

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-77903; File No. SR-MSRB-2016-07)

May 25, 2016

Self-Regulatory Organizations; Municipal Securities Rulemaking Board; Notice of Filing of a Proposed Rule Change Consisting of Proposed Amendments to MSRB Rule G-12, on Uniform Practice, Regarding Close-Out Procedures for Municipal Securities

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the “Exchange Act” or “Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on May 11, 2016, the Municipal Securities Rulemaking Board (the “MSRB” or “Board”) filed with the Securities and Exchange Commission (the “SEC” or “Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the MSRB. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

The MSRB filed with the Commission a proposed rule change consisting of proposed amendments to Rule G-12, on uniform practice, regarding close-out procedures for municipal securities (“proposed rule change”).

The text of the proposed rule change is available on the MSRB’s website at [www.msrb.org/Rules-and-Interpretations/SEC-Filings/2016-Filings.aspx](http://www.msrb.org/Rules-and-Interpretations/SEC-Filings/2016-Filings.aspx), at the MSRB’s principal office, and at the Commission’s Public Reference Room.

II. Self-Regulatory Organization’s Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the MSRB included statements concerning the purpose

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The MSRB has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization’s Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

Background

Rule G-12(h)<sup>3</sup> and the MSRB’s Manual on Close-Out Procedures<sup>4</sup> provide optional procedures that can be used by brokers, dealers, or municipal securities dealers (“dealers”) to close out open inter-dealer fail transactions. The rule currently allows the purchasing dealer to issue a notice of close-out to the selling dealer on any business day from five to 90 business days after the scheduled settlement date.<sup>5</sup> Rule G-12(h) currently does not mandate a purchasing dealer to initiate a close-out, or to execute a close-out notice it has initiated nor does it provide the selling dealer with the right to force a close-out of the transaction. If the purchasing dealer chooses not to initiate a close-out within 90 business days of the original contract settlement date (and ultimately execute it) then that dealer loses its right to use the Rule G-12(h) procedure, and the transaction remains open until it is resolved by agreement of the parties or through arbitration. During this period, the selling dealer is subject to market risk for any increase in the price of the municipal securities. Rule G-12(h) provides the close-out options of substitution and

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<sup>3</sup> See [MSRB Rule G-12](#).

<sup>4</sup> See [Manual on Close-Out Procedures](#).

<sup>5</sup> The purchasing dealer may initiate a close-out within 15 business days after a reclamation made under Rule G-12(g)(iii)(C) or G-12(g)(iii)(D), even though more than 90 business days have elapsed since the original settlement date.

mandatory repurchase because municipal securities often are not available for a buy-in within a reasonable period of time.

If the selling dealer does not deliver the securities owed on the transaction within 10 business days after receipt of the close-out notice (15 business days for retransmitted notices), then the purchasing dealer may execute a close-out procedure using one of three options: (1) purchase ("buy-in") at the current market all or any part of the securities necessary to complete the transaction for the account and liability of the seller; (2) accept from the seller in satisfaction of the seller's obligation under the original contract (which shall be concurrently cancelled) the delivery of municipal securities that are comparable to those originally bought in quantity, quality, yield or price, and maturity, with any additional expenses or any additional cost of acquiring such substituted securities being borne by the seller; or (3) require the seller to repurchase the securities on terms that provide for the seller to pay an amount that includes accrued interest and bear the burden of any change in market price or yield.

Rule G-12(h) includes a 90-business day time limit for close-outs to encourage dealers to resolve open transactions in a timely manner, but there is no requirement that open transactions be closed out within 90 business days. Currently, a purchasing dealer is not required to initiate a close-out or to execute a close-out notice if one is initiated, nor does the selling dealer have a right to force a close-out of the transaction. If the purchasing dealer chooses not to initiate a close-out within 90 business days of the original contract settlement date (and ultimately execute the close-out), then that dealer loses its right to use the Rule G-12(h) procedure and the transaction remains open until it is resolved by agreement of the parties or through arbitration. During this period, the selling dealer is subject to market risk for any increase in the price of the securities.

