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Firm Short Positions and Fails-to-Receive in Municipal Securities: 2022 Report on FINRA's Examination and Risk Monitoring Program

Regulatory Obligations and Related Considerations

Regulatory Obligations:

As detailed in *Regulatory Notice* 15-27, customers may receive taxable, substitute interest instead of the tax-exempt interest they were expecting when a firm effects sales to customers of municipal securities that are not under the firm's possession or control.7 This can occur when firm trading activity inadvertently results in a short position or a firm fails to receive municipal securities it purchases to fulfill a customer's order.

Firms must develop and implement adequate controls and procedures for detecting, resolving and preventing these adverse tax consequences to customers. Such procedures must include closing out fails-to-receive within the time frame prescribed within Municipal Securities Rulemaking Board (MSRB) Rule G-12(h) and confirming that their communications with customers regarding the tax status of paid or accrued interest for municipal securities are neither false nor misleading, in accordance with MSRB Rule G-17.

Related Considerations:

- Does your firm use exception reports to manage its municipal securities' short positions or fails-t--receive? If so, how does your firm use such reports, and which departments are responsible for managing them?
- When municipal securities short positions are identified, does your firm begin to cover the shorts, or do they wait until the trades have settled?
- What is your firm's process to close out fails-to-receive in accordance with the methods and time frame prescribed under MSRB G-12(h)?
- How does your firm detect instances that would require them to pay customers substitute interest? In those circumstances, what is the firm's process for notifying impacted customers and paying them substitute interest in a timely manner? If a customer does not want to receive substitute interest, what alternatives does the firm offer (e.g., offering to cancel the transaction and purchasing a comparable security that would provide tax-exempt interest)?
- How does your firm handle inbound or outbound account transfers sent through the Automated Customer Account Transfer Service (ACAT) that are delivered with no corresponding municipal bonds in possession or control?

Exam Findings and Effective Practices

Exam Findings:

- **Inadequate Controls and Procedures** – Not maintaining adequate procedures and controls for

preventing, identifying and resolving adverse consequences to customers when a firm does not maintain possession or control of municipal securities that a customer owns.
- **Inadequate Lottery Systems** – Opting to use a random lottery system to allocate municipal short positions to certain customer accounts, but the system did not fairly or adequately account for or allocate substitute accrued interest payments.

Effective Practices:

- **Preventative Controls** – Maintaining processes to prevent or timely remediate municipal positions from settling short (e.g., covering these positions, finding a suitable alternative, cancelling the customer's purchase).
- **Operational and Supervisory Reports** – Developing operational and supervisory reports to identify customer long positions for which the firm has not taken possession and control of the security.
- **Review of Fail Reports** – Municipal securities principals performing regular, periodic reviews of Fail Reports to comply with the close-out requirements of MSRB Rule G12-(h).

Additional Resource

Regulatory Notice 15-27 (Guidance Relating to Firm Short Positions and Fails-to-Receive in Municipal Securities)

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7 These regulatory obligations stem from Exchange Act Rule 15c3-3(d)(4) and MSRB Rules G-17 and G-27 (for firm shorts), and MSRB Rule G12-(h) (for fails-to-receive).

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