



October 16, 2020

Ms. Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006

Re: FINRA Request for Comment on the Practice of Pennying in the Corporate Bond Market (Regulatory Notice 20-29)

Dear Ms. Mitchell:

The American Securities Association¹ welcomes this opportunity to provide comment on the Financial Industry Regulatory Authority's (FINRA) request for comment regarding the practice of "pennying" in the corporate bond market (Request).

General.

While ASA commends FINRA for soliciting public input on this matter, we are concerned this initiative will ultimately lead regulators to unnecessarily interfere with micro-structure of bond markets based upon ill-defined terms and insufficient analytical data. Accordingly, we urge FINRA to refrain from any regulatory action that does not benefit investors and could decrease liquidity and transparency in the corporate bond and other fixed income markets. Regulation-by-anecdote is fundamentally at odds with the principles of smart, effective data driven regulation.

Best Execution.

ASA members take their best execution obligations under FINRA Rule 5310 very seriously. Rule 5310 states that a broker-dealer "shall use reasonable diligence to ascertain the best market for the subject security and buy or sell in such market so that that resultant price to the customer is as favorable as possible under prevailing market conditions." In other words, the long-standing best execution rules generally prohibit broker-dealers from executing trades for client orders at inferior prices when better prices are readily available for execution.

¹ The ASA is a trade association that represents the retail and institutional capital markets interests of regional financial services firms who provide Main Street businesses with access to capital and advise hardworking Americans how to create and preserve wealth. The ASA's mission is to promote trust and confidence among investors, facilitate capital formation, and support efficient and competitively balanced capital markets. This advances financial independence, stimulates job creation, and increases prosperity. The ASA has a geographically diverse membership base that spans the Heartland, Southwest, Southeast, Atlantic, and Pacific Northwest regions of the United States.





When reviewing bids received through the corporate bond auction process, broker-dealers may internalize certain trades, often at an improved price over the best auction bid. Broker-dealers routinely make decisions as to whether they should accept a bid received through auction or internalize a customer order, taking into account their best execution obligations and what is ultimately in the best interest of customers. Internalization is a longstanding market practice that is subject to regular and rigorous reviews by broker-dealers and FINRA under Rule 5310.

Lack of Consensus Exists.

In June 2019, the Securities and Exchange Commission's (SEC) Fixed Income Market Structure Advisory Committee (FIMSAC) issued recommendations regarding what FIMSAC referred to as "pennying" in the corporate bond market.² FIMSAC defined pennying as a term used by "certain bond dealers" to describe when a 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." FIMSAC recommended that (1) the SEC issue a statement "disapproving of the use of pennying in either the municipal or corporate bond markets"; and (2) FINRA should "publish a request for comment on the use of pennying in the corporate bond market."

The FIMSAC recommendations made no mention of any academic or market research supporting the theory that pennying was a widespread or harmful practice. A 2018 Municipal Securities Rulemaking Board (MSRB) request for comment also acknowledged that the MSRB is "not aware of any economic literature analyzing pennying in the municipal market."³ Additionally, other than off-hand conversations with some market participants, FIMSAC provided no evidence to support its assertion that pennying "deters aggressive pricing or participation in the auction process."

Furthermore, there does not appear to be any uniform definition or agreement of what constitutes the practice being referred to as pennying. The MSRB equated pennying with the practice of "last-look," and defined these terms as when a broker-dealer internalizes a trade that either matches the high bid received in auction, or provides a price that is "nominally higher" than the highest bid. FIMSAC and FINRA, on the other hand, differentiate pennying from last look – arguing that last look results in "meaningful" price improvement whereas pennying either matches or "slightly improves" the best auction bid.

As the Request notes, an analysis conducted by FINRA shows that internalization often benefits customers. Based on a sample of internalized trades, FINRA found that 40 percent of trades were improved over the best auction price by at least 25 basis points; 9 percent were improved by

² FIMSAC Technology and Electronic Trading Subcommittee "Preliminary Recommendations Regarding the Practice of Pennying in the Corporate and Municipal Bond Markets" (June 2019).

³ MSRB Request for Comment on Draft Interpretive Guidance on Pennying and Draft Amendments to Existing Guidance on Best Execution (September 2018).





between 10.01 and 25 basis points; and 23 percent were improved by 10 basis points or less. Only 28 percent of internalized trades did not improve the best external bid. So, the overriding question is what harm is being caused here that is not already governed by the “best execution” rule?

Workable Solution.

In the event that FINRA and/or the SEC feels the need to move forward with a rule proposal to reform or abolish the pennyng/last look practice with data, then we strongly believe such a proposal should acknowledge and reiterate the importance of the current “best execution” regime and use data to substantiate any recommendations it makes.

If our regulators substantiate such a position, then we believe the only workable solution for market participants that will not harm investors, obfuscate transparency, or impair liquidity is to adopt a policy where *(1) every fixed income desk in every fixed income market must be allowed to have the option to participate in offering a bid to their clients; and (2) the desk can exercise this option by engaging in a blind bidding process along with other dealers.*

Conclusion.

While we greatly appreciate FINRA providing a forum for public feedback on this issue, we view this as a concerning example of regulators providing recommendations based upon unsubstantiated assertions, poorly defined terms, and an absence of a broad swath of analytical data.

Rather than creating new terms and disincentivizing beneficial market practices, we believe that FINRA and the SEC should focus on the robust oversight and enforcement of the best execution rule which exists to protect investors and clearly encompasses any concerns that FIMSAC or others have raised to micro-manage various U.S. fixed income markets.

The ASA looks forward to further discussing this important issue at your convenience.

Sincerely,

Christopher A. Iacovella

Christopher A. Iacovella
Chief Executive Officer
American Securities Association

