DCU BULLETIN

Division of Credit Unions

Washington State Department of Financial Institutions

Phone: (360) 902-8701 ***FAX: (360) 704-6901***

April 2, 2003 No. B-03-04

Deposit Brokers and Finders

Deposit brokers and deposit finders continue to present a challenge to the safe operation of a number of credit unions. If followed, the advice in this bulletin could serve to reduce or eliminate many of the concerns identified by regulators. Further suggestions may be found in NCUA Letter to Credit Unions 00-CU-05 found on the NCUA web site.

Credit unions should deal only through brokers with sterling reputations. To help evaluate an individual broker or firm, a credit union should perform a background check on both the broker and the firm. At a minimum you should analyze and annually update the following factors:
(1) The background of any sales representative with whom you are doing business.
(2) 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. This could begin at www.nasdr.com where a wide variety of information is available. If your potential broker is listed with any issues of concern, you should strongly consider finding another broker.
(3) If the broker-dealer is acting as your counterparty, the ability of the broker-dealer and its subsidiaries or affiliates to fulfill commitments, as evidenced by capital strength, liquidity, and operating results. You should consider current financial data, annual reports, reports of nationally recognized statistical rating agencies, relevant disclosure documents, and other sources of financial information.

Credit unions should evaluate potential investments using bond equivalent yield. It is a common tactic by unscrupulous brokers or deposit finders to manipulate components of an investment and provide a misleading number for the yield of the investment. Bond equivalent yield (BEY) is the industry convention and will allow a credit union to compare investments from various sources in a reasonable manner. A knowledgeable credit union investment officer will require investment quotes in BEY and test the accuracy of the yield quote with a hand-held business calculator or through the use of a web based financial calculator such as www.tipsinc.com . If your broker is unwilling or unable to provide accurate and reliable information you should consider finding another broker.

Credit unions should use an independent safekeeping agent. Your safekeeping agent or custodian is intended as a protection for the credit union against a wide variety of unsafe practices. When a credit union allows securities or CDs to be safe-kept by a party related to your broker, those safeguards are negated. Unfortunately there have been a number of instances when the close relationship between the broker and the safekeeping agent was not disclosed to the credit union. The obvious solution would be to have your corporate credit union or another party well known to the credit union act as the safekeeping agent.

Credit unions should carefully review broker and custodial agreements. Many times a careful review of the agreements with brokers and safekeeping agents will disclose relationships that are not in the best interest of the credit union (see above). Pay particular attention to names and addresses of parties as well as the terms for payments. In event of default, the records of the custodian will serve to determine ownership of certificates and any FDIC pay out.

Credit unions should never rely on oral promises or securities descriptions from brokers. It should be clear that a broker has an interest in completing the transaction and getting paid. Regulators have seen numerous instances in which brokers have stated certain terms, conditions or promises only to have the credit union later discover inaccuracies or there are significant costs associated with exercising its "rights" under those promises. An example includes a broker "guaranteeing" that the credit union can sell back its fractional portion of a certificate prior to the actual maturity of the underlying certificate, leading the credit union to think they would get their original $100,000 investment back. However, the contract stated that sales will be handled on "a best efforts basis," meaning the price may be at market or at any price set by the broker. The market risk is transferred to the credit union. No purchase should be undertaken before receiving a written confirmation of the exact terms described by the broker.

<u>Credit unions should complete a basic review of financial institutions before purchasing a certificates of deposit.</u> The web sites National Credit Union Administration and FDIC: Federal Deposit Insurance Corporation can provide a potential depositor with a wealth of useful information about insured institutions before a credit union invests. A credit union should perform and document a basic review of potential investments to ensure that they are suitable investments.

<u>Credit unions should understand when they are working with a deposit broker and when they are working with a deposit finder.</u> A deposit finder is an information provider and may not be registered with the SEC or a member of NASDR. The finder does not handle funds. Instead, the credit union usually contacts the issuer directly and makes arrangements to purchase the certificate either directly or through a custodian. On the other hand, a deposit broker handles the funds and may show as the owner of the certificate on the books of the issuer. The SEC licenses brokers and reputable brokers are members of NASDR. Be alert to deposit finders who require specific custodians. Some custodians have been found to be subsidiaries of firms advertising themselves as "finders" when in fact their subsidiary is handling the funding.

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Should you have further questions, please contact Jane Johnson at (360) 902-0508.
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