

## Municipal Securities Trading

### Guidance Relating to Firm Short Positions and Fails-to-Receive in Municipal Securities

#### Executive Summary

FINRA is issuing this *Notice* to remind firms engaging in municipal securities transactions that their written supervisory procedures should identify the process for detecting, resolving and preventing the consequences of firm short positions and fails-to-receive in municipal securities, as well as the controls for ensuring that communications with customers regarding municipal securities transactions, including the tax status of interest payments, are not false or misleading. FINRA examinations have found that, as a result of trading errors and inadequate firm controls, some customers who purchased tax-exempt municipal securities have been paid substitute interest, which is not tax-exempt under the Internal Revenue Code.

Questions concerning this *Notice* should be directed to:

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#### Background and Discussion

As the SEC has previously recognized, “short positioning municipal securities is rare because the Internal Revenue Service will not allow both a borrower and lender of a municipal security to claim a tax exemption” and “[i]n effect, the lender of a municipal security would be trading tax exempt interest for taxable interest.”<sup>1</sup> Recent FINRA examinations, however, have identified a number of instances where firms have effected sales of municipal securities to customers where either the firm’s trading activity inadvertently resulted in the firm creating a firm short position, or the firm failed to receive the securities it purchased to fill a customer’s municipal

July 2015

#### Notice Type

- ▶ Guidance

#### Suggested Routing

- ▶ Compliance
- ▶ Legal
- ▶ Operations
- ▶ Senior Management
- ▶ Trading

#### Key Topics

- ▶ Branch Error Account Supervision
- ▶ Fails-to-Receive
- ▶ Firm Short Positions
- ▶ Municipal Securities

#### Referenced Rules & Notices

- ▶ FINRA Rule 4530
- ▶ MSRB Rule G-8
- ▶ MSRB Rule G-9
- ▶ MSRB Rule G-12
- ▶ MSRB Rule G-15
- ▶ MSRB Rule G-17
- ▶ MSRB Rule G-27
- ▶ SEA Rule 15c3-3

securities order, collectively referred to as municipal short positions. Although municipal short positions may be infrequent, FINRA is concerned that firms may lack supervisory controls and procedures reasonably designed to detect and resolve them and to prevent the consequences described below.

Firms need to be mindful of the additional concerns that arise when customer long positions in tax-exempt municipal securities allocate to short positions. Consequently, a customer seeking tax-exempt interest may be receiving substitute interest from the firm, which could in fact be taxable.<sup>2</sup> Communications provided to the customer, including confirmations, account statements and tax forms, must not contain false or misleading information regarding the tax status of paid or accrued<sup>3</sup> interest payments in connection with municipal securities.

For example, a firm buys 100 tax-exempt Issuer A municipal bonds from the market and subsequently sells 100 tax-exempt Issuer A bonds to Retail Customer 1. The firm then inadvertently sells the same 100 tax-exempt Issuer A bonds to Retail Customer 2, thus creating a firm short position. Although the firm over-sold 100 tax-exempt Issuer A bonds to Retail Customer 2, both customers receive a confirmation indicating a long position of 100 tax-exempt Issuer A bonds and both receive monthly statements and Forms 1099 indicating the receipt of tax-exempt interest. However, Issuer A will only pay tax-exempt interest on 100 bonds. The firm will need to pay substitute interest on 100 bonds. As a result, the IRS has indicated that in such a scenario, the substitute interest allocated to customers would be taxable, causing any disclosures to the contrary to be inaccurate.<sup>4</sup> Where a municipal security accrues interest from settlement date, resolving the firm short position prior to settlement date can avoid a potential misrepresentation to a customer regarding the tax status of the security's interest accrual and payment.

In another example, a firm buys 100 tax-exempt Issuer B municipal bonds from Counterparty 1, and subsequently sells 100 Issuer B bonds to a retail customer. Counterparty 1 does not deliver the bonds to the firm on settlement date, thus setting up a fail-to-receive at the firm and the potential payment of substitute interest to the customer.<sup>5</sup> Although the firm has not yet taken possession of the security, the customer may receive communications from the firm, such as a confirmation or account statement, indicating that interest on Issuer B bonds is tax-exempt.

## Guidance on Specific Controls and Remedial Action

FINRA is providing the following guidance for consideration to assist firms in developing policies and procedures relating to municipal short positions.<sup>6</sup>

Firms should review Municipal Securities Rulemaking Board (MSRB) rules to ensure compliance with applicable securities laws and regulations and with MSRB rules, both through a supervisory system, including for the processing and clearance of municipal securities transactions, and written supervisory procedures. Relevant MSRB rules include:

- ▶ MSRB Rule G-8, including G-8(a)(iv),<sup>7</sup> which sets forth the recordkeeping standards for municipal securities;
- ▶ MSRB Rule G-9, which sets forth the record retention requirements for municipal securities;
- ▶ MSRB Rule G-12, which sets forth the requirements for the inter-dealer delivery of securities and close-out procedures;
- ▶ MSRB Rule G-15, which sets forth the confirmation requirements with respect to transactions with customers;
- ▶ MSRB Rule G-17, which requires that municipal securities firms deal fairly with all persons and not engage in any deceptive, dishonest, or unfair practice; and
- ▶ MSRB Rule G-27, which imposes an obligation on municipal securities firms to supervise their municipal securities activities.

