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Mary Rupp, Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314-3428

Re: Draft of Comment Letter to Proposed Interpretative Ruling and Policy Statement No. 05-1 Sales of Nondeposit Investment Products

Dear Ms. Rupp,

I am writing this comment letter as legal counsel to credit unions and credit union service organizations who offer investment services in networking arrangements with affiliated broker/dealers and to credit union service organizations who are registered broker/dealers.

Overview

NCUA Letter to Credit Unions Number 150 is a product of a time when there were Congressional hearings investigating bank sponsored investment programs. Some customers of bank investment programs were being misled by registered representatives as to whether the investment products purchased were covered by deposit insurance. As a result of these false assurances, some customers incorrectly believed that the investments they purchased through the bank investment programs could not lose principal and Congress wanted to stop this abusive practice.

NCUA did not want credit unions to be caught up in this issue. Credit unions were not part of the Interagency Agreement applicable to banks and therefore NCUA had to issue its own guidance to credit unions. NCUA was anxious to communicate a message to Congress that credit unions would act as an additional set of eyes to oversee the transactions and prevent such abuses. Thus, NCUA issued Letter Number 150 to federally insured credit unions in December 1993. Letter 150 imposed oversight functions on the credit unions such as approval of products that the affiliated broker/dealer could offer and examination of records for potential abuses by the broker/dealer. This put the credit union in a position of interjecting itself into their affiliated

broker/dealer's regulatory compliance issues. For reasons that follow, I have advised credit unions to refrain from interjecting themselves into regulatory oversight of the broker/dealer.

While additional oversight by the credit union sounds like a great layer of protection for members, that oversight creates the possibility that credit unions would incur liability if a regulatory issue was overlooked. For example, if Letter 150 requires that the credit union take on a compliance role and a member has a claim that the broker/dealer did not provide the securities for the lowest cost due to a violation of the break point rules, would the credit union be liable to the member as well as the broker/dealer? The member could allege that the credit union had the obligation to discover any abuses by the broker/dealer and failed to fulfill its duties.

The additional risk to the credit union might be justified if there was effective oversight that was not redundant. Credit unions have no expertise in the supervision and compliance function of securities activities. They may have heard of concepts such as investor suitability and break points, but they have no education or experience which would enable them to supervise sales of security products. Through Letter 150, NCUA imposed a burden upon credit unions to perform functions they are not qualified or able to perform. To fully comply with the directives of NCUA, credit unions would have to hire expensive experts to duplicate the supervisory and compliance efforts of the broker/dealers and their regulators.

Broker/dealers have a supervisory function performed by the branch registered principal, sometimes known as the office of supervisory jurisdiction and a separate internal compliance function. Broker/dealers are subject to examinations by the National Association of Security Dealers, the state security regulators and the Securities and Exchange Commission. What could an inexperienced credit union add to this oversight? The SEC and NASD in recent years have demonstrated a zealous focus on the protection of the investor. This duplication of oversight by the credit unions creates unnecessary costs and exposes the credit unions to potential liability that they would not otherwise incur.

When I discovered that Letter Number 150 was being replaced by an IRPS, I was anticipating that tNCUA would be reexamining the oversight role of the credit union in the delivery of nondeposit investment products. I was hoping that this duplication of regulatory oversight on securities sales issues would be eliminated. Unfortunately this is not the case. In fact, the scope of that oversight seems to have been expanded. My concerns have grown.

Specific Comments to the Proposed IRPS

I thought the most productive means to respond to the proposed IRPS was to set forth what I believe are the key policy reasons for an IRPS on Offering Nondeposit Investment Products and determine whether the proposed IRPS promotes or is contrary to the policy reason.

Policy Reason Number 1: Credit union members must understand that the investment products are not being sold by the credit union, the investment products are not insured and the members may lose principal. It is necessary for members to fully comprehend the investment risk before they invest.

The obligation for the credit union to provide disclosures is set forth on pages 13 and 14 of the proposed IRPS. There is the ability to abbreviate the disclosures per NASD Rule 2350. There is the obligation to have a signed acknowledgement of the disclosures at the account opening and specific signage requirements at the point of sale. The portion of the proposed IRPS related to the disclosure obligation serves the purpose of Policy Reason Number 1.

Policy Reason Number 2: Credit unions should have policies and procedures that limit the credit union's liability exposure in the sale of investment products.

