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Article for *Minnesota Counties*

Safekeeping County Investments

By Rebecca Otto, State Auditor

Over the past two years there have been several instances of large losses to public investments. One area in which public investors can help protect themselves is in careful holding of their investments, or safekeeping.

A Cautionary Tale

One Minnesota government entity's experience serves as an instructive example. The entity had invested in Certificates of Deposit (CDs), an investment insured by the FDIC, yet still lost over $2 million in spite of the deposit insurance. These losses occurred because of the manner in which the investments were held.

The entity had engaged the services of a Certificate of Deposit "placement service" called Rate Search, of Saint Louis, Missouri. Rate Search promised customers it would seek out and purchase CDs paying the highest rates of interest, then hold the CDs for their customers. The entity worked with Rate Search for nearly twenty years: each month, they received a statement from Rate Search listing the CDs they owned. Then, in 2007, Rate Search abruptly closed its doors.

When Rate Search went out of business, the entity discovered that a large number of their CDs held by Rate Search could not be found. The value of the missing CDs was over $2 million. The entity has been working to recover their losses and has learned that some of the CDs on their statement were never actually purchased by Rate Search: obviously for those CDs there was no FDIC protection. Rate Search customers across the country found themselves in similar situations. Criminal investigations and civil actions were brought against Rate Search, and in February 2009 the president of Rate Search pled guilty to fraud and tax charges.

How Investments Are Held

Both the Minnesota Legislature and the Government Accounting Standards Board (GASB) have been concerned about the methods by which public investments are held.

Through Minn. Stat. § 118A.06, the legislature has prescribed the minimum requirements for safekeeping public investments. The statute greatly restricts who can hold investments on behalf of a Minnesota government entity. Safekeeping is limited to Federal Reserve banks, banks with a trust department, primary reporting dealers and broker dealers with a principal executive office in Minnesota. It is common for public investors to allow their brokers to hold their investments. However, very few brokers have a principal executive office in the state.

Rate Search was neither a bank nor a primary reporting dealer. It is not clear whether Rate Search was qualified as a broker dealer, but certainly it had no presence in the State of Minnesota, with its principal executive office in Missouri. As a result, Rate Search was not qualified under Minn. Stat. § 118A.06 to hold public investments.

The Government Accounting Standards Board (GASB) has required that certain levels of "custodial credit risk" be disclosed. Custodial credit risk is the risk that, if the entity holding a county's investments fails, the county will be unable to get its investments back. GASB has developed criteria to measure and disclose custodial credit risk. A disclosure of the presence of such risk is required in the notes to the financial statements.

Whether or not a broker has a principal executive office in the state does not affect custodial credit risk. However, this risk is affected when a broker has coverage from the Securities Investors Protection Corporation (SIPC). Unlike the FDIC, the SIPC is not a government agency but a member institution made up of financial organizations that pay in to the corporation. If a broker or financial institution closes its doors, SIPC will replace many of the investments, including CDs, held in an investor's account up to a certain dollar amount. Brokers can extend these limits by purchasing excess SIPC from private insurance companies. GASB considers SIPC and excess SIPC coverage as a way to negate custodial risk entirely. Rate Search did not have SIPC coverage.

There is currently a bill before the legislature that would modify the criteria for safekeeping so that any broker could hold public investments but only to the extent they have SIPC or excess SIPC coverage.

Steps to Reduce or Eliminate Risk

Until Minn. Stat. § 118A.06 is changed by the legislature, counties will need to make sure their investments are held for safekeeping by eligible entities under state law. Regardless whether the entities eligible to hold securities is changed, we recommend that counties reduce or eliminate custodial risk by:

- Only allowing brokers who are eligible to safekeep under state law to hold securities to the extent they have SIPC or excess SIPC coverage, or

- Transferring investments to a bank with a trust department once the investments have been purchased by a broker.

It seems that each week there are more news reports of investors who have lost money because they trusted their broker too much. With public funds, a cautious approach is always worthwhile.