Since Rule G-12(h) was last revised in 1983, evolutions in the municipal securities market have changed how securities are offered and modernized the manner in which inter-dealer transactions are cleared and settled. There are electronic alternative trading systems (“ATS”) and broker-dealers that serve in the role of a “broker’s broker” in the municipal market, facilitating the ability of dealers to find securities for purchase. MSRB rules requiring use of the Depository Trust & Clearing Corporation (“DTCC”) automated comparison system and book entry settlement, as well as the shortening of the settlement cycle from T+5 to T+3, likewise have contributed to lowering the occurrence of inter-dealer fails since the rule’s adoption. The initiative to move to T+2 settlement has received broad support from both the industry and the SEC,<sup>6</sup> and is likely to further reduce the instances of inter-dealer fails.<sup>7</sup> The MSRB believes that a more timely resolution of inter-dealer fails would ultimately benefit customers by providing greater certainty that their fully paid for securities are in fact owned in their account, not allocated to a firm short, and would benefit dealers by reducing the risk and costs associated with inter-dealer fails.

MSRB Rule G-14<sup>8</sup> requires the use of National Securities Clearing Corporation’s (“NSCC”) Real-Time Trade Matching (“RTTM”) for submitting or modifying data with respect

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<sup>6</sup> See Michael S. Piwovar, Commissioner, and Kara M. Stein, Commissioner, SEC, Statement Regarding Proposals to Shorten the Trade Settlement Cycle (June 29, 2015) available at <http://www.sec.gov/news/statement/statement-on-proposals-to-shorten-the-trade-settlement-cycle.html>.

<sup>7</sup> On April 29, 2016 the SEC approved amendments to MSRB Rules G-12, on uniform practice, and G-15 on confirmation, clearance, settlement and other uniform practice requirements with respect to transactions with customers, to define regular-way settlement for municipal securities transactions as occurring on a two-day settlement cycle (“T+2”). Exchange Act Release No. 77744 (April 29, 2016), 81 FR 26851 (May 4, 2016), File No. SR-MSRB-2016-04.

<sup>8</sup> See [MSRB Rule G-14](#).

to Inter-Dealer Transactions Eligible for Comparison. Additionally, dealers' almost universal use of DTCC's continuous net settlement ("CNS") on a voluntary basis<sup>9</sup> has resulted in inter-dealer transactions that are netted (or paired-off) with counterparties that may not have originally transacted together causing new settlement dates to be continually established. This scenario was not contemplated when Rule G-12(h) was originally adopted, thus making it unclear that firms should use the original contract settlement date pursuant to the rule today.<sup>10</sup>

### Proposal

The proposed rule change to Rule G-12(h), regarding close-outs, would significantly compress the timing to initiate and complete a close-out by allowing a close-out notice to be issued the day after the purchaser's original settlement date, with the last day by which the purchasing dealer must complete a close-out on an open transaction being reduced to 20 calendar days.

With the vast majority of municipal securities in book entry form and DTCC's continued efforts to promote dematerialization, the MSRB is proposing that firms should no longer have to provide a 10-day delivery window before implementing an execution period. The MSRB believes a three-day delivery window would be sufficient as the majority of inter-dealer fails are

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<sup>9</sup> As a key part of the CNS system, NSCC acts as the central counterparty for clearance and settlement for virtually all broker-to-broker equity, corporate and municipal bond and unit investment trust trading in the United States. CNS processes include an automated book entry accounting system that centralizes settlement and maintains an orderly flow of security and money balances.

<sup>10</sup> In NSCC's CNS and RECAPS program, transactions are marked to market, and receive new settlement dates that may also serve for purposes of the SEC's net capital rules. This may reduce the dealer's net capital deductions for "aged" failed transactions, but does not always resolve the open transaction. If the dealer keeps the transaction open, it must use the original contract settlement date for purposes of the 90-day limit on close-outs.

resolved within days of the original settlement and/or a fail situation is known prior to the original settlement date.

Additionally, the current rule requires that the earliest day that can be specified as the execution date is 11 days after telephonic notice. The proposed amendments would amend the current allowable execution time frame from 11 days to four days after electronic notification. Accelerating the execution date could improve a firm's likelihood of finding a security for a buy-in, lower overall counter-party risk and may further reduce accrual, capital and other expenses.

Under the proposed rule change, a purchasing dealer notifying the selling dealer of an intent to close out an inter-dealer fail would continue to prompt DTCC to "exit" the position from CNS and the two parties are responsible for effecting the close-out. Because a municipal security may not be available for purchase, incorporating the buy-in procedures of a registered clearing agency will often not solve the inter-dealer fail. The MSRB expects firms to not solely rely upon the CNS system or the services of a registered clearing agency to resolve inter-dealer fails and take prompt action to close out inter-dealer fails in a timely manner. Under the proposed rule change, regardless of the date the positions are exited from CNS, the inter-dealer fail must be resolved within 20 calendar days of the purchasing dealer's original settlement date. The MSRB is also proposing to retire the Manual on Close-Out Procedures.<sup>11</sup>