The proposed IRPS sets forth the three types of risk: legal, reputation and economic. The legal risks of financial institutions in investment services network arrangements have been low over the years, as reflected in the relatively low insurance premiums charged to cover the financial institution's risk, notwithstanding the case cited in the proposed IRPS.

The proposed IRPS imposes compliance duties on credit unions that are inconsistent with a networking arrangement and places credit unions at greater legal risk. Policy Reason Number 2 is **not** being served by the proposed IRPS. The portion of the proposed IRPS imposing compliance duties on credit unions is set forth on pages 18 through 22. My comments, as applicable to the referenced sections, are as follows:

The features of the sales program. This section requires a credit union to analyze the level of complexity and volatility in the investments that the credit union will permit the broker/dealer to offer to members. Broker/dealers are perform an investor suitability analysis before selling an investment to a customer. An investment not suitable for a person of modest means who relies upon their investments for income may be the perfect investment for a high net worth sophisticated and diversified investor. Putting aside the issue of the qualifications of a credit union to make that decision, how can a credit union state that a particular investment is not appropriate for any member of the credit union? If the credit union limits the investments the broker/dealer may offer, it may prevent the broker/dealer from being able to fully meet its investor suitability obligation and drive some members to use other broker/dealers. Further, if a credit union prohibits the sale of a particular investment product that may have arguably been more suitable to an investor and the investor purchases another investment product, the credit union may be exposing itself to liability if the investor becomes dissatisfied with the investment product purchased.

A description of the relative responsibilities of the credit union and the brokerage firm. The proposed IRPS states that the broker/dealer is primarily responsible for compliance and that the credit union has a right to check for compliance. This is a very big mistake unless the credit union's compliance obligation is limited to verifying compliance with disclosures. First, NASD and SEC insist that the broker/dealer is exclusively responsible for securities law compliance. In the agreements I negotiate, I insist on language that requires the broker/dealer to exclusively supervise compliance. If responsibility for compliance is shared with the credit union, then credit unions can expect that liability will also be shared and that the indemnification from the

broker/dealers will be diluted. Is NCUA ready to accept the additional risk to the Share Insurance Fund as a result of interjecting credit unions into compliance oversight of the broker/dealers? Does NCUA plan to train its examiners in securities law compliance to oversee whether credit unions are adequately overseeing the broker/dealers?

Access to member accounts may not always be possible. While the joint marketing exception works under the Gramm-Leach-Bliley Act, there are states with laws that require opt-in and opt-out procedures that will prevent universal access to investment accounts by credit unions. How will a credit union comply with this oversight directive if it cannot access accounts due to state privacy laws?

Termination of the contract. I concur with this section and I always negotiate this for my clients, however, I question whether this detail of contract negotiation is appropriate for an IRPS.

Compliance with the requirements in this IRPS and applicable law and regulation. Credit unions are required to have personnel who are independent and qualified to perform a variety of compliance oversight of the broker/dealer. The credit union is to look at accounts for issues regarding churning, investor suitability and improper use of loan proceeds to make investments.

"Qualified counsel" is expected to guide credit unions through the compliance oversight process. In my judgment only a person qualified to be a registered principal has the training and experience to provide this oversight compliance function. Is the credit union really expected to retain a registered principal qualified person who is not associated with the investment program simply to second guess the registered principal assigned to the program? Since the credit union's independent registered principal will have to be registered with the credit union's broker/dealer in order for the broker/dealer to be able to disclose the account information to him or her, the credit union's fulfillment of its duty becomes even more complicated and unfeasible. I note that if the credit unions' independent registered principal finds something he or she does not like, the only appropriate action is to refer the matter to the broker/dealer and its registered principal.

The depository/loan functions of a credit union are generally not integrated with the investment functions. How are credit unions going to track the loan and investment relationship to determine if investments where made from loan proceeds? This obligation is going to take a great deal of staff time and require a significant technology investment to cross reference loan and investment activity. If a member who is also an investment client of the credit union's affiliated broker/dealer takes out a loan with the credit union, does NCUA expect the credit union to require the member to prove how the loan proceeds are used? Why would a member use the credit union's investment program if these additional obligations are imposed by the credit union? How can credit unions comply with sharing loan and investment information in those states with restrictive privacy laws?

