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NATIONAL CREDIT UNION ADMINISTRATION
Washington, D.C. 20456

November 15, 1988

Office of General Counsel

Ms. Lisa Lintecum
Trust Examiner
Investment Securities Division
Comptroller of the Currency
Washington, D.C. 20219

Re: Information Notice on the Government Securities Act (Your October 5, 1988, Memo)

Dear Ms. Lintecum:

You have asked for our comments on a proposed notice to be made available to all financial institutions, including federally-insured credit unions, concerning their responsibilities under regulations implementing the Government Securities Act (the "GSA"). Our substantive comments are contained herein. Minor typographical errors and editorial changes have been noted on the enclosed draft.

The proposed notice discusses the provisions of the GSA regulations that apply to: (1) financial institutions that engage in repurchase transactions with customers while retaining custody or control of the subject government securities, and (2) depository institutions that hold government securities for customers. The notice does not discuss additional provisions of the GSA regulations that apply to financial institutions that are required to give notice of acting as government securities broker-dealers.

Page 7 of the proposed notice states, in part:

> a financial institution issuing a hold-in-custody repurchase agreement must disclose to the customer in writing that the funds held pursuant to the repurchase agreement are not a deposit, and, therefore, not insured by the Federal Deposit Insurance Corporation or in the case of a savings and loan association, the Federal Savings and Loan In-

FOIA Vol. V, H, 8, Govt Securities Act

> surance Corporation (see 17 CFR 403.5(d)(1)(iii)).

A reference to the National Credit Union Share Insurance Fund should be added to this paragraph.

Part 450 of the GSA regulations applies to depository institutions, including federally-insured credit unions, that hold government securities on behalf of customers. Since Federal credit unions ("FCU's") do not have general trust authority, the situations in which an FCU would be subject to Part 450 are limited. FCU's do have the authority to serve as a custodian or trustee of IRA or Keogh plans (see 12 CFR Part 724). Some FCU's offer members self-directed IRA and Keogh plans, and in this capacity, may hold government securities on behalf of members. Under the GSA regulations, to the extent FCU's are involved in hold-in-custody repurchase transactions, they would also be subject to Part 450. Federally-insured state credit unions may have broader trust authority under state law, and therefore may engage in other activities that would trigger application of Part 450.

Part 450 contains certain requirements that depository institutions must follow. Section 450.3(a) exempts certain holdings of government securities from these requirements. It provides:

> The Secretary has determined that the rules and standards of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation governing the holding of government securities in a fiduciary capacity by depository institutions subject thereto are adequate. Accordingly, such depository institutions are exempt from this part with respect to their holdings of government securities in a fiduciary capacity and their holdings of government securities in a custodial capacity provided that (1) such institution has adopted policies and procedures that would apply to such custodial holdings all the requirements imposed by its appropriate regulatory agency that are applicable to government securities held in a fiduciary capacity, and (2) such custodial holdings are subject to examination by the appropriate regulatory agency for compliance with such fiduciary requirements.

Page 10 of the proposed notice discusses this exemption. The notice states: "[t]hus, depository institutions will be exempt

from Part 450 requirements provided two conditions are met ...." This section of the notice is misleading because federally-insured credit unions, which are depository institutions, have not been exempted by Treasury from Part 450 of the regulations. NCUA, given FCU's limited trustee authority, has no regulations or other standards governing FCU's authority to hold government securities on behalf of members.[1]

You have asked for our views on how to issue the proposed notice. You state that originally, issuance through the FFIEC was planned, but that there is now some concern that this process may be too time-consuming. NCUA does issue "Letters to Credit Unions", which are advisory letters explaining or interpreting a given subject. Such a format could be used to disseminate the information contained in the proposed notice. We would, however, prefer to see the notice issued through the FFIEC, and would assist in expediting this process in any way possible. The FFIEC endorsement process ensures that all financial institutions will receive uniform guidelines. In any event, NCUA may deem it necessary to tailor the notice to more specifically address the concerns of federally-insured credit unions.

Should you have any further questions, please call Julie Tamuleviz at 357-1030.

Sincerely,

Hattie M. Ulan

HATTIE M. ULAN
Acting Assistant General Counsel

JT:sg

Enclosure

[1] NCUA's Interpretive Ruling and Policy Statement 85-1 provides guidance to FCU's with respect to the maintenance of self-directed IRA and Keogh accounts.

