinvest investors' money in the same CDs at the same rates for the same terms. For example, if investors currently have a 5% interest rate on their CDs and the market rate decreases to 2.5% interest, issuers have the option to renew the CDs at the lower interest rate. Once the rate is locked, investors must abide by the terms until the next maturity date.

Jumbo CDs

Jumbo CDs are investment ventures that require a minimum of a $100,000 deposit. Investors agree to certain terms and interest rates for their deposits. Jumbo CDs are generally 1 to 10 year investments. Generally speaking, jumbo CDs have a high yield of return over time. However, Investors must be willing to leave the money in the CDs for at least 5 to 10 years in order to achieve maximum benefits. As long as investors do not withdraw their money, they earn a high yield of return over the length of the CDs.

If redeemed early, the most that investors can lose is a few months of interest on the principle amount invested. They do not have to worry about losing the interest and the principle. Therefore, because of the way they work, the original amount of the deposit essentially is 'guaranteed' at any time even if the earned interest does not amount to much or anything at all. This 'guarantee' is not to be confused with FDIC coverage. In fact, it is worth noting that many Jumbo CDs are not FDIC insured at all, particularly for any amounts over the FDIC coverage limits.

Liquid CDs

Traditional CDs cannot be cashed in before the maturity dates without incurring penalties. On the other hand, Liquid CDs are said to allow investors to withdraw their CD investment without penalties. But this statement is not an absolute. Financial institutions do require varying grace periods that investors must wait if they do not want to incur penalties.

Once through the grace period, Investors can withdraw money without penalties**.** However, some financial institutions limit the number of withdrawals. Example, some allow one withdrawal per month and others allow one withdrawal per 7 days.

Even though a Liquid CD is designed to be 'liquid' and penalty-free after the grace period, there actually are penalties for withdrawals of money outside of the terms even though the grace period is long past. Financial institutions allow withdrawal according to their specific terms. Investors that withdraw the money more frequently than the terms stipulate will suffer hefty penalties that cut into their profit.

The deposit amount for a Liquid CD must generally be $10,000 or higher and that minimum balance must be maintained. If investors withdraw money until the balance is lower than the minimum, Issuers have the right to close the account or transfer the money to another CD account.

Liquid CD typically auto-renew at the end of the terms**.** Like all auto-renew CDs, if investors do not renew the investment in the same type of CDs, Issuers may choose to invest the money in lower rate CDs with longer terms, or they may even renew the CDs in non-liquid CDs.

And, again, not all financial institutions are FDIC insured whether for traditional CDs, Liquid CDs or any other type of CD.

Brokered CDs

Brokered CDs are CDs that investors find in financial institutions other than banks. These CDs are brokered, which means that a financial advisor surveys the market for the best rates available and notifies the investors with the findings. Instead of only having bank rates available, Investors choose from the entire market. Investors then agree to keep the money in the financial institution for the length and specified terms. Brokered CDs are not free. Investors pay fees to the brokers for their services. These fees are in addition to the amount of money that investors invest into brokered CDs.

Brokered CDs may come in all different varieties. For example, Investors may have the option to purchase liquid CDs in which they can withdraw money. Brokered liquid CDs like most liquid CDs have a limit on the number of withdrawals and the length of time between withdrawals.

Brokered CDs are tradable in the secondary market and can be transferred between brokerage firms. They may be bought, sold, or transferred (depending on the variety of CD). However, in order to get rid of a brokered CD, Investors may have to sell on the secondary market for less than they paid for the CDs thus resulting in a loss of some principle. Also, brokered CDs are often not insured by the FDIC.

Variable Rate CDs

Traditional CDs lock investors into a certain interest rate for a fixed amount of time. Variable rates increase and decrease interest rates as the market changes. Even though an Investor may benefit from interest rate increases, they may also lose money if the market drops. At a minimum, an Investor could lose current and future interest.

An Investor in variable rate CDs agrees to keep their money in these CDs until the maturity date so that they do not encounter early withdrawal penalties. However, if an early withdrawal does become necessary, there are higher penalties. Those fees are usually harsher than the fees for early withdrawal of traditional CDs.

