

Client Alert

Current Issues Relevant to Our Clients

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FINRA Issues Guidance on Municipal Security Short Positions and Fails-to-Receive

The Financial Industry Regulatory Authority (“FINRA”) recently issued a Regulatory Notice to remind firms that their written supervisory procedures should identify the process for detecting, resolving and preventing the consequences of short positions and fails-to-receive in municipal securities. The notice also notes that procedures should include controls for ensuring that communications with customers regarding municipal securities transactions, including the tax status of interest payments, are not false or misleading. The guidance follows a series of FINRA examinations finding that some customers who purchased tax-exempt municipal securities have been paid non-tax-exempt substitute interest as a result of trading errors and inadequate firm controls. FINRA also notes that municipal short positions remain an area of focus for FINRA examiners. The complete FINRA Regulatory Notice is available [here](#).

Background

Recent FINRA examinations have identified a number of instances where broker-dealers have short positions in municipal securities. This can occur as a result of a broker-dealer selling municipal securities to a customer where either the firm’s trading activity inadvertently resulted in a firm short position or the firm failed to receive the securities it purchased to fill a customer’s municipal securities order. Unique issues arise in connection with short positions in tax-exempt municipal securities. When a broker-dealer has an unresolved firm short position as a result of a sale of a tax-exempt municipal security to a customer, the firm would typically pay substitute interest to the customer. This substitute interest is not tax-exempt income to the customer affected by the short position. This would also render any communications to the customer describing the interest as tax-exempt, such as trade confirmations, account statements or tax forms, potentially false and misleading. FINRA is concerned that firms may lack supervisory controls and procedures reasonably designed to detect and resolve municipal short positions and to prevent customers from receiving non-tax-exempt substitute interest.

FINRA Guidance on Policies and Procedures

The FINRA notice encourages firms to review Municipal Securities Rulemaking Board (“MSRB”) rules and relevant securities laws and regulations to ensure their policies and procedures adequately address issues surrounding municipal short positions, both through a supervisory system and written supervisory procedures. FINRA listed the following MSRB rules as relevant to municipal short positions:

- Rule G-8 (recordkeeping standards);
- Rule G-9 (record retention requirements);
- Rule G-12 (inter-dealer delivery of securities and close-out procedures);
- Rule G-15 (customer trade confirmations);
- Rule G-17 (requiring that municipal securities firms deal fairly and not engage in any deceptive, dishonest or unfair practice); and
- Rule G-27 (municipal securities activities supervisory requirements).

FINRA also encourages firms to review Securities Exchange Act of 1934 Rule 15c3-3 in connection with policies and procedures on municipal security short positions. Among other things, Rule 15c3-3 requires that when a broker-dealer has a deficit in the quantity of a security that it is required to have in its possession and control, the firm must take prompt steps to obtain physical possession or control of a customer’s fully paid and excess margin securities of the same issue and same class as those allocated to a short position for more than 30 calendar days. FINRA also notes that while the 30-day period begins upon allocating a security in deficit to a short position, firms should not view the 30-day period as a “safe harbor” for resolving firm short positions in municipal securities.

Finally, FINRA reminds broker-dealers that they should have procedures to timely correct any communications provided to customers that are, as a result of the short position in municipal securities, inaccurate or misleading.

Firms Should Take Steps to Identify and Resolve Inadvertent Municipal Short Positions

FINRA notes that most municipal short positions are inadvertent and often the result of errors. The FINRA notice encourages firms to detect municipal securities trading activity that inadvertently creates firm short positions as early as the trade date, and at a minimum by the following business day (T+1). FINRA provides the following examples of remedial actions that a firm can take to resolve a short position and avoid paying substitute non-tax-exempt interest to a customer:

- cancelling the trade, consistent with instructions from a customer;
- cancelling the trade and, consistent with instructions from a customer, purchasing a comparable bond;
- purchasing the bond from the market or another customer on a shortened settlement basis; or
- an introducing firm requesting the assistance of its clearing firm to identify other correspondents' customers who are long the security and may be willing to sell it to the introducing firm.

Firms Should Take Steps to Identify and Resolve Fails-to-Receive

A fail-to-receive occurs when a firm's counterparty fails to deliver the purchased securities by the settlement date. FINRA believes that one of the first steps a firm should take after identifying a fail-to-receive is to determine if there is a customer long position in the bonds. FINRA reminds firms that procedures designed to address fails-to-receive in municipal securities need to be consistent with the procedures for closing out a municipal securities transaction in accordance with MSRB Rule G-12(h). FINRA notes that if a firm's counterparty fails to deliver the securities after five business days, the firm may initiate a close-out of the transaction and, if the counterparty is not able to deliver the securities as of the original settlement date, the counterparty would be responsible for paying accrued, substitute non-tax-exempt interest to the buying firm (which will, in turn, pay its customer) from settlement date until the close-out is executed.

FINRA Exams and Rule 4530 Self-Reporting

The FINRA notice alerts broker-dealers that municipal short positions remain an area of focus for FINRA examiners. The notice also instructs firms that if they become aware that the activity described in the regulatory notice has taken place, it is important that a firm evaluate the conduct to determine if a filing pursuant to FINRA Rule 4530 is required. Among other things, FINRA Rule 4530 requires firms to promptly report specified events to FINRA no later than 30 calendar days after the firm knows or should have known of their existence, including violations of any securities, financial or investment-related laws, rules, regulations or standards of conduct of any regulatory body or self-regulatory organization. FINRA also expressly suggests that firms should consider consulting legal counsel and the appropriate taxing authorities, such as the Internal Revenue Service or appropriate regulatory bodies of the states in which affected customers reside, to resolve tax reporting or underpayment issues, if any.

For More Information

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