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FINRA Report Finds Short Position Controls Lacking.

Financial Industry Regulatory Authority examinations have uncovered a theme of inadequate controls and procedures related to municipal short positions and fails-to-receive, something the regulator stressed firms must be diligent about detecting and resolving to prevent adverse tax consequences to customers.

Firm short positions and fails-to-receive in municipal securities were among several new topics highlighted in the Financial Industry Regulatory Authority's 2022 report on its Examination and Risk Monitoring Program released Wednesday.

The 70-page report covers more than two dozen topics. In addition to other compliance areas, the report also provides exam findings and compliance recommendations regarding municipal securities advertisements and communications.

In a release, Greg Ruppert, FINRA's executive vice president for member supervision, noted the evolving nature of the securities industry landscape, describing it as "highly dynamic in terms of business models, technologies, products and compliance practices."

"FINRA's report looks at those significant changes through the lens of FINRA's commitment to investor protection and market integrity, so that firms' compliance programs can benefit from our findings about emerging and ongoing issues," Ruppert added.

In terms of content, for each of the compliance areas addressed, FINRA's report identified relevant rules and highlighted key compliance considerations.

"The report also summarizes noteworthy findings from recent examinations, outlines effective practices that FINRA observed during its oversight, and provides additional resources that may be helpful to member firms in reviewing their supervisory procedures and controls and fulfilling their compliance obligations," according to FINRA.

The section of the report dealing with regulatory obligations and considerations tied to firm short positions and fails-to-receive focused heavily on controls.

A muni short position, which FINRA has said in previous guidance is usually inadvertent, occurs when a firm sells bonds it does not actually have. This is sometimes due to a failure to receive bonds it ordered, and it then has to make substitute payments on those securities to the customer. That substitute interest paid to the customer might actually be taxable, because the Internal Revenue Service will not allow both that customer and whoever actually holds the bonds to both receive tax-exempt interest.

FINRA has brought enforcement actions against firms related to this problem. Notably, Merrill Lynch agreed last year to pay more than $1 million to settle FINRA charges related to short positions.

In this report, FINRA noted that firms must "develop and implement adequate controls and

procedures for detecting, resolving and preventing adverse tax consequences to customers" that can stem from sales of municipal securities that are not under a firm's possession or control.

FINRA pointed out that those procedures must include closing out fails-to-receive within time frames specified in the Municipal Securities Rulemaking Board's Rule G-12(h). Related communications must not be false or misleading as prescribed in MSRB Rule G-17.

Exam findings in this area showed inadequate controls and procedures in instances where a firm does not maintain possession or control of a customer's municipal securities.

FINRA also found lottery systems that it says, "do not fairly or adequately account for or allocate substitute accrued interest payments for allocating municipal short positions to certain customer accounts."

According to the report, some effective compliance practices for firm short positions and fails-t--receive include maintaining processes to prevent or remediate municipal positions from settling short, and developing operational and supervisory reports to identify customer long positions outside of the firm?s possession and control.

Conducting regular and periodic review of fail reports to ensure compliance with MSRB Rule G-12(h), is another best practice, according to FINRA.

FINRA also posed a number of questions as related considerations in the municipal securities area. For example, does a firm use exception reports to manage municipal securities short positions or fails to receive? Another question involves timing – when municipal securities short positions are identified, does a firm cover the short or wait until the trades have settled?

Other considerations include the nature of a firm's process to close out fails-to-receive under MSRB Rule G-12(h), how firms detect instances that require them to pay customers substitute interest, and how firms handle inbound or outbound account transfers that are delivered without corresponding municipal bonds in possession or control.

The report also contains a section addressing regulatory obligations stemming from communications with the public, including communications involving mobile apps, digital communications channels, and digital asset and cash management accounts communications.

That communications section also covers MSRB Rule G-21 concerning advertising by brokers, dealers or municipal securities dealers.

FINRA outlined general standards regarding false, misleading or promissory statements or claims. For example, do a firm's communications include material information necessary to make them fair and balanced and not misleading?

Exam findings for municipal securities communications show firms "using false and misleading statements or claims about safety, unqualified or unwarranted claims regarding the expertise of the firm, and promissory statements about claims regarding portfolio growth," according to the report.

To address these concerns, FINRA pointed to some effective compliance practices for municipal securities advertisements including prior approval, training, risk disclosure, and review.

Essentially, FINRA suggests that firms require "prior approval of all advertisements concerning municipal securities by an appropriately qualified principal to confirm the content complies with applicable content standards."

In terms of risk disclosure, an effective practice identified by FINRA is “balancing statements concerning the benefits of municipal securities by prominently describing the risks associated with municipal securities, including credit risk market risk and interest rate risk.”

Additionally, FINRA’s report suggested that firms should provide education and training on applicable FINRA and MSRB rules and their firm’s policies regarding municipal securities advertising.

According to FINRA, this means that firms should also review their communications to “confirm that the potential benefits of tax features [of municipal securities] are accurate and not exaggerated.”

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