#### Proposed Amendments to MSRB Rule G-12(h)

Rule G-12, on uniform practice, establishes uniform industry practices for processing, clearance and settlement of transactions in municipal securities between a broker, dealer or municipal securities dealer and any other broker, dealer or municipal securities dealer. The

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<sup>11</sup> See [Manual on Close-Out Procedures](#). The Manual on Close-Out Procedures would be retired because such procedures would be outdated and, given the proposed rule change's overall simplicity, developing an updated version of the manual is not warranted.

proposed amendments would amend Rule G-12(h) by requiring close-outs to be settled no later than 20 calendar days after the settlement date. The proposed amendments to G-12(h)(i)(B) would allow for the close-out process to continue to provide three options to the purchasing dealer. The three options include: (1) purchase (“buy-in”) at the current market all or any part of the securities necessary to complete the transaction for the account and liability of the seller; (2) accept from the seller in satisfaction of the seller’s obligation under the original contract (which shall be concurrently cancelled) the delivery of municipal securities that are comparable to those originally bought in quantity, quality, yield or price, and maturity, with any additional expenses or any additional cost of acquiring such substituted securities being borne by the seller; or (3) require the seller to repurchase the securities on terms which provide that the seller pay an amount which includes accrued interest and bear the burden of any change in market price or yield.

Firms must coordinate internally to determine which of the three close-out options are appropriate for any given fail-to-deliver situation. While a buy-in may be the most preferred method, Rule G-12(h) provides two other options to a purchaser in the event a buy-in is not feasible. Firms are reminded that, regardless of the option agreed upon by the counterparties, including a cancellation of the original transaction, the close-out transaction is reportable to the Real-time Transaction Reporting System (“RTRS”) as currently required pursuant to Rule G-14.

Additionally, the proposed amendments to Rule G-12(h)(i)(A) would allow a purchaser to notify the seller of the purchaser’s intent to close-out the transaction the first business day following the purchaser’s original transaction settlement date, instead of waiting five business days as currently required in Rule G-12(h)(i)(A).

Currently Rule G-12(h) references use of the telephone and mail as part of the notification process. The proposed amendments would update Rule G-12(h) throughout, to reflect modern communication methods and widely-used industry practices that would facilitate more timely and efficient close-outs. For example, DTCC's SMART/Track is available for use by any existing NSCC clearing firm or DTCC settling member, allowing users to create, retransmit, respond, update, cancel and view a notice.

The proposed amendments to Rule G-12(h)(i)(D) would require sellers to use their best efforts to locate the securities that are subject to a close-out notice from a purchaser. The proposed amendments to Rule G-12(h)(i)(E)(1) would also require the seller to bear any burden in the market price, with any benefit from any change in the market price remaining with the purchaser.

The proposed amendments would also require a purchasing dealer that has multiple counterparties, to utilize the FIFO (first-in-first-out) method for determining the contract date for the failing quantity. Amendments to Rule G-12(h)(iv) would require dealers to maintain all records regarding the close-out transaction as part of the firm's books and records.

#### Compliance Date

As part of implementation of the proposed amendments, the MSRB would allow for a 90-calendar day grace period for resolving all outstanding inter-dealer fails. The MSRB understands that many of the outstanding fails have been open for years and is concerned that such fails could continue to exist until maturity unless dealers are mandated to close-out all outstanding inter-dealer fails. While firms may be reluctant to seek a solution other than a buy-in, the proposed rule change provides alternative solutions that should be considered as part of an inter-dealer fail resolution.

## 2. Statutory Basis

The MSRB believes that the proposed rule change is consistent with Section 15B(b)(2)(C) of the Exchange Act,<sup>12</sup> which provides that the MSRB's rules shall:

be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in municipal securities and municipal financial products, to remove impediments to and perfect the mechanism of a free and open market in municipal securities and municipal financial products, and, in general, to protect investors, municipal entities, obligated persons, and the public interest.

The MSRB believes that the proposed rule change would benefit investors, dealers and issuers. Specifically, the MSRB believes that dealers may benefit from clarifications and revisions that more closely reflect actual market practices. In addition, dealers may be able to more quickly and efficiently resolve inter-dealer fails, which may reduce dealer risk, reduce the likelihood and duration that dealers are required to pay "substitute interest" to customers and reduce systemic risk. The MSRB believes that the proposed rule change may also reduce the likelihood and duration of firm short positions that allocate to customer long positions, reduce investor tax exposure and increase investor confidence in the market. Issuers and the market as a whole may benefit from increased investor confidence.