MEMORANDUM

Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

To: Distribution

From: Lisa Lintecum, Trust Examiner, Investment Securities Division

Date: October 5, 1988

Subject: Information Notice on the Government Securities Act

Attached is a draft of a proposed notice to be made available to all financial institutions concerning their responsibilities under the Government Securities Act. Please provide edits and comments concerning the draft. We are also looking for suggestions on the best way for all regulators of financial institutions to issue this notice in the quickest manner possible. We originally thought we would go through the FFIEC endorsement process, however, we are aware this may be slow and difficult process.

Please provide us with your feed back and suggestions on how to proceed with the document's issuance as soon as possible. If you have any questions or verbal feed back, please contact me at 447-1901.

Thank you.

Distribution:

Larry Clark, Federal Home Loan Bank Board
Diana Garmus, Federal Home Loan Bank Board
Sally King, FDIC
Ann Meister, Department of Treasury
Robert Plotkin, Federal Reserve
[redacted], National Credit Union Association

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Information Notice

Government Securities Act Requirements

Applicable to All Financial Institutions

PURPOSE

This issuance provides general information concerning those portions of the regulations implementing the Government Securities Act (GSA)[1] that apply to all financial institutions, including those whose limited government securities activities may exempt them from filing a broker-dealer notice with their federal regulator. Specifically, certain provisions covered in this issuance apply (a) to all financial institutions that engage in repurchase transactions with customers while retaining custody or control of the subject government securities and (b) to all depository institutions that hold government securities for customers.

Not discussed in this issuance are additional provisions of the GSA regulations that apply to financial institutions that are required to give notice of acting as government securities broker-dealers. All financial institutions

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[1] 17 CFR 400-405; 449 and 450.

should review the exemptions for limited government securities activities to determine whether they are required to give notice and are therefore subject to other provisions of the regulations not covered in this issuance.

This issuance is intended to highlight certain provisions of the GSA regulations. All financial institutions need to familiarize themselves with the actual provisions of the regulation.

DEFINITION

Government securities are defined at Section 3(a) (42) of the Securities Exchange Act of 1934 (see 15 USC 78 c (a) (42)). For purposes of the GSA regulations, government securities include U.S. Treasuries, as well as securities such as obligations of the Government National Mortgage Association (GNMA), the Federal National Mortgage Association (FNMA), the Federal Home Loan Mortgage Corporation (FHLMC), the Student Loan Marketing Association (SLMA) and the Farm Credit System. "Off exchange" puts, calls, straddles and "similar privileges" on government securities are also considered to be government securities for part of the regulations but not for purposes of Part 450, the rules addressing custodial holding of securities by financial institutions.

BACKGROUND

Activities affected by the Government Securities Act Regulations

All financial institutions that engage in government securities activities are subject to the GSA regulations to some extent. To determine the extent of applicability, it is important to understand the exemptions provided in the regulations.

Partial Exemptions for Limited Government Securities Activities

The GSA regulations permit financial institutions that perform limited government securities activities to be exempt from some, but not all, of the regulations. For example, a bank that qualifies for certain exemptions under part 401 of the regulations is not required to give notice of being a government securities broker-dealer; however, an "exempt" bank is still subject to certain GSA regulations outlined in this issuance.

A financial institution qualifies for exemption if its government securities activities are limited to one or more of the following:

(1) Handling savings bond transactions;

(2) Submitting original issue tenders for Treasury securities for customers, on a fully disclosed basis;

(3) Doing limited brokering of government securities (This means either effecting fewer than 500 brokerage transactions per year or effecting all brokerage transactions on a fully disclosed network basis through a registered government securities broker-dealer, provided the networking meets conditions described in the regulations.);

(4) Engaging in limited government securities dealer activities. (This means that the dealer-type activity is limited to sales or purchases in a fiduciary capacity and to repurchase/reverse repurchase transactions.)

All financial institutions, including those that qualify for exemptions (2)-(4) above, are subject to the GSA regulations on custodial holdings of government securities. Additionally, all financial institutions engaging in hold-in-custody repurchase transactions, transactions, including those eligible for exemption (4) above, are required to comply with the GSA regulations governing hold-in-custody repurchase transactions.

Hold-In-Custody Repurchase Agreements

All financial institutions that retain custody of securities sold under an agreement to repurchase must comply with the requirements for hold-in-custody repurchase agreements described in 17 CFR 403.5(d)(1). For purposes of applying these requirements, the financial institution is also considered to be retaining custody of the repurchase agreement securities when the securities are maintained through an account at another institution (e.g., correspondent bank, Federal Reserve Bank) and the securities continue to be under the control of the financial institution.

