

## NCUA LETTER TO CREDIT UNIONS

NATIONAL CREDIT UNION ADMINISTRATION NATIONAL CREDIT UNION SHARE INSURANCE FUND

LETTER NO. 157

DATE: September 1994

DEAR CREDIT UNION MANAGERS AND DIRECTORS:

In the wake of the recent collapse of HIGH YIELD MANAGEMENT (HYM) FINANCIAL, a securities firm that was doing an active business with more than 1,000 state and federal credit unions, the National Credit Union Administration (NCUA) has received many telephone calls and inquiries concerning the safety of securities purchased through the failed broker. In response to these many concerns on the part of credit union investment managers and their board members, it seems appropriate to review the proper ground rules for the selection and use of brokers.

**Broker Selection.** Credit union managers will often agonize over the purchase of an office copy machine and yet routinely transact millions of investment dollars with brokers they have never met. When selecting a broker, credit union managers must conduct a thorough investigation which should include the following minimum criteria:

- a. **Reputation.** Before beginning a business relationship with a broker, request a list of at least a dozen of the broker's active clients in your area, including several credit unions. Contact each reference and ask tough questions concerning the broker's integrity, product knowledge of investments which are appropriate for credit unions, and overall professionalism in providing competitive quotes on these securities.
- b. **Financial Strength.** Obtain and study the broker's latest audited financial statement. If necessary, seek professional assistance to evaluate complex financial data such as derivatives.

Brokers whose firms are among the primary dealers who report to the Federal Reserve and/or are members of the National Association of Securities Dealers (NASD), usually have a better track record in providing professional services to investors. Additionally, credit unions should transact investment business only with brokers that offer Securities Investor Protection Corporation (SPIC) insurance.

- c. **Background Check.** The National Association of Securities Dealers (NASD) (1-800) 289-9999, an industry self-regulatory organization, offers access to brokers' files for a search of information on completed actions, but not in-process or pending actions. Completed actions are official records of complaints by the public against members for violations of NASD rules.

The Securities and Exchange Commission (SEC) (202) 942-8090 and Credit Union State Regulators are also primary sources of background information on broker enforcement actions. Credit union managers should conduct thorough background checks on all brokers that service their credit union and file these reports for review by examiners. If you are satisfied with the results of this preliminary phase of the broker investigation, extend an invitation to the new broker and his office manager or sales manager to make a formal presentation to your board of directors. This meeting is a critical part of the broker selection process because it will offer all board members the opportunity to ensure that the new broker understands your credit union investment policy, and the types of investments that are legal and appropriate. The minutes of this

meeting should be filed for review by examiners.

One final point on broker selection, credit union managers should maintain a current list of approved brokers that have been screened and investigated by the board of directors. As part of their annual review, federal and state examiners will refer to audited financial statements, background checks and references on brokers who have been approved by the board of directors.

**Using a Broker.** After completing the selection process, a credit union investment manager should spend several months testing the new broker's product knowledge and ability to provide competitive quotes on legal and appropriate investments. The best way to begin the process is to place the new broker in competition with other brokers who service your credit union.

For example, when you wish to purchase an investment, you should solicit at least three offerings. When selling a portfolio item, obtain three bids. These competitive bids and/or offers should be filed with confirmation reports of all transactions.

If this process appears too time-consuming or burdensome, please be assured that many institutional investors such as thrifts conduct all their investment business in this manner despite the fact that they may have known and used the same brokers for years.

Negotiating for best bids and offers with aggressive brokers can be intimidating at first. Yet, this negotiating is a critical part of the investment process. It is sad but true that millions of member dollars are left on the bargaining table daily by credit union investment managers who either shun or short circuit this difficult but essential task. On the other hand, if you place brokers in competition for your business, brokers will soon respect your professionalism and sense of fairness in trying to do the best job on behalf of your credit union and its members.

**Safekeeping Securities.** Selecting a trustworthy custodian to safekeep your credit union securities is as important as the investment process itself. The same thorough screening and investigation by your board of directors is essential in selecting an independent third-party custodian for securities.

A practical way to eliminate most of the risk in settling and safekeeping securities is to arrange with your broker for delivery versus payment (DVP) at a custodian agent bank. DVP provides for simultaneous transfer of funds and securities, ensuring that your credit union is always in possession of either the securities or the funds.

With third-party custody, as opposed to dealer safekeeping, the investor receives a separate custodial account and clear identification of the securities in that account as his. The agent bank clears its clients' securities trades, holds securities for them, and collects and credits to their account monies due them when the securities they own pay interest, or when they mature. When a credit union enters into a custodial-agency agreement with a bank instead of a dealer, the bank acts under that agreement as a fiduciary for your credit union.

As in the selection of a broker, credit unions should search for a custodial-agent bank in their area rather than one that is located thousands of miles away. The same settlement and safekeeping services are available through the Corporate Credit Union Network, and are especially recommended for small credit unions.

For further inquiries on the proper selection and use of brokers and safekeeping agents, please call NCUA's Investment Hotline between 1 p.m. and 4 p.m. EST at (1-800) 755-5999.

By embracing the guidelines offered in this letter, credit unions can avoid unnecessary risk when using brokers and in providing for safekeeping of securities. Additionally, you will save your members many dollars by shopping for at least three competitive bids or offers when buying or selling securities.

For the National Credit Union Administration Board,

Norman E. D'Amours  
Chairman