Zero Coupon CDs

Zero coupon CDs have fixed rates and do not pay interest to investors until the maturity date. The interest rates of these CDs are lower than that of traditional CDs, but investors purchase these CDs at below value prices. Investors are expected to pay taxes on these CDs even though they do not receive any actual payments on the investment until maturity. Some Zero coupon CDs are callable.

Add-on CDs

Traditional CDs do not allow investors to add money to the account. Unlike traditional CDs, Add-on CD Investors may be allowed to add extra money to the CDs. The terms of Add-on CDs generally requires that investors set up an automatic payment from savings or checking accounts. The payment withdrawal is taken on a monthly basis, and the minimum payment is usually $50 per month.

Some financial institutions do limit the additional deposits to the amount of the initial deposit, and others limit the number of deposits over the terms. Otherwise, the additional Add-on payment amount can vary as the investor chooses. There is no penalty to add money, and except for the limits mentioned above, investors may add money as they please. Add-On CDs require a minimum daily balance and that minimum amount may vary by financial institution. The penalties for going below the minimum balance also vary by financial institution.

Once the money is invested in an Add-on CD, the investor is locked into the agreement until the maturity date. Nevertheless, Investors can withdraw interest without penalties. They have the option to receive their interest on a monthly or yearly basis, and they do not have to worry about incurring penalties in the process.

Step Up & Step Down CDs

Step up and step down CDs have a fixed interest rate for a certain amount of time – usually one year. After this time, the interest rate increases or decreases to a predetermined interest rate. Issuers have exclusive control over <u>when</u> the interest rates go up or down to match current rates. Other non-traditional CDs require that investors make requests to receive rate increases, and these increases may take several months to be in effect.

Investors will lose money if rates decrease**.** Nonetheless, no matter how the issuer changes the interest rates, the principle investment is safe. Further, step up and step down CDs may be insured by the FDIC for up to $250,000. Such coverage is not a given. As with other CD issuers, some financial institutions are not insured by FDIC and, therefore, some step up and step down CDs are not covered at all or are not covered to the maximum $250,000.

Step up and step down CDs should not be confused with bump-up CDs. Bump up CDs allow <u>investors</u> to request a rate increase before the terms end. However, with step up and step down CDs, <u>issuers</u> control the interest rate changes whether up or down.

CDs that Pay Dividends

Dividends are additional gains that investors make on their investments. Credit unions are more likely to offer dividends than banks. CDs that pay dividends are rare in today's economy, but they do exist. The CD portion of the transaction works the same way that traditional CDs work. Investors decide to invest a certain amount of money with certain terms and at a specified interest rate. Investors then gain principle based on their ability to keep the term agreement.

Some financial institutions pay dividends based on the number of shares investors own, and others pay dividends to all of their members holding accounts. These funds are paid out annually or semi-annually to investors. The dividends paid are based on the amount of loans, stocks, and deposits investors have in the financial institution. Investors may make money on both interest and dividends. Investors will have to pay taxes on the dividends that they earn. Financial institutions can decide at any time to reduce or eliminate dividends.

IRA CDs

IRA CDs work similar to traditional CDs. Investors agree to certain terms and interest rates before opening the CDs. Investors agree to keep the money in the accounts according to the agreement, or they will have to pay withdrawal fees. The differences include:

- The IRA CD funds are either tax sheltered or tax-free. (Traditional IRAs are tax sheltered and Roth IRAs are tax-free);
- Deposits for IRA CDs are much higher than that of traditional CDs (as much as $5,000). However, the deposit is tax deferred or tax-free;
- The interest rates are generally higher than traditional CD interest rates;
- Many of these CDs are for terms of 5 to 10 years;
- Investors are expected to pay taxes on the earned interest when money is withdrawn. Investors can opt to pay the taxes either before or after withdrawal;
- Each CD is FDIC insured, as long as the financial institutions are FDIC insured; and
- IRA CDs have high early withdrawal penalties (as much as 10% for early withdrawal). The penalties may cost investors all of their interest and much of their principle interest.

WHAT DO OTHER JURISDICTIONS DO?

