



BEST PRACTICE

Using Safekeeping and Third-Party Custodian Services (2010) (NEW)

Background. The safety of public funds should be the primary objective of all governments. One of the most important protections and a control against fraud is the separation of the safekeeping and custody function from the investment function. Investment policies should include a section regarding independent third-party safekeeping or custody of securities. By arranging to have securities held by a third party, governments can effectively minimize safekeeping or custodial risk in an investment transaction.

In a third-party safekeeping agreement, the government arranges for a firm other than the party that sold the investment to provide for the transfer and safekeeping of the securities. Financial firms should not serve as both government broker-dealer and custodian. Safekeeping represents a financial institution's obligation to act on behalf of the owner under the owner's control. Custody is a more clearly defined control position by the agent responding to the owner's requirements. Custody normally does not take place in the governmental entities depository bank.

Investments should be settled in a delivery-versus-payment (DVP) basis. In this procedure, the buyer's payment for securities is due at the time of delivery. Security delivery and payment occur simultaneously. This practice ensures that no funds are at risk in an investment transaction as funds are not released until securities are delivered, ensuring the governmental entity has either money or securities at all times during the transaction.

Recommendations. The Government Finance Officers Association (GFOA) recommends that state and local governments utilize independent third-party custodians to safeguard their investments and protect against safekeeping/custodial risks. To accomplish this goal, the GFOA recommends that governmental entities:

1. competitively select third-party custodians and safekeeping agents
2. have safekeeping/custodial agreements reviewed by government legal counsel prior to execution
3. evidence their safekeeping or custodial relationship with a signed, written security agreement that is reviewed by counsel and establishes the firm as its agent
4. execute all investment transactions on a delivery-versus-payment basis
5. designate a specific DDA (demand deposit account) clearing account in conjunction with the safekeeping or custodial account
6. require that the independent third-party safekeeping agent or custodian mark the portfolio to market at least monthly. Ideally, marking should take place daily with independent pricing.
7. require reports and monthly statements to be received directly by the governmental entity from the agent.
8. ideally, have electronic access to the safekeeping or custody account for monitoring and reporting purposes, if cost effective.

9. require safekeeping or custodial agents to be insured for error and omissions.
10. require review of internal safekeeping and custodial procedures annually with the independent auditor.

References.

- *Investing Public Funds*, Second Edition, Girard Miller with M. Corinne Larson and W. Paul Zorn, GFOA, 1998.
- GFOA Sample Custodial Trust Agreement, 2006, www.gfoa.org.
- *An Introduction to Collateralizing Public Deposits for State and Local Governments*, Second Edition, M. Corinne Larson, GFOA, 2006.
- GFOA Best Practice *Collateralizing Public Deposits (1984, 1987, 1993, 2000, and 2007)*
- GFOA Sample Security Agreement (long and short version) 2010. www.gfoa.org

Approved by the GFOA's Executive Board, October 15, 2010.