

Preliminary Recommendations Regarding the Practice of Pennyning in the Corporate and Municipal Bond Markets

The Technology and Electronic Trading Subcommittee (“Subcommittee”) of the Fixed Income Market Structure Advisory Committee (“FIMSAC”) was formed to consider the impact of increased use of electronic trading platforms on the liquidity, efficiency and resiliency of the corporate and municipal bond markets. Although the increased use of electronic trading has had a variety of positive impacts on both the corporate and municipal bond markets, one troubling trading practice immediately came to the Subcommittee’s attention: the abusive use of last look in the auction process to systematically internalize orders, often referred to as “pennyning” by certain bond dealers.

For purposes of this recommendation, the Subcommittee considers last look to refer to the valid process of a dealer reviewing auction responses as part of its best execution process before executing a customer order. If the winning price fails to satisfy the dealer’s best execution obligation, the dealer may internalize the order by providing meaningful price improvement to the customer.¹ Pennyning, on the other hand, occurs when the dealer, after reviewing the auction information received back in a bid wanted (BWIC) or offer wanted (OWIC), either matches the best price or executes the bond at a price that is slightly better than the best price. At first glance, this practice appears to benefit the customer, as the dealer is providing at least as good a price as was obtained through the auction process. But, over time, this practice harms competitiveness. For example, the use of pennyning to systematically internalize orders deters aggressive pricing or participation in the auction process by other dealers who fear that the submitting dealer is going to “step in front of” their winning prices or is otherwise using the auction process solely for price discovery purposes. Thus, competing dealers face diminished incentives to “put their best foot forward” or even submit a price into the auction. This process would also appear to give the submitting dealer an unfair advantage in the auction.

The Municipal Securities Rulemaking Board (“MSRB”), the primary regulator of the municipal bond market, expressed concern about this practice in the context of broker’s brokers trading in municipal bonds in a December 22, 2012 Notice to Dealers. The MSRB stated that the use of bid-wanted by broker’s brokers solely for price discovery purposes and without a bona fide intent to trade harms the bid-wanted and offering processes by reducing bidders, thereby reducing the likelihood that the high bid in a bid-wanted will represent the fair market value of the securities. Unfortunately, the Notice to Dealers did not end this unfair practice in the municipal bond market.

On September 7, 2018, the MSRB published a Request for Comment on Draft Interpretative Guidance on Pennyning by not just broker’s brokers, but also by dealers on ATs (“MSRB Request for Comment”). Therein, the MSRB states “[i]n recent outreach to a broad range of market participants, it has been suggested that pennyning is prevalent in the municipal market and that widespread pennyning does indeed disincentivize participation in the bid-wanted process, discourages bidders from giving their best price in a bid-wanted and may impact the efficiency of the market.” Accordingly, the MSRB requested comments on its proposal to extend the December 22, 2012 Notice to Dealers and its guidance on the use of bid wanteds in the context of broker’s brokers to the use of pennyning following a bid-wanted

¹ Given the competitive nature of the auction process, the Subcommittee believes the use of last look to internalize an order for best execution should be an infrequent occurrence. Dealers should not use last look as a mechanism to systematically internalize orders.

distributed via an ATS. The MSRB stated it wants to “make clear that, depending on the facts and circumstances, the use of bid-wanteds (whether distributed via an ATS or broker’s broker) solely for price discovery purposes would be an unfair practice within the meaning of [MSRB] Rule G-17, and that the repeated practice of pennyng would be indicative of having the sole purpose of price discovery.”

The Subcommittee applauds the recent MSRB Request for Comment as the right step towards curbing this abusive practice in the municipal bond market. However, the Subcommittee believes that pennyng is not exclusive to the municipal bond market, but is also utilized by certain dealers in the related, and much larger, corporate bond market. The Subcommittee believes that the long-term implications for market structure are negative when market participants become skeptical of many of the bid-wanteds they see because they think the bid-wanteds are only being used for price discovery by the selling dealers.

As the MSRB has no jurisdiction over the corporate bond market, the Subcommittee believes that the Securities and Exchange Commission (“SEC”) should encourage the Financial Industry Regulatory Authority (“FINRA”), the primary regulator of the corporate bond market, to follow the MSRB’s actions and issue a similar request for comment from corporate bond market participants. The Subcommittee recognizes that these two markets are not identical, but they do have many similarities. With the MSRB now addressing the systematic abuse of last look, a coordinated response to this practice is warranted to preserve the integrity of both of these important markets.

Recommendation: The Subcommittee recommends the following actions to correct the abusive use of the last-look mechanism:

- (1) FIMSAC requests that the SEC make a statement disapproving of the use of pennyng in either the municipal or corporate bond markets on any electronic trading venue, as the practice harms price discovery and market efficiency. The SEC should consider setting the clear expectation that the use of last-look to provide nominal price improvement should occur only in the rare situation, such as when the dealer needs to use the practice to conform with its best execution responsibilities. Furthermore, the SEC should encourage dealers to have clear policies and procedures in place delineating when last-look may be used.
- (2) The SEC should encourage FINRA to publish a request for comment on the use of pennyng in the corporate bond market, similar to the September 7, 2018 MSRB Request for Comment. The SEC should encourage FINRA and MSRB to expand its review of pennyng to cover all electronic trading venues rather than limit specifically to ATSs. Finally, the SEC should encourage FINRA and MSRB to coordinate their respective final responses.