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Finra: Firm Short Positions and Fails-to-Receive in Municipal Securities

Regulatory Obligations and Related Considerations

Regulatory Obligations

As detailed in *Regulatory Notice* 15-27 (Guidance Relating to Firm Short Positions and Fails-t--Receive in Municipal Securities), customers may receive taxable, substitute interest instead of the tax-exempt interest they were expecting when a member firm effects sales to customers of municipal securities that are not under the firm's possession or control.1 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.

Member 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); **taking prompt steps to obtain physical possession or control of municipal securities that are short more than 30 calendar days in accordance with Exchange Act Rule 15c3-3(d)(4)**;2 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 monitor its municipal securities' short positions, fails-t--receive and **fails-to-deliver**? If so, how does your firm use such reports, and which departments are responsible for monitoring and responding to them?
- When municipal securities short positions are identified, does your firm start the process of covering the shorts, or does your firm wait until the trades have settled?
- What is your firm's process to close out fails-to-receive **and fails-to-deliver** 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 your 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 your firm offer (e.g., offering to cancel the transaction and purchase a comparable security that would provide tax-exempt interest)?
- **How does your firm handle inbound or outbound account transfers sent through ACATS that are delivered with no corresponding municipal bonds in possession or control?**

Findings and Effective Practices

Findings

- **Inadequate Supervisory Controls and Procedures**: Not maintaining procedures and controls

reasonably designed to prevent, identify and resolve **short positions in municipal securities and the potential 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 as its primary means for addressing the consequences of existing short positions, given that these systems may not fairly or reasonably account for or allocate the associated and accrued substitute interest, or may result in the random allocation of the substitute interest to customer accounts that may not have contributed to the short position.**
- **Not Complying with the Prescribed Close-Out Timing: Failing to follow the close-out timeline under MSRB Rule G-12(h)—including the initial 10 days, the 10-day extension and the maximum close-out period of 20 days—and under Exchange Act Rule 15c3-3(d)(4), which requires a firm to take possession and control of such instruments within 30 days.**
- **Excluding Institutional Customers: Operating under the erroneous assumption that firms are not required to provide institutional (i.e., Delivery-versus-Payment or DVP) customers with the same level of care in preventing, detecting and resolving adverse tax consequences when the firm does not have possession and control of a tax-exempt municipal security (e.g., not addressing these customers in firm controls, procedures, WSPs or exception reports).**

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) and **reviewing or auditing the effectiveness of the processes.**
- **Review of Fail Reports**: Municipal securities principals performing regular, periodic reviews of Fail Reports as part of firms' efforts to comply with the close-out requirements of MSRB Rule G-12(h).

Additional Resources

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

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1 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 G-12(h) (for fails-to-receive).

2 *Regulatory Notice* 15-27 reminds firms that "[w]hile the 30-calendar-day period begins upon allocating the security in deficit to a short position, firms should not view this 30-calendar-day period as a 'safe harbor' for resolving firm short positions in municipal securities." If it were, the payment of taxable substitute interest would be unavoidable.

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