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Invested in America

November 13, 2018

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

Re: MSRB Notice 2018-22: Request for Comment on Draft Interpretive Guidance on Pennying and Draft Amendments to Existing Guidance on Best Execution

Dear Mr. Smith:

The Securities Industry and Financial Markets Association ("SIFMA")[1] appreciates this opportunity to respond to Notice 2018-22 (the "Notice")[2] issued by the Municipal Securities Rulemaking Board (the "MSRB") in which the MSRB is requesting comment on draft interpretive guidance related to "pennying" and draft amendments to existing guidance on best execution relating to the posting of bid-wanteds on multiple trading platforms. On balance, SIFMA appreciates the principles-based approach that the MSRB has taken, however, our members feel additional clarity is necessary.

I. Pennying Interpretive Guidance

a. Definitions

i. Pennying and "Last Look"

In the Notice, the MSRB states that pennying may have harmful effects on the

[1] SIFMA is the leading trade association for broker-dealers, investment banks and asset managers operating in the U.S. and global capital markets. On behalf of our industry's nearly 1 million employees, we advocate on legislation, regulation and business policy, affecting retail and institutional investors, equity and fixed income markets and related products and services. We serve as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance, and efficient market operations and resiliency. We also provide a forum for industry policy and professional development. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.

[2] MSRB Notice 2018-15 (July 19, 2018).

municipal securities market based upon concerns from "several dealers." Our members believe this is not a pervasive practice. "Pennying" may mean different things to different market participants. SIFMA and its members believe that "pennying" should be defined as the persistent or pattern of internalization of orders for which the dealer internalized at prices that are only nominally better than the cover bids.

SIFMA and its members want to begin this interaction with the MSRB by making clear that a fulsome conversation on this issue cannot be had without clear definitions of pennying, internalizing, and "last look."[3] In particular, we feel that the draft guidance does not sufficiently answer the question of what is pennying, and to some extent appears to synonymize "pennying," internalization and "last look". Additional clear guidance on these points would be helpful. Again, SIFMA and its members believe pennying should be defined as the persistent or pattern of internalization of orders by the dealer, at bid prices that are only nominally better than the cover bids. The determination of what is "nominal" should be based on the facts and circumstances of the credit and the order. Again, it is critical to note that pennying, internalizing, and last-look are not all the same thing, and clear delineations should be made among these three terms.

ii. Internalization

Internalizing is not in and of itself a problem with respect to liquidity in the municipal securities market. SIFMA and its members are pleased that the MSRB recognizes that not all forms of internalization have negative effects on the market and some may be beneficial to the market. SIFMA and its members agree that internalizing to improve upon the best bid in a bid-wanted, due to the best bid received not resulting in a fair and reasonable price to the customer, is beneficial. SIFMA and its members also agree with the MSRB that when a dealer itself provides the best bid in a blind competition, there is no perceived or actual harm to the market as the winning bidder won pursuant to the terms of the auction.

iii. Nominal Price Improvement

In our view, "nominal" should be defined and determined by a facts and circumstances analysis. Each firm should be able to develop policies, procedures and supervisory procedures that set reasonable parameters for what is a nominal price improvement. SIFMA and its members note that the supplementary material to MSRB Rule G-18, on best execution, sets forth the requirement for periodic review of a firm's policies and procedures, including the quality of executions of its customer's

[3] The term "last look" has negative connotations in certain contexts, most notably in municipal securities bid rigging cases nearly a decade ago. SIFMA would like to clarify there are different uses of "last look" other than in the context of MSRB G-43 and the prohibition against broker's brokers giving preferential information to bidders in bid-wanteds. Using the term "last look" interchangeably in the MSRB's guidance would be confusing, particularly without a clear definition, as utilizing a "last look" is not in and of itself problematic so long as it does not result in pennying as defined herein.

transactions. Through this process required pursuant to MSRB Rule G-18, dealers have a mechanism for reviewing customer executions to which they could add a review for pennying. We encourage the MSRB consider this mechanism as an efficient potential solution to the concerns stated in the Notice.

b. Price Discovery

As noted above, we believe that pennying should be defined as the persistent or pattern of internalization of orders by the dealer at prices that are only nominally better than the cover bids. We agree that the use of bid-wanteds solely for price discovery purposes by a dealer without any intention to trade if a favorable bid is received may be a violation of a dealer's fair-dealing obligations under MSRB Rule G-17. In the 2013 SIFMA MSRB Rule G-43 Best Practices,[4] SIFMA highlighted to market participants that the MSRB warned selling dealers that they should not use the bid-wanted process solely for price discovery.