### B. Self-Regulatory Organization's Statement on Burden on Competition

Section 15B(b)(2)(C) of the Exchange Act<sup>13</sup> requires that MSRB rules not be designed to impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act. In determining whether these standards have been met, the MSRB was guided by the

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<sup>12</sup> 15 U.S.C. 78o-4(b)(2)(C).

<sup>13</sup> Id.

Board's Policy on the Use of Economic Analysis in MSRB Rulemaking.<sup>14</sup> In accordance with this policy, the Board has evaluated the potential impacts on competition of the proposed rule change, including in comparison to reasonable alternative regulatory approaches, relative to the baseline. The MSRB also considered other economic impacts of the proposed rule change and has addressed any comments relevant to these impacts in other sections of this document.

According to DTCC, during the period December 16, 2015 through December 22, 2015, NSCC had an average of 500 end-of-day municipal security interdealer fails in CNS with an average total daily value of \$54.0 million. Of that total, there were an average of 170 end-of-day inter-dealer fails with an average total daily market value of \$6.3 million that had been outstanding for more than 20 days.

As discussed above, the MSRB believes that the proposed rule change would benefit investors, dealers and issuers.

The MSRB believes that the proposed rule change may disproportionately impact some market participants including smaller selling dealers that may have more difficulty locating securities owed, selling dealers that frequently fail to deliver securities or who owe a large number of securities, purchasing dealers that frequently fail to resolve interdealer fails or do not have policies and procedures in place to monitor interdealer fails and clearing firms that do not regularly communicate fails to correspondents.

The MSRB sought additional data that would support a quantitative evaluation of the magnitude of any of these, or any other potential burdens, but was unable to identify relevant data directly or through the comment process. Therefore, at present, the MSRB is unable to

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<sup>14</sup> Policy on the Use of Economic Analysis in MSRB Rulemaking, available at, <http://www.msrb.org/About-MSRB/Financial-and-Other-Information/FinancialPolicies/Economic-Analysis-Policy.aspx>.

quantitatively evaluate the magnitude, if any, of any burden on competition. However, the qualitative analysis and review of comments received supports the MSRB's view that the proposed rule change will not impose any additional burdens on competition, relative to the baseline, that are not necessary or appropriate in furtherance of the purposes of the Exchange Act.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

The MSRB received four comment letters<sup>15</sup> in response to the Request for Comment<sup>16</sup> on the draft amendments to Rule G-12(h) and all four comment letters were in support of the shorter mandated timeframes for resolving inter-dealer fails. Overall, the four commenters were supportive of the Board's Request for Comment and the Board's efforts to update close-out procedures, underscoring that municipal securities may fail to settle due to operational or trading desk errors, customer-based execution errors, failure to receive a security, or a partial call between trade and settlement date. BDA, NSCC and SIFMA noted that the draft amendments would decrease the costs and risks associated with dealer fails, while providing investors greater certainty.

None of the commenters objected to the proposed requirement to resolve all current outstanding transaction fails, though BDA requested a longer grace period. None of the

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<sup>15</sup> Comment letters were received in response to the Request for Comment from: Bond Dealers of America, Letter from Michael Nicholas, Chief Executive Officer, dated March 4, 2016 ("BDA"); Breena LLC: E-mail from Geraldine Lettieri dated January 6, 2016 ("Breena"); National Securities Clearing Corporation, Letter from Murray C. Pozmanter, Managing Director, dated January 12, 2016 ("NSCC"); and Securities Industry and Financial Markets Association, Letter from Leslie M. Norwood, Managing Director and Associate General Counsel, dated March 6, 2016 ("SIFMA").

<sup>16</sup> MSRB Notice 2016-02, Request for Comment on Amendments to MSRB Rule G-12 on Close-Out Procedures (January 6, 2016) ("Request for Comment").

commenters objected to settling money differences or expenses within five business days, with SIFMA specifically supporting this requirement. SIFMA also supported utilizing the FIFO method for determining which contract date to use for the failing quantity when the fail is a result of multiple transactions.

#### Shortening the Close-Out Period

SIFMA and Brener suggested a tighter time frame to resolve a fail of 15 and 10 days respectively, significantly less than the proposed time frame of 30 calendar days, with SIFMA emphasizing that “failed transactions don’t get better with age.”