All hold-in-custody repurchase transactions are required to be conducted pursuant to a written repurchase agreement (see 17 CFR 403.5(d)(1)(i)).[2] If the customer agrees to allow substitution of securities in a hold-in-custody repurchase transaction then authority for the financial institution to

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[2]On August 1, 1988, an exception in this portion of the regulations was rescinded. Financial institutions that had been relying on that exemption are now required to comply with the written repurchase agreement requirements for transactions entered into on or after September 1, 1988, unless the transaction is with an existing customer. For transactions with existing customers, these financial institutions have until December 1, 1988 to fully comply with the written agreement requirements. (A customer is considered to be an existing customer if the financial institution has engaged in repurchase transactions with this customer on or after September 1, 1987 and before September 1, 1988.)

substitute securities must be contained in the written repurchase agreement (see 17 CFR 403.5(d)(1)(iv)). In all hold-in-custody repurchase agreements where the financial institution reserves the right to substitute securities, the following disclosure statement must be prominently displayed in the written repurchase agreement immediately preceding the provision allowing the right to substitution:

"REQUIRED DISCLOSURE"

The (seller) is not permitted to substitute other securities for those subject to this agreement and therefore must keep the (buyer's) securities segregated at all times, unless in this agreement the (buyer) grants the (seller) the right to substitute other securities. If the (buyer) grants the right to substitute, this means that the (buyer's) securities will likely be commingled with the (seller's) own securities during the trading day. The (buyer) is advised that, during any trading day that the (buyer's) securities are commingled with the (seller's) securities, they may be subject to liens granted by the (seller) to third parties and may be used by the (seller) for

deliveries on other securities transactions. Whenever the securities are commingled, the (seller's) ability to resegregate substitute securities for the (buyer) will be subject to the (seller's) ability to satisfy any lien or to obtain substitute securities."

No editing or paraphrasing of the above language of the required disclosure statement is permitted under the regulations with the exception that other terms may be substituted for the bracketed terms "buyer" and "seller". If the disclosure statement is emphasized in any fashion that visually distinguishes it from other terms of the agreement, it will be acceptable for purposes of this section.

Also, a financial institution issuing a hold-in-custody repurchase agreement must disclose to the customer in writing that the funds held pursuant to the repurchase agreement are not a deposit, and, therefore, not insured by the Federal Deposit Insurance Corporation or in the case of a savings and loan association, the Federal Savings and Loan Insurance Corporation or NCUSIF in the case of a credit union (see 17 CFR 403.5(d)(1)(iii)).

The regulations do not require written agreements for repurchase transactions where the securities are delivered

to the customer or to another depository acting pursuant to a tri-partite agreement with the financial institution and the customer. Refer to the Federal Financial Institutions Examination Council's (FFIEC) endorsed policy statement concerning repurchase agreements for general regulatory requirements for all repurchase agreements.

For all hold-in-custody repurchase transactions, written confirmations describing the specific securities subject to the transaction must be sent to the customer by close of business on the day the transaction is initiated, as well as on any day on which substitution of securities occurs (see 17 CFR 403.5(d)(1)(ii)).[3] The frequency or short duration of a particular type of transaction, such as an overnight repurchase agreement or a daily "sweep" of a customer's deposits into a hold-in-custody repurchase transaction does not eliminate the requirement for a financial institution to send a prompt and accurate

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[3]An exception to the repurchase transaction rules was ~~were~~ rescinded on August 1, 1988. Financial institutions that were relying on that exception have until December 1, 1988 to comply with the timing requirements for confirmations. In the interim, however, such institutions must issue to their counterparts at least monthly confirmations of the specific securities that are the subject of their repurchase transactions conducted during the period.

confirmation to its customer. Confirmations must identify the specific securities by issuer, maturity, coupon, par amount, market value, CUSIP or mortgage pool number of the underlying securities (see 17 CFR 403.5(d)(2)(i)). Market value is defined as the most recently available bid price for the security plus accrued interest.

"Blind pooled" hold-in-custody repurchase transactions occur when a seller does not deliver securities and does not identify specific securities as belonging to a specific customer. Instead, the ~~bank~~ financial institution sets aside, or otherwise designates, a pool of securities to collateralize its outstanding repurchase obligations. Pooling is no longer permitted for repurchase transactions. The regulations require that the written confirmation sent to a customer must identify the specific securities that are the subject of the hold-in-custody repurchase transaction. A specific security identified to a specific customer must be in an authorized denomination, that is, in a par amount that could be delivered out.

