

NCUA LETTER TO CREDIT UNIONS

**NATIONAL CREDIT UNION ADMINISTRATION
1775 Duke Street, Alexandria, VA 22314**

DATE: April 2004 **LETTER NO.:** 04-CU-04

TO: Federally Insured Credit Unions

SUBJ: Investment Safekeeping Due Diligence

Dear Board of Directors:

The purpose of this letter is to reiterate the need for credit unions to implement adequate due diligence methods and procedures for safekeeping investments, particularly certificates of deposit (CDs). Federally insured credit unions are encouraged to carefully review their safekeeping practices to ensure that they provide adequate protection against fraudulent investment schemes and potential losses.

Risk of Loss. Investment safekeeping problems can and have resulted in losses. Such a scenario was recently presented to those credit unions holding investments with Bentley Financial Services Inc. (Bentley) and Entrust Group (Entrust). The Securities and Exchange Commission (SEC) charged Bentley with securities fraud for selling securities misrepresented as insured CDs. Bentley created Entrust to safekeep CDs for investors. Entrust, however was not registered with the SEC and was not affiliated with a financial institution as is required for federal credit unions under Part 703 of NCUA Rules and Regulations. As a result, credit unions with Bentley-related investments incurred losses that may have been avoided had proper due diligence reviews been performed.

Safekeepers play an important role in securing the custody of the credit union's investments. The accuracy and reliability of the safekeeper's records are critical and serve to:

- Protect ownership interest in the event the safekeeper enters bankruptcy or liquidation; and
- Ensure the credit union can collect on deposit insurance in the event the CD issuer fails.

Due Diligence. A credit union should perform adequate and appropriate due diligence of its prospective safekeepers. This review should be periodically updated to protect the credit union against potential fraud or misconduct by the safekeeper

and any broker-dealer who may be acting in concert with the safekeeper. While minimum due diligence requirements are set forth in §703.9 of NCUA Rules and Regulations for federally-chartered credit unions, in our view, state-chartered credit unions could also benefit by following these or similar requirements. An appropriate and adequate due diligence review includes, among other things, the following:

- A determination that approved safekeepers are regulated by the SEC, or a federal or state depository institution regulatory agency such as the Federal Deposit Insurance Corporation, or a state trust company regulatory agency.
- An assessment of the reputation of the safekeepers. The credit union should track and review publicity regarding the safekeeper, both positive and negative.
- Documentation of the capital strength of the safekeeper. Generally, the safekeeper used by the credit union should have substantially more capital than the amount of investments it holds for that credit union. A safekeeper regulated by a depository institution or state trust regulatory agency must file financial reports that are publicly available. The SEC requires every registered broker-dealer to send to its customers its certified balance sheet on an annual basis. Credit unions can access public financial information for banks at www.fdic.gov, and for credit unions at www.ncua.gov. Information regarding broker-dealers can be accessed at www.sec.gov and www.nasdr.com.
- The execution of a written custodial agreement with the safekeeper before any transactions take place. A credit union should make certain that it enters into an “institutional” agreement and not a “retail” agreement. Retail agreements may allow the custodian to use the retail customer’s securities for activities such as securities lending transactions without notification of the retail customer and are not appropriate for credit unions. A simple way to differentiate a retail agreement from an institutional one is that a retail agreement generally will not include a signature block for signing on the behalf of a company or organization. A credit union should also ensure the agreement specifies the safekeeper will exercise at least “ordinary care.”
- A review of monthly safekeeping statements which are reconciled to the credit union’s records.

Credit unions that perform adequate and timely due diligence reviews for all safekeepers will greatly reduce the risk of loss from fraudulent investment schemes.

Should you have any questions, please do not hesitate to contact your district examiner, regional office, or state supervisory authority.

Sincerely,

/S/

Dennis Dollar
Chairman