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Safekeeping Town Investments

By Rebecca Otto, State Auditor

Many town governments invest in Certificates of Deposit (CDs) because their investment is guaranteed by Federal Deposit Insurance Corporation (FDIC). The FDIC guarantees that it will pay the value of a CD up to a certain amount (currently \$250,000) if the bank issuing the CD fails.

Unfortunately, even “safe” investments may have risks involved. One such risk for investment CDs is the “safekeeping” or custodial risk, a risk associated with how the investment is held.

A Cautionary Tale

One Minnesota government entity’s experience serves as an instructive example. The entity had invested in CDs, 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, it received a statement from Rate Search listing the CDs it 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 its CDs held by Rate Search could not be found. The value of the missing CDs was over \$2 million. Since then, the entity has been working to recover its losses and has learned that some of the CDs on its statement were never actually purchased by Rate Search: 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 federal 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 government investments are held.

Through Minn. Stat. § 118A.06, the legislature has set the minimum legal 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 its principal executive office was in Missouri, not Minnesota. As a result, Rate Search was not qualified under the statute to hold public investments.

GASB requires auditors to evaluate various investment risks including custodial risk. Under the criteria developed by the GASB, custodial risk is greatly affected when a broker has insurance coverage from the Securities Investors Protection Corporation (SIPC). Unlike the FDIC, the SIPC is not a government agency but rather 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.

Those towns that have annual audits have their custodial risk evaluated by their auditors and disclosed when appropriate in the notes to the financial statements.

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. If enacted this would mean that SIPC coverage becomes as important in legal compliance as it currently is under the accounting standards.

Steps to Reduce or Eliminate Risk

Until Minn. Stat. § 118A.06 is changed by the legislature, towns will need to make sure their investments are held for safekeeping by entities eligible under state law. Regardless whether

the entities eligible to hold securities is changed, we recommend that towns 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.