Credit unions should take an active role within the scope of their expertise. Credit unions should receive and monitor member complaints and verify receipt and understanding of disclosures by the members. If the credit union receives a compliant from a member or is has a

compliance concern, the IRPS should direct the credit union to forward the issue to the broker/dealer's registered principal and follow up with the registered principal and member to see if the member's complaints are adequately addressed. If there are persistent unresolved problems, the credit union can change broker/dealers. This level of involvement will enable the credit union to protect its reputation risk without increasing its legal risk.

Separation of duties. "The duties performed for the credit union should not bring the employee into contact with members that might also purchase nondeposit investments." What is the purpose of this requirement? While most dual employees are totally dedicated registered representatives, there are some programs that have credit union member service representatives and credit union branch managers who also are licensed to sell investments. They are often called platform representatives. Banks have had them for years. Does this statement prevent credit union member service representatives and branch managers from selling investment products? If so, this is contrary to NCUA's current policy and all industry trends of product integration. This position would put many successful credit union programs out of compliance and at a significant competitive disadvantage to banks.

"The dual employee should have no management or policy-setting responsibilities within the credit union related to nondeposit investments." While most registered representatives only have sales duties and are not involved in policy making, many credit unions have hired investment program managers who are registered representatives and dual employees. The investment program manager provides the credit union with expertise in the delivery of investment services and often holds a vice-president level staff position at the credit union.

Some investment program managers have some selling duties. In the larger programs, the investment program manager does not have any sales duties but he or she is the registered principal and has compliance supervision duties over the other registered representatives. As a registered principal, the investment program manager is often paid a commission override which is customary in the securities business. The investment program manager has input into the credit union's investment services policies which are set by credit union's senior management and board.

The dual employee program manager cannot be isolated from the very duties for which he or she was hired. To preclude the investment services manager from participating on the credit union's management and policy making team would create an immediate compliance and operational issue for the most successful credit union investment programs in the country. It is akin to telling the head of lending that they cannot participate in setting lending policies.

There is a fundamental misunderstanding of the loyalty of these dual employees. It is to the credit union and not the broker/dealer. This dual employee primarily identifies himself or herself with the credit union and not the broker/dealer. A principal reason for credit unions to use the dual employee model is to give the registered representatives the comfort of knowing that the credit union is committed to them and the success of the investment program. The dual employees reciprocate with loyalty to the credit union. I note that when a credit union transitions

from one broker/dealer to another, the dual employees almost uniformly stay with the credit union's program and transition their registrations to the new affiliated broker/dealer.

Dual employee compensation. By way of clarification, a dual employee is always paid by the credit union so there is no split of compensation. This would change if credit unions are not allowed to pass on commissions on nonmember business to the dual employees. Broker/dealers may have to pay the dual employees directly for nonmember commissions. Where the registered representatives are paid directly by the broker/dealer and there is no employment relationship with the credit union, there are no dual employees. These investment programs are often referred to as managed plans.

Indemnification. "The use of dual employees increases the risk a credit union may be held liable for abusive sales practices. At the same time, this brokerage firm may have less incentive to supervise nondeposit sales activates properly when conducted by a dual employee." I challenge this statement. Frankly, broker/dealers are quite surprised that NCUA would think this was the case. A broker/dealer has the same compliance risk for a dual employee registered representative as it does for any other registered representative. The NASD and SEC hold the broker/dealer solely responsible for the actions of all their registered representatives.

If the credit union allows the broker/dealer to exclusively supervise the securities sales compliance function, the use of dual employees will not have any significant legal risk. In any event, I support the use of a strong indemnification clause that protects the credit union from the acts or omissions of the broker/dealer and its registered representatives.

Policy Reason Number 3: Maintain the ability of credit unions to compete in the financial marketplace. The regulatory framework has to be reasonable and cannot cause credit unions to incur costs to render them non-competitive.

If credit unions actually did the compliance oversight that this IRPS requires, credit unions would have to hire registered persons to perform the oversight, incur additional information technology costs to integrate the loan and investment functions, and incur additional clerical support time. If the credit union has properly performed its due diligence and the broker/dealer is a respected and competent broker/dealer, the supervision and compliance function should be left to the broker/dealer and their regulators who are far more capable than the credit union to perform these functions. There is no pattern of abuse by broker/dealers serving credit union members in 2005. Banks do not hire people to oversee the overseers. NCUA is putting credit unions at a significant market disadvantage if credit unions are required to incur the cost of additional expertise, technology and staff time to comply with the this additional oversight, especially since the oversight is unnecessarily redundant.