Some states don’t allow trust funds to be kept in any sort of interest-bearing account. Without mentioning Certificates of Deposit, Nevada has taken the position that federal law generally prohibits financial institutions from paying interest on commercial demand accounts. However, Nevada says that interest may be paid on trust accounts only if the entire beneficial interest in the account “is held by one or more individuals or by an organization which is operated primarily for religious, philanthropic, charitable, educational, political, or similar purposes and which is not operated for profit”, or on deposits of public funds. *Citing to 12 USC, ' ' 1828, 1832*. As a result, Nevada has taken the position that brokers are required to account for and remit client’s money “on demand” and are not a nonprofit charitable organization under the federal law. Therefore, Nevada says that federal law will “preclude the establishment of an interest-bearing trust account in most situations”. In the rare instances that Nevada allows interest-bearing trust accounts, they also require compliance with very strict conditions. It does not appear that trust funds kept in Certificates of Deposit would satisfy Nevada’s strict requirements.

Unhampered by Nevada’s concerns regarding federal prohibitions, at least one other state does allow trust funds to be kept in the form of Certificates of Deposit in limited circumstances albeit with some restrictions and conditions. The *North Carolina Real Estate License Law and Commission Rules* provides:

> Trust money may be deposited in an interest-bearing trust account ONLY under the following conditions: (1) the broker must obtain from the persons for whom he or she is holding the funds written authorization to deposit the funds into an interest-bearing account; (2) the authorization must clearly specify how and to whom the interest will be disbursed; and (3) if the authorization is contained in an offer, contract, lease or other transaction instrument, it must be set forth in a manner which shall draw attention to the authorization and distinguish it from other provisions of the instrument (for example, italics, boldface type, underlining, a blank _________ to be filled in with the name of the party to whom the interest will be paid, or some similar means).
>
> Inasmuch as trust money must be deposited in a demand deposit account as defined by G.S. 93A-6(g), the investment of such funds in any type of security, including government bonds, would be prohibited. The investment of trust money in most certificates of deposit is also prohibited. Trust money may be maintained in a certificate of deposit with a federally insured depository institution lawfully doing business in North Carolina only if the certificate of deposit is federally insured, the terms governing it permit withdrawal of the trust money on demand and without any penalty that would reduce the principal amount of the trust money invested in this manner, and the institution agrees to make the records available for inspection by the Commission’s representatives. Trust monies may not be deposited in sweep accounts or invested in repurchase agreements.

Similarly, Washington allows (or even demands) trust funds to be kept in interest-bearing accounts but they don't necessarily allow the broker to keep the proceeds. The funds either go to certain nonprofit charitable organizations or to certain public fund accounts.

Washington law provides:
RCW 18.85.285
. . .
(8)(a) If a real estate broker receives or maintains earnest money or client funds for deposit, the real estate firm shall maintain a pooled interest-bearing trust account for deposit of client funds, with the exception of property management trust accounts.
(b) The interest accruing on this account, net of any reasonable and appropriate financial institution service charges or fees, shall be paid to the state treasurer for deposit in the Washington housing trust fund created in RCW 43.185.030 and the real estate education program account created in RCW 18.85.321. Appropriate service charges or fees are those charges made by financial institutions on other demand deposit or "now" accounts. The firm or designated broker is not required to notify the client of the intended use of the funds.
. . . .

(10) For an account created under subsection (8) of this section, the designated or managing broker shall direct the depository institution to:

(a) Remit interest or dividends, net of any reasonable and appropriate service charges or fees, on the average monthly balance in the account, or as otherwise computed in accordance with an institution's standard accounting practice, at least quarterly, to the state treasurer for deposit in the housing trust fund created by RCW 43.185.030 and the real estate education program account created in RCW 18.85.321;
. . .

Almost certainly there are other states which do or don't allow real estate trust funds to be kept in Certificates of Deposit. Whether a majority of states do or don't allow it should not be the primary consideration of this Board. Rather, the Board should determine what is best for the public and licensees. If necessary, the Board may wish to consider writing new rules within the contest of existing statutes. Depending on what the board wants to do with this issue, the Board may wish to seek new legislation in an upcoming legislature.