However, there are instances in which the use of a bid-wanted solely for price discovery should not be deemed an unfair practice within the meaning of Rule G-17. For example, a client may not wish to decide whether to place an order until they know the bonds can be sold at a reasonable price. If the client wants to put an item out to bid to try to sell the item if such item can be sold at a reasonable price, the dealer may instigate a bid-wanted to gauge potential liquidity for the customer. Dealers are concerned about any guidance that may create the unintended consequence of limiting the ability of the dealer to service the client's needs or regulatory obligations without the request creating regulatory issues.

c. Changing Market

SIFMA and its members note that the number of bid-wanted responses has been trending higher, in part due to technology and algorithmic trading,[5] and the proposed guidance may not necessarily have the desired effect. Dealers bid on items fully understanding that they will only buy a very small percentage of items. Some firms feel that a dealer who has posted a bid-wanted improving the bid for the purpose of

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[4] SIFMA Municipal Division MSRB Rule G-43 Best Practices (December 2013), available at: https://www.sifma.org/wp-content/uploads/2017/08/Municipal_MSRB-Rule-G43-SIFMA-Best-Practices.pdf.

[5] *See* MSRB Analysis of Municipal Securities Pre-Trade Data from Alternative Trading Systems (October 2018), found at: http://msrb.org/~/media/Files/Resources/Analysis-of-Municipal-Securities-Pre-Trade-Data.ashx?la=en ("Furthermore, a new breed of market participants—proprietary trading firms that rely upon automated algorithms to trade their own capital—have increasingly occupied a significant space in the municipal securities market. While proprietary trading firms are often registered as broker-dealers, they are not a traditional broker-dealer (or an investment adviser, for that matter), since they only trade their principal accounts without acting as an agent, a dealer or an investment manager for their customers. Proprietary trading firms are naturally heavy users of ATS platforms, as they are drawn to the anonymity and speedy auto-execution features of ATSs to interact with other market participants.")

internalization does not in any way impact the bidding dealer's decisions on how to bid and when to bid items on the alternative trading system. Price improvement of any kind is widely accepted in other financial markets and used as a measure of performance.

d. Need for Additional Study

Pennying, as we have defined such term above, is abusive. However, there is only anecdotal evidence that pennying harms liquidity in the municipal market. Although SIFMA and its members acknowledge the MSRB's concern regarding "bidder fatigue," it is unclear if bidding dealers would bid more often or more aggressively if internalization did not occur. Prior to the finalization of any proposed interpretive notice on pennying, we believe there should be studies showing the practice hinders liquidity.

II. Best Execution Amendments

SIFMA appreciates the draft amendment to the implementation guidance on best execution. This guidance takes a step in the right direction to clarify the guidance. However, the change may not go far enough. SIFMA and its members suggest changing the "may" to a "does" in the first edit on page 11. This change would make it clear that such multiple postings are not necessary. Also, in the second insertion on page 11, the second use of "may" should be removed to make clear that each dealer constitutes a "market", as that term is broadly defined in paragraph .04 of the Supplementary Material.