Policy Reason Number 4: Credit unions need guidance on how to deal with nonmember transactions.

The percentage nonmember approach is the wrong way to go. While I appreciate the purposes served by the percentage approach, it will create such complications in operations as to make it unworkable. The percentage approach raises more questions than it answers. Is the percentage measured by gross income and expenses? Is the percentage measured at year end or is it measured on a more regular basis? When a new registered representative starts and all his or her business is all nonmembers (family and friends), is he or she out of compliance immediately or is there a grace period while the registered representative begins to serve credit union members? Should the measurement method be by the number of members versus nonmembers served instead of the dollars earned as trade volumes can be disproportionate? How does a broker/dealer and registered representative discharge their fiduciary obligation to a nonmember customer who needs to make a sales transaction and the transaction will exceed the income or expense limitation?

A much better way to approach the nonmember issue is to recognize that nonmember business is a necessary by-product of permitting a broker/dealer to offer investment services with registered representatives who have some nonmember customers. The registered representatives would write under two representative numbers, one for member business and one for nonmember business. A full revenue share would be paid to the credit union for the member business and the nonmember business would be paid only to the extent of the actual expenses incurred by the credit union to service the business. This is not a hard number to establish. A transaction cost model could be established which would show the cost of a transaction. The cost would include the representative's commissions, fair market space rental and other actual overhead costs. The validity of the transaction cost figure could be documented and would be defensible against outside criticism. Since the credit union would not be making a profit on the transaction, there would be no incentive to increase the nonmember business.

It should make a difference that the nonmember served is a member of an associated credit union. Why are members of another credit union treated the same as nonmembers for purposes of a credit union being able to earn a fee for its services related to the sale of investments? In other circumstances, it makes a difference whether a nonmember is a member of another credit union. Reg flex qualified credit unions can buy nonmember loans if the borrowers are members of another credit union. Credit unions have traditionally helped members of other credit unions. They can cash checks for members of other credit unions under the correspondent powers and the serving credit union can be paid a fee to cover its costs of services. Why does this rule have to be different as applied to investment services? The employing credit union is just acting as a paymaster. The broker/dealer and not the employing credit union is providing the services to the members of another credit union. Permitting the credit union employer of dual employees to be paid a fee for its services to another credit union is consistent with past practices for other services.

I have noted to NCUA on several previous occasions that the ability of larger credit unions to assist smaller credit unions in the delivery of investment services is essential in order to make effective investment services available to members of smaller credit unions. A rule of thumb is that a registered representative needs a credit union of at least $100 million in assets to support one registered representative. In order to maintain the health of the credit union industry as a whole, we should not put unnecessary impediments in the way of credit unions helping other credit unions, especially when it comes to serving members and earning much needed non-interest income.

If the assisting credit union cannot make money for their efforts in assisting other credit unions, they should at least be able to recover their costs. Since serving some nonmembers is a necessary by-product of being in the investment business with experienced registered representatives, credit unions will incur some costs in serving nonmembers. If credit unions are compelled to support the nonmember sales without an ability to be paid their out-of-pocket costs, the financial burden upon credit unions could be too much for credit unions to bear and some investment programs will be discontinued. Investment programs serving multiple credit unions are especially vulnerable in that they are dependent upon the ability to reimburse costs among the participating credit unions in order to function.

Conclusion

These are different times than 1993. The perceptions of 1993 are not the reality of 2005. The average investor is more educated and experienced in investment services. In twelve years, financial institutions have gained experience and insight in the proper and prudent way to offer investment services. Many credit unions have hired persons with significant investment services experience. The vast majority of credit unions use broker/dealers that specialize in the credit union marketplace and take their compliance obligations very seriously. The NASD and SEC are looking closely over the shoulder of every broker/dealer.

Regulation often stems from impressions. I urge NCUA to re-examine their impressions as I submit that they are dated. As long as there are securities sales there will be compliance issues but there is no evidence that there are wide-spread systemic compliance issues that justify injecting credit unions into compliance functions and the risks and unnecessary costs associated with that action.

I also urge NCUA to not try to use a nonmember percentage test. It will not accomplish the purpose of simplicity NCUA is trying to achieve. It will have just the opposite effect in practice. I appreciate the opportunity to comment on this proposed IRPS.

Very truly yours,

Guy A. Messick

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