

Standards for Credit Union Investment Pilot Program – Short Sales of U.S. Treasury Securities

A federal credit union may sell U.S. Treasury securities short under this pilot program.

Financial Condition

At the time of approval, the credit union must:

- Be classified as Well Capitalized under Part 702 for at least the preceding four (4) quarters; and
- Have positive, stable earnings for the preceding 12 months.

Board of Directors

The credit union board of directors must adopt policies that address, at a minimum:

- Limitations on short sales activities, including at a minimum:
 - *Investment pilot program limits.* An aggregate limit on the liability for short sales not to exceed 50 percent of net worth;
 - *Risk limits.* Limits on price risk (e.g., duration, or value at risk) of the gross short position; and
 - *Stop-loss limits.* An aggregate loss limit covering a specified period of time (e.g., calendar month or calendar quarter) that triggers a halt in trading and a liquidation of short positions for the remainder of that period.
 - Illustrative Example: Assume a credit union has net worth of \$50 million. The credit union board may set a maximum limit of \$25 million on the liability for short sales, a gross portfolio duration of 5 years, and a stop loss policy stipulating that short sales will cease immediately for the remainder of the quarter if losses exceed \$1.25 million and short sales will cease for the remainder of the calendar year if cumulative losses for the year exceed \$2.5 million.
- Daily measurement and monitoring of compliance with limitations on short sales activities; and
- Monthly reports to the board on short sales activities.

Internal Controls

Internal control procedures must be established that require, at a minimum:

- Review of all trades by the close of each business day by an authorized second party.
- Segregation of duties between risk assessors and risk takers, e.g., staff responsible for measuring compliance with board risk limits are not supervised by staff with short sale transaction authority.

- Daily assessment (mark-to-market) and reporting of positions in relation to board approved limitations (see above).

A credit union may use a qualified agent to perform these functions. If a credit union uses a qualified agent to perform the internal control functions, the credit union must ensure that the agent has appropriate internal segregation of duties between risk taking and risk assessment and the credit union must check at least monthly that the position reporting is accurate.

Broker-Dealer/Investment Advisor Due Diligence

Before conducting a short sale through a broker-dealer or investment advisor, a credit union must analyze and annually update the following:

- The background of any sales representative or advisor with whom the credit union is doing business;
- Information available from state or federal securities regulators and securities industry self-regulatory organizations such as the National Association of Securities Dealers and the North American Securities Administrators Association, about any enforcement actions against the broker-dealer, its affiliates, or associated personnel; and
- Its capital strength, liquidity, and operating results and, for investment advisors, the amount under management.

Accounting

The credit union must report all short positions in its financial statements in accordance with GAAP, and identify the liability for short positions as a supplement to the Call Report. The application must include sample accounting entries for taking, maintaining, and closing short positions.

Agreements and Contracts

The credit union must provide agreements to sell short with required limitations, if short sale activities are delegated to an investment advisor. If short sale activities are conducted directly with a broker-dealer, the credit union must provide margin requirements.

Termination of Authority

If the credit union is classified as less than Well Capitalized, the credit union will close out all short sales positions in a commercially reasonable manner, report the disposition of all short sales positions to the appropriate Regional Director within 30 days of the effective date of net worth classification (in 702.101(b)) as less than Well Capitalized, and the pilot program will be deemed terminated.

Reassessment of the Pilot Program

No later than 5 years after the program is approved, the pilot program will be reassessed and staff will provide a recommendation to the NCUA Board.

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