Firms should also review SEA Rule 15c3-3, which requires, among other things, that a member firm obtain and maintain possession and control of customer fully paid and excess margin securities.<sup>8</sup>

Further, a firm should have procedures to correct any communications provided to customers that are, as a result of the short position in municipal securities, inaccurate or misleading.<sup>9</sup>

Since short positions in municipal securities can be caused by both introducing and clearing firms, such firms should review their existing policies and procedures to address any gaps between those procedures and the appropriate policies and procedures described herein.<sup>10</sup> Based on the particular circumstances of a clearing firm and its correspondent, both may have regulatory obligations arising from a single municipal securities transaction.

## Identifying and Resolving Firm Short Positions

FINRA has observed that most municipal short positions are inadvertent and may result from branch or trading errors, duplicate transactions, the sale of a security in the process of a partial redemption or a partial call, or a delay in delivery of the securities from a counterparty. In addition to the scenarios explained above, two common situations that may cause short positions are described below.

- ▶ A firm may sell an incorrect CUSIP from a customer's account and subsequently cancel the trade after settlement date. However, the firm has already delivered the security to the counterparty and it is no longer available in the market to effect a buy-in, leaving the customer with a long position that identifies to a firm short position.
- ▶ A firm may sell a security after the record date for a partial redemption or partial call, causing the firm to be short when completing the redemption process with the issuer.

Firms can reduce the impact of short positions by detecting municipal securities trading activity that inadvertently creates firm short positions as early as trade date, and at a minimum by T+1. Remedial actions to resolve a municipal securities firm short position and avoid the risk of paying substitute interest to a customer include, for example:

- ▶ 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.

## Identifying and Resolving Fails-to-Receive

One of the first steps a firm should take after identifying a fail-to-receive in municipal securities is to determine if there is a customer long position in the bonds. 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).<sup>11</sup> If a firm's counterparty fails to deliver the securities after five business days, the firm may initiate a close-out of the transaction. If the counterparty is not able to deliver the securities as of the original settlement date, the counterparty will be responsible for paying accrued, substitute interest to the buying firm (which will, in turn, pay its customer) from settlement date until the close-out is executed. Substitute interest paid by the counterparty may not be tax-exempt.

FINRA recognizes that the majority of fails-to-receive are resolved within days of the original settlement date. Consequently, a firm's procedures for correcting a communication that could be misleading because of an inadvertent municipal short position could reasonably afford more time to correct the communication when the municipal short position is caused by a fail-to-receive.

## Other Considerations

Municipal short positions remain an area of focus for FINRA examiners. If the firm, through a self-review process, becomes aware that the activity described in this Notice has taken place, it is important to evaluate the conduct to determine if a filing pursuant to FINRA Rule 4530 is required. In addition, the firm should consider consulting legal counsel and the appropriate taxing authorities, such as the IRS or appropriate regulatory bodies of the states in which affected customers reside, to resolve tax reporting or underpayment issues, if any.

## Endnotes

1. Securities Exchange Act Release No. 33743 (March 9, 1994), 59 FR 12767, 12769 n.24 (March 17, 1994) citing Internal Revenue Code, Sec. 6045(d). The SEC also noted that, to the extent any short positioning occurs with respect to municipal securities, the IRS imposes additional reporting requirements on the participating parties.
2. For example, the Internal Revenue Service previously addressed the tax implications of a short sale transaction where title passes from the lender of a municipal security to the purchaser, and the lender receives a substitute payment instead of receiving interest on the municipal security. In this instance, the IRS has found that, because title passed to the purchaser as a result of the short sale, the lender is no longer the owner of the bond, and so any subsequent payment received by the lender is not interest on an obligation of a state or political subdivision for purposes of determining the lender's gross income under the Internal Revenue Code. See IRS Rev. Rul. 80-135 (1980-1 C.B. 18).
3. If by transaction settlement date the firm is not in possession of the securities for which the customer is long, the firm assumes the accrued interest liability until the firm covers its short position. Even if the firm covers the short before the next coupon date, the interest accrued between settlement date and the date the firm covers the short will be taxable to the customer (*i.e.*, substitute interest). This is because when the firm purchases the security from a dealer or another customer to cover the short, the

- firm will pay the accrued interest to the seller. The seller, not the customer, is entitled to tax exempt interest during the accrual period. One exception would be a fail-to-receive that cleans up as of the original settlement date with the original counterparty. This would not result in a substitute interest payment.
4. *See supra* note 3.
  5. *See supra* note 3.
  6. Firms should not consider this guidance to include all rules and interpretations applicable to municipal short positions. Firms are reminded that, in designing written supervisory procedures, firms are to consider, among other things, the nature of the business the firm conducts, the manner in which procedures are implemented and followed, and the extent to which the firm updates and revises its procedures to reflect operating experience and regulatory and operational changes.
  7. *See also* SEA Rule 17a-3(a)(5) and MSRB Rule G-8(a)(iii).
  8. When a member firm has a deficit in the quantity of a particular security that it is required to have in its possession and control, SEA Rule 15c3-3(d)(4) requires the firm to take timely curative action 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. The rule states, in relevant part, that "[s]ecurities included on the broker's or dealer's books or records that allocate to a short position of the broker or dealer or a short position for another person, excluding positions covered by paragraph (m) of this section, for more than 30 calendar days, then the broker or dealer must, not later than the business day following the day on which the determination is made, take prompt steps to obtain physical possession or control of such securities." While 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.
  9. *See, e.g.*, MSRB Rules G-15 and G-17.
  10. For example, MSRB Rules G-17 and G-27 apply to both introducing and clearing firms.
  11. *See* MSRB Rule G-12(h) regarding the process to close out a transaction between any broker, dealer or municipal securities dealer and any other broker, dealer or municipal securities dealer which has been confirmed or otherwise agreed upon by both parties but which has not been completed and the MSRB's [\*Manual on Close-Out Procedures\*](#).