

October 16, 2020

Jennifer Piorko Mitchell  
Office of the Corporate Secretary  
FINRA  
1735 K St NW  
Washington DC 20006-1506

Dear Ms. Mitchell,

The Bond Dealers of America is pleased to comment on FINRA Notice 20-29, “FINRA Requests Comment on the Practice of Pennying in the Corporate Bond Market” (the “Notice”). BDA is the only DC-based group exclusively representing the interests of securities dealers and banks focused on the US fixed income markets.

BDA generally agrees with the characterizations of “pennying” and “last look” provided by the SEC’s Fixed Income Market Structure Advisory Committee (FIMSAC).<sup>1</sup> We generally concur with FIMSAC that the persistent use of pennyning to systematically internalize orders has the potential deter some dealers from 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. We also agree that it is important that any action taken to curb pennyning does not also capture “the valid process of a dealer reviewing auction responses as part of its best execution process before executing a customer order” and sometimes offering customers price improvement.

We do not believe pennyning has caused damage to the corporate bond market, constrained market liquidity, or harmed customer trade execution. As the FIMSAC heard during its deliberations on this issue—and we concur—“we have seen a decline in pennyning in the last five years.”<sup>2</sup> We also do not believe that pennyning regulation is needed at this time. To the extent that FINRA is considering rulemaking in the area of pennyning and last look, we do not believe a quantitative, “bright line” test for pennyning is appropriate. There are simply too many factors affecting the price of a customer trade to specify, say, a minimum degree of price improvement for a trade internalization to be “legitimate.” We do, however, commend FINRA for taking a quantitative approach to examining the prevalence of trade internalization.

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<sup>1</sup> U.S. Securities and Exchange Commission Fixed Income Market Structure Advisory Committee, “Recommendations Regarding the Practice of Pennyning in the Corporate and Municipal Bond Markets,” June 11, 2019.

<sup>2</sup> U. S. Securities and Exchange Commission, “Meeting of the Fixed Income Market Structure Advisory Committee” (transcript), statement of John Calhane, Managing Director, Tradeweb, April 15, 2019, page 76, [www.sec.gov/spotlight/fixed-income-advisory-committee/fimsac-041519-transcript.txt](http://www.sec.gov/spotlight/fixed-income-advisory-committee/fimsac-041519-transcript.txt).

We offer responses to select questions posed by FINRA in the Notice.

**2.** Do the results of FINRA’s sample study accurately represent the nature or frequency of practices you observe in the markets? Do the results of the sample study demonstrate that in the corporate bond market, last look is a common practice to achieve best execution, or the practice of pennyng is prevalent, or both?

A. While we do not have any data to offer on the prevalence of internalization or pennyng, BDA members have reported that the practice of pennyng varies widely among firms. Some firms internalize trades more frequently than others. BDA members have reported that the identities of firms that frequently internalize trades with minimal or no customer price improvement tend to be known by market participants. We do not believe the practice of pennyng has damaged the corporate bond market in any way.

**2b.** If you have observed pennyng or last look practices, are they more prevalent on certain types of electronic trading platforms? If so, which ones? Are these practices limited to alternative trading systems or do they occur on other electronic trading platforms? Are certain types of RFQs more likely to result in pennyng

A. In the observation of BDA members, internalization tends to be more prevalent in securities that are less liquid or where auction responses are fewer, wider in price, and often less correlated to the true prevailing market for the securities, requiring dealers to step in and internalize transactions for regulatory obligations. We have not noticed patterns of internalization by trading platform or type of trading platform.

**2c.** Have you observed pennyng or last look practices occurring in transactions with institutional customers? If so, is there any relevant data or evidence you can provide based on your observations? Do you believe that FINRA should consider a study of such practices in the institutional markets?

A. Internalization is not prevalent among institutional trades, but it happens from time to time according to reports from BDA members. We do not have any data on the practice. We support FINRA conducting a study on the prevalence of internalization in the institutional corporate bond market.

**3.** If pennyng is defined as a pattern or practice of internalization with no or slight price improvement after viewing prices obtained through an RFQ, what amount of price improvement should be considered meaningful and what level of regularity would constitute a pattern or practice?

A. We do not believe a quantitative definition of pennyng—say, requiring a minimum level of price improvement for an internalization to be “legitimate”—is the right approach. FINRA Rule 5310, “Best Execution and Interpositioning,” requires dealers to “use reasonable diligence to ascertain the best market for the subject security and buy or sell in such market so that the resultant price to the customer is as favorable as possible.”

In practice, Rule 5310 results in a substantial number of retail customer trades being “put out for quote.” Sending a potential trade to trading platforms is often simply the fastest, most efficient way of “ascertaining the best market” as Rule 5310 requires. But a dealer’s obligations under 5310 do not end with obtaining competing quotes. The Rule requires dealers to review quotations and “employ their market expertise” in achieving best execution. That often means determining whether even the best

quotation obtained through a request for quotes represents a price that is “as favorable as possible” to the customer as the Rule requires. If it is not, and the customer insists on execution, the dealer may have no choice but to internalize the trade at a price more favorable to the customer than the best auction quote.

