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Understanding Index Linked CDs

A Notice for Clients Who Trade or Who Anticipate Trading Index Linked CDs

Index-linked CDs and notes can be confusing products. They seem so straight forward and uncomplicated in their structure, but some can involve complex payoff rules that may make it difficult for an unsophisticated investor to accurately evaluate the potential risks and rewards. One of our missions at Benjamin F. Edwards and Company is to provide an appropriate mix of suitable products for each of our clients. As a part of that process, we want to make an extra effort to answer any questions or concerns you might have about any recent or pending purchases of index-linked CDs. We urge you to contact your Financial Advisor if you would like any further explanation of the features, characteristics and risks of any particular security.

The securities industry first developed these hybrid products more than 20 years ago. Initially the products offered upside participation in a popular stock market index with 100% principal protection. In the cases of CD versions of the product, the protected principal was even insured up to the limits of FDIC coverage.

This sounds like a very attractive alternative: upside participation with no downside risk! In reality, of course, there are opportunity costs involved with using these products. Not only does the index-linked CD investor forego whatever fixed-rate interest they would have been able to earn on a traditional CD, but also, they do not get credit for any dividends paid on the underlying index over the life of the CD. Like traditional CDs, the index-linked variety includes an "estate liquidity" feature, more bluntly referred to as a "death put." In the event of the death or incapacity of the CD owner, the owner's estate can request that the CD issuer redeem the CD at its full par value. Like traditional CDs, the index-linked variety should be considered "buy & hold" investments. They should be considered to be illiquid securities. While the issuer may maintain a secondary market for their CDs, they're not required to do so. Anyone who might be forced to sell an index-linked CD before maturity should expect that the best price they're likely to find could be at a substantial discount to fair value, and perhaps even below par value.

As market conditions changed, the products evolved; more complicated structures were concocted. As interest rates continued to decline, the economics of these structures suffered. Where full upside participation with full protection had been available in a higher interest rate environment, lower rates meant that issuers might only be able to offer just 50% to 60% upside participation. The problem is that a product with 50% participation doesn't sound very tempting. The result was that issuers employed modifiers like averaging, periodic caps, volatility limiters and countless other custom structures. The common feature of these custom structures was that they reduced or limited the range of potential future outcomes enough so that the issuer could proudly proclaim, "Yes, I promise to pay you 100% of THAT performance." These CDs can be very simple packages, or they can be very complex concoctions.

Understanding the Risks

An exhaustive list of the various risks to which an investor might be exposed through the purchase of an index-linked CD will be included in the prospectus and term sheet for each CD. Among the risks enumerated therein, we draw your attention to the following:

2022-3327 Exp. 10/31/2025

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The CDs do not pay any regular periodic interest. Holding the CDs for their full term does not assure a gain, it only assures that your original principal amount will be returned. This investment could result in zero profit. You will not receive dividends or interest paid on any underlying constituent indices.

- **Lack of Liquidity:** The CDs will not be listed on an organized securities exchange. The issuer may offer to purchase the CDs upon terms and conditions acceptable to them but are not required to do so. You may not be able to sell your CDs. The CDs are not designed to be short-term trading instruments. Accordingly, you should be able and willing to hold your CDs to maturity.
- **Limitations on FDIC Insurance:** As a general matter, holders who purchase CDs in a principal amount greater than the FDIC insurance limits will not be insured by the FDIC for the principal amount exceeding such limit. In addition, under FDIC interpretations, the "return" on the CDs over and above the par amount, is considered to be "contingent" interest, and it is not insured by the FDIC until the amount is finalized per the calculation procedure. Any amounts due on the CDs in excess of the applicable FDIC insurance limits will be subject to the credit risk of the issuing bank.
- **Taxed as "Contingent Payment Debt Instruments":** In some cases, taxpayers may be required to recognize "phantom income" annually on the CDs even though no income is paid out. Any income so recognized increases the holder's tax basis in the CDs.
- **Higher Fees than Traditional CDs:** Creating these structures is much more difficult and time consuming than issuing a new traditional CD. Each one is its own custom creation. Advisors offering these products generally need to spend much more time educating clients about the particular structure. For these reasons, issuers build in higher fees to compensate themselves and the advisors who offer their product. It's not unusual for the advisor to be paid 1 to 3% as a selling concession, with overall fees, including the issuer's spread totaling 4 to 6%.
- **The "I Think I've Got It" Risk and the "Seems Too Good to be True" Risk:** If a structure seems to be promising more potential benefit than other similar CDs, it must be taking something away somewhere. It might be helpful to compare two or three different CDs to better enable you to understand the give and take of the various structures. Don't hesitate to ask your advisor for help in understanding the differences.
- **Constraints on Performance:** In order to be able to offer an attractive "participation rate" on the underlying index's performance, one or more built in constraints may be included in the process of calculating the underlying index. Performance constraining devices such as averaging, periodic caps, volatility limiters and others may be incorporated into the index calculation process. Before purchasing an index linked CD, you should understand which, if any, of these methods could be impacting the underlying performance potential. Ask your advisor to describe the degree to which underlying performance may be diluted.

Index-Linked CDs are complex products and are not suitable for all investors. The risks identified above are not exhaustive. There are a wide variety of Index-Linked CDs available, with attributes which affect their risks and potential rewards. Before making any investment decision, you should carefully consider the investment objectives, risks, charges, and expenses before investing in this product. This and other important information are included in the offering documents, which can be obtained from your Financial Advisor and should be read carefully. Benjamin F. Edwards & Co.® does not provide tax advice. You should obtain advice from your financial, legal and tax advisers for information about and analysis of the investment, its risks and its suitability in your particular circumstances.

2022-3327 Exp. 10/31/2025