While SIFMA supports an even shorter time frame for close-outs, they also suggest that the rule permit the buyer to grant the seller a one-time 15-day extension, for an aggregate total of 30 days to close-out an inter-dealer fail. While the Board commends these industry participants on an aggressive time frame to resolve inter-dealer fails, the Board is concerned that shortening the 30 calendar day period to 15 days may overburden smaller dealers who may not have the same resources that would be required to locate a security and effectively close-out a failed transaction in a shorter time frame. The MSRB believes it is better to provide all dealers a fixed time frame that is sufficient to complete the close-out process rather than a reduced time frame with an additional permissive 15-day extension as suggested by SIFMA. Therefore, the MSRB revised its original proposal in the Request for Comment; the proposed rule change would require firms to complete a close-out in 20 calendar days, which reflects not only the expressed commitment and desire of the industry to expedite a close-out, but also reduces the risk of placing an undue burden on smaller dealers.

#### Grace Period for Outstanding Fails

Rather than the 90-day grace period proposed in the Request for Comment, BDA recommended a 180-day grace period to allow the industry ample time to resolve existing aged fails. As noted in the Request for Comment, NSCC had an average of 170 end-of-day inter-dealer fails outstanding for more than 20 days during the period December 15, 2015 to December 22, 2015. The Board believes that the industry will have ample time to clean up the approximately 170 existing aged inter-dealer fails given that dealers with failed transactions could begin working on closing out those transactions immediately.

#### Documentation

SIFMA requested guidance regarding the documentation needed for the situation where one dealer is trying to resolve a fail, but the other party is not willing to cooperate. The proposed rule change would mandate that dealers utilize an inter-dealer communication system of the registered clearing agency through which the transaction would be compared to ensure consistency and which would provide a clear audit trail. The MSRB does not believe any further guidance on documenting the inter-dealer interaction is necessary at this point.

#### Partial Deliveries

SIFMA noted that a purchasing dealer should not be required to accept a partial delivery on an inter-dealer fail and would like to have further dialog with the MSRB and DTCC on this issue. Currently CNS will make a partial delivery if the full amount of securities is not available through CNS and a buyer in CNS is not able to reject a partial delivery from CNS and return the securities to CNS. According to DTCC, partial deliveries have been occurring in CNS for 20 years. The proposed rule change does not mandate acceptance of partial deliveries and the close-out process is done outside of the CNS process and the MSRB believes the comment was outside the scope of the proposed rule change.

### More Onus Placed on the Failing Dealer

SIFMA noted that some of their members feel consideration should be given to a simpler rule in which more onus is placed on the dealer that fails to deliver the securities by forcing those dealers to take responsibility for resolving the short, even suggesting the seller break the trade or resolve a fail through a buy-back. Currently the rule places more emphasis on the buyer, allowing the buyer to control the execution and agree to the terms of the close-out in the event the seller does not resolve the fail. SIFMA noted that it is not uncommon for dealers to simply allow the delivery deadline to pass, thereby forcing the buyers to do all the “heavy lifting.” In response to this comment the proposed rule change would amend Rule G-12(h)(i)(D) to specifically address “seller’s responsibilities,” which will further clarify that the seller is expected to use its best efforts to locate the securities referenced in the notice. Currently, the Manual on Close-out Procedures interprets any change in market price as attributable to the seller. The proposed amendments would further clarify that any financial burden as the result of the purchaser effecting a “buy-in” is borne by the seller, but any benefit remains with the purchaser.

### Guidance for Customer Accounts

SIFMA would like guidance on how to close-out a short position that results from an inter-dealer fail when that position is in a customer’s self-directed account where the dealer may not have the discretion to sell or cancel a position in that account or purchase a comparable security for that account. The MSRB believes the guidance requested by SIFMA is outside the scope of the Request for Comments because the proposal does not impose an obligation on dealers to effect transactions in customer accounts in order to resolve inter-dealer fails and should a customer want to retain a position that effectively requires a dealer to pay substitute interest, that issue is one outside the scope of MSRB rules.

### III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 45 days of the date of publication of this notice in the Federal Register or within such longer period of up to 90 days (i) as the Commission may designate if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

- (A) by order approve or disapprove such proposed rule change, or
- (B) institute proceedings to determine whether the proposed rule change should be disapproved.

#### IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

##### Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-MSRB-2016-07 on the subject line.

##### Paper comments:

- Send paper comments in triplicate to Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549.

All submissions should refer to File Number SR-MSRB-2016-07. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed

rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549 on official business days between the hours of 10:00 am and 3:00 pm. Copies of the filing also will be available for inspection and copying at the principal office of the MSRB. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-MSRB-2016-07 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, pursuant to delegated authority.<sup>17</sup>

Brent J. Fields  
Secretary

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<sup>17</sup> 17 CFR 200.30-3(a)(12).