Because market and trading conditions vary so widely, specifying, say, a minimum price improvement in basis points would be too restrictive and could prevent dealers from legitimate internalization and price improvement necessary to comply with Rule 5310. Instead, we urge FINRA, to the extent you are contemplating pennyng regulation, to consider a principles-based rule that provides general guidelines for acceptable internalization and sufficient flexibility to allow dealers to provide customers with even small price improvements when market conditions and trade specifics warrant.

Another approach to addressing pennyng could involve the trading platforms. We note that the SEC has released a proposed rule change and a request for comment for SEC Rule ATS, which governs certain electronic trading platforms.<sup>3</sup> One element of the SEC’s request for comment focuses on electronic trading platforms that support trading in corporate and municipal bonds. In the context of this review, the SEC could consider changes to Rule ATS that would, for example, require platforms to collect and report to the SEC, FINRA or the MSRB data on auctions, ranges of quotes received, and whether trades were executed on the platform. Those data could assist regulators and the platforms in identifying problem users and taking corrective action.

**4.** What are the market quality and economic consequences of pennyng? Does or will pennyng harm overall auction competitiveness over time, for example by causing fewer firms to provide bids in response to auctions, or by causing responding firms to bid less aggressively? How can the impact of pennyng be measured?

A. Persistent, systematic pennyng has the potential to harm auction competitiveness over time. It is possible that firms could become less aggressive in quoting trades if they know that their quotes will be undercut. However, we have not observed that effect. Most retail fixed income firms do not engage in persistent pennyng. In our observation, the practice is mostly concentrated among a limited number of firms. We do not believe the practice of pennyng has caused or is causing harm to the market.

FINRA already has the authority to collect virtually any trade information from member dealers necessary to analyze the practice of pennyng, as your quantitative analysis in the Notice demonstrates. Additional dealer data reporting rules would be superfluous. If regulators need to collect more timely data on pennyng than current authority provides, we believe the best source for that information would be the trading platforms themselves.

**5a.** During FIMSAC discussion of the Recommendation, there was some support for a requirement that dealers “bid blind” in response to auctions their firm initiates. Under this kind of requirement, dealers would need to bid on auctions initiated by their firm on a blind, competitive basis during the auction period, the same as any other firm, without the opportunity to review other firms’ auction responses

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<sup>3</sup> Securities and Exchange Commission, “Regulation ATS for ATSS that Trade U.S. Government Securities, NMS Stock, and Other Securities; Regulation SCI for ATSS that Trade U.S. Treasury Securities and Agency Securities; and Electronic Corporate Bond and Municipal Securities Markets,” September 28, 2020, [www.sec.gov/news/press-release/2020-227](http://www.sec.gov/news/press-release/2020-227).

before entering the firm's own order. Would a blind bidding requirement be an appropriate regulatory approach?

A. There are two reasons why requiring dealers to "bid blind" at the auctions they initiate is not an effective solution for persistent pennyng. First, the best market for a customer's trade may be internal. As FIMSAC members heard last year during their discussion on these issues, "what we see, statistically, as the most frequent reason for internalizing or stepping in the middle is crossing."<sup>4</sup> A cross occurs when a dealer buys a bond from one customer and sells it to another. Forcing a firm to trade with its own customer through a platform could inhibit the ability of a dealer to effect the best possible price for both customers in a cross. Second, trading platforms charge fees. It would be inappropriate to require a dealer to bear the cost of quoting on a platform or passing that cost to customers when they can provide the same price to their customer directly.

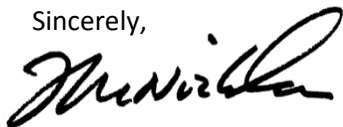
6. As FINRA continues to coordinate on pennyng with the MSRB, consistent with the FIMSAC Recommendation, are there any differences between the corporate and municipal bond markets for which FINRA and the MSRB should account?

A. The corporate and municipal markets are obviously distinctly different from each other. The municipal market is more diverse and more retail than the corporate market. However, with respect to issues surrounding pennyng and last look, like in the corporate bond market, pennyng has not caused any harm to market liquidity or the quality of trade execution available to retail municipal customers.

While persistent pennyng has the potential to be harmful to the auction market for secondary corporate trading, the practice to date has not been damaging. The practice is limited in scope, and pennyng has not threatened the ability of retail customers to obtain aggressive quotes for potential trades. At this time, we do not believe further regulation of pennyng is necessary. If FINRA does move forward with regulation, we urge you to avoid quantitative, bright-line definitions of pennyng in favor of a more flexible, principles-based rule. In addition, we urge FINRA to coordinate closely with both the MSRB on pennyng rules to ensure that regulations for municipals and corporates are as aligned as possible, and with the SEC to incorporate the trading platforms in monitoring and regulation of pennyng.

We appreciate the opportunity to comment. Please call or write with any questions.

Sincerely,



Mike Nicholas  
Chief Executive Officer  
Bond Dealers of America

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<sup>4</sup> U. S. Securities and Exchange Commission, "Meeting of the Fixed Income Market Structure Advisory Committee" (transcript), statement of John Calhane, page 76.