Since the original guidance was released, it has become common practice by some dealers in the municipal securities industry to post the same bid-wanted simultaneously on multiple trading platforms. Posting of the same bid-wanted simultaneously on multiple trading platforms provides dealers with marginal, if any, increased access to liquidity. Other than a marginal increase in liquidity, or potentially increased connectivity, posting the same bid-wanted simultaneously on multiple trading platforms largely occurs for MRSB Rule G-18 compliance. The posting of the same bid-wanted simultaneously on multiple trading platforms may impact a dealers' willingness to respond to bid-wanteds. Dealers do sometimes alter their bidding strategies when responding to bid-wanteds that are posted simultaneously on multiple trading platforms. Depending on the size of the dealer firm and the sophistication of their technology, some firms may have an aggregator, and send the same bid to all trading platforms at once, whereas other firms pick one channel through which to respond. Some firms will not respond. The practice of posting the same bid-wanted simultaneously on multiple trading platforms may have a negative impact on the market, depending on the size of the trade,[6] by giving market participants a false impression that there are more positions out for bid than there really are, and therefore a false perception of liquidity. However, it is clear

[6] The impact of this practice is apparent for large trades; the effects of this practice on odd lot trades is insignificant.

that a dealer posting bonds they own or posting a bid-wanted on multiple platforms is not a rule violation.

The offering side of the market is very different than the bid-wanted side of the market. With respect to offerings, the process is much more controlled event though some of the same "noise" exists.

With respect to the draft amendments, we don't have enough information to determine if any inadvertent costs or burdens would be created, but we don't believe there would be any such costs or burdens.

IV. Conclusion

SIFMA and its members appreciate this opportunity to comment on the draft interpretive guidance and draft amendments. We would be pleased to discuss any of these comments in greater detail, or to provide any other assistance that would be helpful. If you have any questions, please do not hesitate to contact the undersigned at (212) 313-1130.

Sincerely yours,

Leslie M. Norwood
Managing Director and
Associate General Counsel

cc: ***Municipal Securities Rulemaking Board***
Lynnette Kelly, President and Chief Executive Officer
Michael Post, General Counsel
Lanny Schwartz, Chief Regulatory Officer
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Leila Barbour, Market Leadership Manager
Saliha Olgun, Associate General Counsel
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Appendix
MSRB Questions on Draft Interpretive Guidance on Pennying

1. Is pennying prevalent or uncommon in the municipal securities market?

   A: We do not believe that pennying, as we have defined it, is a pervasive practice.

2. Would bidding dealers bid more often or more aggressively if they were confident that widespread pennying did not occur in the municipal market or if they were confident that pennying would not occur in a bid-wanted?

   A: There is no clear evidence, and opinions vary.

3. Does the draft interpretive guidance raise any new questions or sufficiently answer the question of what is pennying? Is more guidance necessary to answer this question? If so, what type of guidance would be valuable?

   A: No, we do not believe that the draft interpretive guidance sufficiently addresses the issues, and that further study would be valuable.

4. Does the draft interpretive guidance represent the appropriate approach to addressing pennying in the municipal securities market?

   A: No. Our suggestions are set forth in our attached letter.

5. As an alternative to adopting the draft interpretive guidance, should the MSRB instead pursue rulemaking to prohibit pennying? Why or why not? Are there other alternatives that may achieve the same or greater benefits sought by the MSRB at lower cost or burden?

   A: No, as stated above, we believe the definition of pennying needs to be clarified and additional study would be helpful.

6. If the dealer bids in competition (the dealer submits a bid as part of the bid-wanted process) and on a blind basis (without knowledge of the other bid prices), should any guidance or rule make clear that pennying has not occurred in those situations, even if the dealer's best such bid is the same as or only modestly better than the next best bid?

   A: Of course. Bids received as part of the bid wanted process, by any dealer, are clearly not pennying. SIFMA and its members feel that dealer bids in competition and on a blind basis clearly do not constitute pennying, and any

guidance or rule should make it clear that pennying has not occurred in those situations. Also, our members feel reviewing the bids received is necessary to check compliance with the fair pricing rule.

7. What are the pros and cons of a dealer using a bid-wanted as opposed to a bid-wanted in competition? Why would a dealer with interest in a bond not distribute a bid-wanted in competition as opposed to distributing a bid-wanted and then purchasing the bond for its account following the end of the bid-collection period?

   A: There is no difference.

