



BEST PRACTICE

Government Relationships with Securities Dealers (1986, 1988, 2003, and 2006) (TIM)

Background. Finance officers, treasurers and investment officers (hereafter referred to as government investors) who manage and invest public funds place billions of dollars in the fixed-income and money markets on a daily basis. They have a fiduciary responsibility to protect public funds, to always act in the best interest of their entity, to maintain safety and an appropriate level of liquidity and to attain a competitive return on their portfolio.

Generally, access to the securities markets is made through securities dealers who are registered broker/dealers and through financial institutions (banks) with broker/dealer subsidiaries. The fiduciary responsibilities of a government investor include ensuring that:

- reasonable comparisons are made to judge the appropriateness of all investments
- all security transactions are made at the best price through a competitive process;
- the counterparty to the transaction will fulfill all of their obligations; and,
- the securities are properly safe-kept and ownership perfected through registration in the name of the entity.

Communication with a broker for the purposes of discussing market conditions, reviewing investment strategies and transacting a trade often occur by phone, e-mail, or fax. Regardless of the method of communicating with a broker, a government investor needs to perform due diligence on all securities dealers prior to adding them to their list of approved brokers/dealers for transacting trades.

Recommendation. The Government Finance Officers Association (GFOA) makes the following specific recommendations to government investors in selecting securities dealers for their approved list, managing the relationships with the broker/dealers, and conducting investment transactions with them:

1. Utilize a defined internal process to select, qualify, renew or terminate brokers and dealers.
 - a. Use a questionnaire and/or peer references to help determine that the broker understands the public entity's needs/objectives.
 - b. Determine that the broker is actively involved in the market sectors utilized by the government entity.
 - c. Select a number of brokers suitable to the entity, allowing for appropriate competition/service on all transactions; while limiting it to a manageable number.
 - d. Require security brokers and dealers to comply with the Federal Reserve Bank of New York's capital adequacy guidelines¹ or SEC Net Capital Rule as a condition of doing business. Obtain annual financial reports of the securities firm.
 - e. Require that brokers certify to a review of the government entity's investment policy to assure compliance with its objectives, portfolio risk constraints, and investment trading requirements.
 - f. Record and retain pertinent information on the firm and the individual broker including an annual review of the Central Registration Depository (CRD®) information for both maintained by the National Association of Security Dealers.

¹ Primary dealers in U.S. government securities adhere to stringent capital adequacy guidelines as prescribed by the Federal Reserve Bank of New York. A current listing of primary dealers can be located www.ny.frb.org.

- Violations or sanctions imposed by a regulatory agency or government should be carefully reviewed for termination of relationship.
 - g. Establish parameters that guide periodic review and potential termination of a broker dealer relationship.
2. Due diligence on Broker/Dealers should include obtaining information on:
 - a. a security dealer's experience and knowledge of public funds investing;
 - a. all contact information for the primary contact, backup and operations staff;
 - b. a broker's manager and supervisor;
 - c. the financial strength of the firm;
 - d. areas of expertise and trading activity;
 - e. registration with NASD and any citations;
 - f. the names and contact information for references similar to the entity; and
 - g. potential conflicts of interest.
 3. Establish a competitive procedure for attaining reasonable market rates:
 - a. Require that all security sales be made through a competitive bid process. If possible, use a competitive offer process on purchases as well.
 - b. Securities sold through a selling group at a set price (usually par) or available for specific bidding should be compared to comparable maturity securities as part of the competitive process to determine the best relative value.
 4. Require that all security transactions be settled on a delivery versus payment basis at the entity's custodian bank to perfect ownership under a written custodial agreement.
 5. Retain complete documentation for audit trail purposes including trade tickets, confirmations and safekeeping receipts.

References

- *Introduction to Broker-Dealers for State and Local Governments, Second Edition*, Sofia Anastopoulos, GFOA, 2008.
- *Investing Public Funds, Second Edition*, Girard Miller with M. Corinne Larson and W. Paul Zorn, GFOA, 1998.
- Federal Reserve Bank of New York, www.frb.ny.gov, http://www.newyorkfed.org/markets/pridealers_listing.html.
- NASD Central Registration Depository (CRD®), www.nasd.com, http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&nodeId=370.
- Securities and Exchange Commission, www.sec.gov, VI. Financial Responsibility of Broker Dealers, A. Net Capital Rule 15c3-1 (17 CFR 240.15c3-1) <http://www.sec.gov/divisions/marketreg/bdguide.htm#VI>.

Approved by the GFOA's Executive Board, October 6, 2006.