Custodial Holdings of Government Securities

All depository institutions that hold or safekeep U.S. government securities for customers must comply with 17 CFR

Definitions

For purposes of Part 450, a customer is any party that safekeeps U.S. government securities with the depository. This includes a counterparty to a hold-in-custody repurchase agreement. This definition does not cover a broker/dealer unless the broker/dealer notifies the depository that a security is in safekeeping for the broker/dealer's customers see (17 CFR 450.2(b)).

Exemption for Fiduciary Holdings

The Department of the Treasury determined that banking regulatory standards concerning the holding of government securities in a fiduciary capacity are adequate to meet the requirements of these regulations. Thus, depository institutions will be exempt from Part 450 requirements provided two conditions are met. The financial institution must adopt policies and procedures that subject the custodial holdings to all the requirements that the applicable banking regulatory agency imposes on holdings in a fiduciary capacity. Also, such custodial holdings must be subject to examination by the regulatory agency for compliance with these fiduciary requirements see (17 CFR

450.3 (a) (1)&(2)).

Fiduciary capacities under Part 450 include trustee, executor, administrator, registrar, transfer agent, guardian, assignee, receiver, managing agent, and any other similar capacity involving the sole or shared exercise of discretion by a depository institution having fiduciary powers that is supervised by a federal or state financial institution regulatory agency (see 17 CFR 450.2(d)). This definition contemplates managerial discretion as well as investment discretion.

Custodial Holding Requirements

In order to comply with the requirements of Part 450, financial institutions must observe several requirements. All government securities held for customers, including those subject to repurchase agreements with customers, must be segregated from the depository's own assets and kept free from lien of any third party or the depository (see 17 CFR 450.4 (a)(1)). A financial institution that holds securities for a customer through another institution ("custodian institution") must notify that custodian institution that such securities are customer securities (see 17 CFR 450.4 (a)(2)(i)(A)). The custodian institution

maintain customer securities in a separate custody account at the FED, although such segregation is encouraged. However, the depository institution must segregate the customer's securities on its own records.

A financial institution may lend customer securities held in safekeeping to third parties and remain in compliance with Part 450. The financial institution must satisfy the requirements of 17 CFR 450.4 (a)(6) which require the securities loan be made under a written agreement with the customer and in compliance with regulatory agency guidelines for securities lending; refer to the FFIEC endorsed policy statement addressing securities lending.

A financial institution engaged in safekeeping U.S. government securities for customers is required to issue to the customer a confirmation or safekeeping receipt for each government security held. The confirmation or safekeeping receipt must identify the issuer, maturity date, par amount and coupon rate of the security being confirmed (see 17 CFR 450 (b)(1)).

Part 450 also requires that a records system of government securities held for customers be maintained separate and distinct from other records of the depository institution (see 17 CFR 450.4(c)). These records must (a) identify each customer and each government security held for a customer;

(b) describe the customer's interest in the security (such as "subject of repurchase agreement" or pledging to secure a public deposit); and (c) indicate all receipts and deliveries of securities and cash in connection with the securities. A copy of the safekeeping receipt or confirmation given to customers also must be maintained. Finally, this system of records must provide an adequate basis for audit (see 17 CFR 450.4(c)(1-5)).

The required records under Part 450 must be maintained in an easily accessible place for at least two years and not disposed of for at least six years (see 17 CFR 450.4(f)).

A financial institution providing safekeeping for customers' government securities is required to conduct a count of physical securities and securities held in book-entry form at least annually. An annual reconcilement with customer account records must also be performed (see 17 CFR 450.4(d)). In order to count securities held outside the depository, such as book entry securities held at a Federal Reserve Bank, the depository must reconcile its records to those of the outside custodian (see 17 CFR 450.4(d)(1)). The depository institution responsible for the count must verify any securities in transfer, in transit, pledged, loaned, borrowed, deposited, failed to receive or deliver or subject to a repurchase or reverse repurchase agreement, where the securities have been out of the depository's

possession for longer than 30 days (see 17 CFR 450.4(d)(2)). The dates and results of the counts and reconcilements must be documented within seven days of the required count with the differences in securities counts noted (see 17 CFR 450.4(d)(3)).