8. The draft interpretive guidance provides 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 Rule G-17, and that the repeated practice of pennying would be indicative of having the sole purpose of price discovery.

   a. Is it appropriate to apply an intent-based standard to determine whether pennying has occurred?

      A: We believe that our definition of pennying addresses the MSRB's concerns.

   b. Is it more appropriate to pursue a bright-line standard?

      A: No.

   c. Are there instances in which the use of a bid-wanted solely for price discovery should not be deemed an unfair practice within the meaning of Rule G-17?

      A: A dealer doesn't know if a customer will sell until the bids come back. The dealer should not be put in a position of having to refuse to put an item out to bid for a client unless the client will definitely sell at any price.

9. Should the MSRB define what volume or frequency of pennying would constitute a "repeated practice"? Is guidance necessary on whether a dealer has engaged in a "repeated practice" of pennying?

   A: No, a bright line test is not warranted. We have made some suggestions on this issue in our letter.

10. Given that Rule G-18, on best execution, is an order-handling rule designed to encourage competition, if widespread pennying discourages dealers from bidding or bidding aggressively, should the MSRB interpret a repeated practice of pennying as impairing a dealer's ability to meet its best-execution obligations? For example, if a dealer's policies and procedures permit it to engage in a repeated practice of pennying, should those policies and procedures be viewed as inconsistent with the dealer's best-execution obligations?

    A: No. As long as SIFMA's definition of pennying is used, feel that MSRB Rule G-17 is sufficient. Also, the MSRB should not define what volume or frequency of internalization at a nominal amount over the cover bid would constitute a persistent or "repeated practice," rather it should permit dealers to set appropriate policies and procedures based on facts and circumstances.

11. Is the process for retail bid-wanteds significantly different than the process for institutional bid-wanteds (e.g., longer firm times—the length of time for which the bidder must honor the bid provided, use of bid-wanteds versus bid-wanteds in competition, use of last looks)? Is it significantly different even for similar-size positions? If so, are there reasonable grounds for the difference in process or should they be more alike?

    A: Yes, and there are reasonable grounds for these differences. The process for retail bid-wanteds is longer than the process for institutional bid-wanteds. The grounds for the difference in processing time is that the markets are different, as is the coverage. It simply is a different and slower market, due in part to the larger number of investors and financial advisors that cover them. Also, by their nature, it may be more difficult to reach a retail client that is not always available, as opposed to an institutional investor. Finally, it is important to note that there is a higher standard of care due to retail investors, so additional time to ensure due care is warranted.

12. Should there be a "safe harbor" under the Rule G-17 interpretation for internalization with a substantial price improvement over the best bid in a bid-wanted? If so, is there an amount that should presumptively be deemed "substantial" price improvement?

    A: Yes, SIFMA is in favor of the development of a "safe harbor" under the Rule G-17 interpretation, as long as it is based on a principles-based approach. Internalization with a greater than nominal price improvement over the best bid in a bid-wanted does not meet our definition of pennying. We do believe that the interpretive notice should be clear that such internalization is permitted, as it is beneficial and not harmful to the market. SIFMA believes there should be no bright line test that demarks where nominal price

improvement ends. Further, there is no set amount that should presumptively be deemed "nominal" or "greater than nominal" price[7] improvement. Market conditions, current interest rates, the price of the security and the term of the securities are some variables that make setting such a presumptive amount challenging. Again, SIFMA and its members feel that the determination of what is a nominal amount for the purposes of ascertaining whether a broker dealer is pennying, should be determined by the facts and circumstances.

13. Is there any data that sheds light on the prevalence or impact of pennying on the market?

    A: None that we are aware of.

14. Would the draft interpretive guidance, if adopted, create direct, indirect or inadvertent costs or burdens? Is there data or other evidence, including studies or research, that support commenters' cost or burden estimates?

    A. We are not aware of other evidence of cost or burden estimates.

[7] We note that we focus on the term "nominal." In our view, there is a range of prices between nominal price improvement and potentially substantial price improvement.