

October 26, 2018

Submitted Electronically

Mr. Ronald W. Smith
Corporate Secretary
Municipal Securities Rulemaking Board
1300 I Street, NW, Suite 1000
Washington, D.C. 20005

Re: MSRB Notice 2018-22: Request for Comment on Draft Interpretative Guidance on Pennying

Dear Mr. Smith:

Headlands Tech Global Markets, LLC (“HTGM”) appreciates the opportunity to comment on the Municipal Securities Rulemaking Board’s (“MSRB”) above-referenced notice proposing the draft interpretative guidance on the practice of pennyning, often referred to as last-look (the “Proposal”). We applaud the MSRB’s Proposal as an appropriate first step to curb this prevalent and anti-competitive practice in the municipal bond market. However, even more needs to be done to prohibit abuse of last-look. The MSRB should propose a rule against the use of last-look, except in very limited circumstances.

HTGM is a quantitative trading company that is a Securities and Exchange Commission registered, Financial Industry Regulatory Authority member broker-dealer.¹ HTGM launched its municipal bond trading business in March 2014 and uses proprietary models to price bonds electronically. Over its four plus years in business, HTGM has frequently encountered the practice of last-look, wherein the dealer observes the prices submitted to a completed auction and decides to purchase the bonds from the customer, usually at a price at least equal to or slightly better than the winning bid. HTGM can state with confidence that the practice is prevalent and widespread in the municipal bond market.

HTGM uses information from a variety of sources, including MSRB trade prints and color report data provided by trading venues, to attempt to piece together what happens in a bid-wanted auction when HTGM determines it submitted the winning bid price. For example, over a recent two-week period on one of the largest alternative trading system (“ATS”) platforms, HTGM estimates it received an execution on only 35 percent of the unique auctions in which it submitted the winning bid.² For another 30 percent of those auctions won by HTGM, it appears no trade took place (i.e. there was no trade reported to MSRB). HTGM estimates that the remaining 35 percent of auctions were affected by some version of last-look.

¹ HTGM is a widely-recognized participant in the municipal bond market, executing approximately 1,300 plus trades per day with over 400 counterparties, responding to more than 13,000 bid-wanted auctions per day, and ranking as a top participant on all major municipal bond ATS platforms. This volume makes HTGM a significant liquidity provider and one of the country’s largest dealers in the municipal bond secondary market. HTGM also transacts directly with institutional counterparties and provides direct prices to certain municipal securities dealers.

² As dealers can initiate a bid-wanted auction for the same bond(s) on multiple ATS platforms, HTGM only included auctions that were on a single ATS platform in its analysis.

Specifically, in nearly 18 percent of unique auctions in which HTGM submitted the winning bid, HTGM was *not* the transacting counterparty. Instead, HTGM can only assume the dealer initiating the auction internalized the order as the transaction occurred at an *equivalent or better* price than HTGM's submitted, winning bid (i.e., last-look in practice). Incredibly, in approximately another 17 percent of auctions won by HTGM, not only was HTGM *not* the transacting counterparty, but the transaction occurred at a *worse* price than HTGM's winning price (i.e., last-look in practice).³ This type of behavior happened consistently across all ATS platforms throughout 2018. On one ATS platform alone, HTGM estimates its winning bid has been last-looked or traded through over 4,600 times so far this year.

Importantly, dealers are choosing to use this practice despite the competitiveness of the bid-wanted auction process. On average, HTGM sees at least seven bidders per auction. With such participation, there is no justifiable need for last-look. And the auctions would likely have even more participation if last-look were not being abused by dealers.

The MSRB is correct in the Proposal that last-look harms competitiveness by deterring aggressive pricing and participation by dealers in the bid-wanted process who know the submitting dealer may step in front of their winning bid. Last-look creates a disincentive to "put your best foot forward" or even bid at all. Indeed, other markets have already learned important lessons about the abuse of similar behavior, such as the equities markets in the 1990s and, more recently, the FX markets.⁴

Furthermore, the MSRB has previously expressed concern about last-look in the context of broker's brokers trading in municipal bonds in a December 22, 2012 Notice to Dealers. The MSRB stated therein that the use of last-look by broker's brokers solely for price discovery purposes and not with 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. Despite the 2012 Notice to Dealers, the abuse of last-look in the municipal market did not, as admitted by the MSRB in the Proposal at issue, stop. The practice is still being abused almost six years later.

There have been important strides in the competitiveness and transparency of the municipal bond market, thanks in large part to the enactment of responsible rules. Although the Proposal should assist in furthering these efforts, the only way to ensure the use of last-look does not continue to be abused, is for the MSRB to go a step further than issuing guidance and propose a rule against the use of last-look except in limited circumstances. Requiring a submitting dealer to place its own prices in the competitive auction for bid-wanted with all other participants would put all liquidity providers on equal footing and encourage more frequent and aggressive pricing by auction participants, thereby improving pricing quality for customers. Additionally, it is difficult to comprehend how this requirement would place an unreasonable burden on the submitting dealer.

Accordingly, more concrete expectations and requirements should be established in a proposed rule than those provided for in the Proposal. A rule will give regulators specific guidelines and exceptions to

³ This occurs when a broker-dealer obtains prices for a customer via the bid-wanted auction, but then internalizes the order by purchasing the bond from its customer for its own account at a lower price than the winning bid in the auction. The price differential may result from the submitting broker-dealer including a "desk credit" – essentially a markdown – in the price at which it purchases the bond from its customer.

⁴ See Barboza, David. "30 Firms to Pay \$900 Million in Investor Suit." *NY Times*, 25 Dec. 1997, <https://www.nytimes.com/1997/12/25/business/30-firms-to-pay-900-million-in-investor-suit.html>. Accessed 26 Oct. 2018. See also Teague, Solomon. "Last-look Guidance Felt as Market Prepares for FX Code Deadline." *Euromoney*, 08 Mar. 2018, <https://www.euromoney.com/article/b177kg8nx48plm/last-look-guidance-felt-as-market-prepares-for-fx-code-deadline>. Accessed 26 Oct. 2018.

review and enforce to eliminate any abusive use of this practice. The rule should set the clear expectation that the use of last-look should not be part of the dealer's every day normal business practices but, instead, should occur only in the rare situation when a dealer does not receive a reasonable response to a request for bid-wanted and/or needs to use the practice to conform with best execution responsibilities. The rule should require dealers that want to use last-look in such exceptional circumstances to have clearly written policies and procedures in place as to when it may be used. This gives dealers flexibility to carry out their duties and responsibilities but makes it clear that abuse of the process will not be tolerated. Such rule-making is the only way to guarantee continued progress in the competitiveness and transparency of the municipal bond market.

Thank you for this opportunity to provide our comments. We welcome any questions from the MSRB regarding this important issue.

Sincerely,

A handwritten signature in blue ink that reads "Matthew F. Andresen". The signature is fluid and cursive, with a long horizontal stroke at the end.

Matthew F. Andresen
CEO