INVESTMENT COMPANY INSTITUTE

MEMO# 32701

August 24, 2020

FINRA Requests Comment on Pennying in the Corporate Bond Market

[32701]

August 24, 2020 TO: Fixed-Income Advisory Committee RE: FINRA Requests Comment on Pennying in the Corporate Bond Market

FINRA recently published a regulatory notice ("FINRA Notice") requesting comment on the practice of "pennying" in the corporate bond market on electronic trading platforms.[1] This regulatory notice is based on the SEC Fixed Income Market Structure Advisory Committee's (FIMSAC) June 2019 recommendation that FINRA review the practice and publish a request for comment.[2] This notice also follows prior guidance from the Municipal Securities Rulemaking Board (MSRB) on pennying in the municipal bond market.[3]

Comments on the FINRA Notice are due by October 16, 2020. We will hold a member call to discuss the notice on **Thursday, September 10, at 2:00 pm** and will send a calendar invite with dial-in information shortly.

Summary of FINRA Notice

FINRA notes that the FIMSAC defines "pennying" as a systematic practice where a dealer initiates a bid or offer-wanted auction on behalf of a customer, reviews the responses, and then internalizes the customer order at a price matching or slightly improving the best-priced auction response. The FIMSAC distinguishes this practice from the more favorable "last look," where a dealer provides meaningful price improvement when internalizing the order to achieve best execution. The FIMSAC expressed concern that pennying harms price discovery and market efficiency in the corporate bond market by disincentivizing auction participation.

Based on the FIMSAC's recommendation, FINRA reviewed sample data from the first quarter of 2019 on electronic RFQ auctions for corporate bonds from firms that generally represent retail customers. Among the transactions that resulted in internal executions,[4] FINRA determined that 60 percent of them provided price improvement of 25 bps or less than the best external bid, of which nearly half provided no price improvement.[5]

FINRA requests comment on several aspects of pennying, including whether the data sample reflects this practice. Specifically, FINRA asks whether pennying or last look has occurred in institutional customer transactions and whether it should consider a study of these practices in those markets.

FINRA also requests comment on

- the FIMSAC's definitions of "pennying" and "last look," including the amount of price improvement and level of regularity that distinguish these practices from one another;
- the market quality and economic consequences of pennying, including whether the practice harms overall auction competitiveness;
- the effectiveness of a "bid blind" requirement, which would require a dealer to blindly and competitively bid in an auction that it initiates without using external responses to inform its own order; and
- the differences, if any, between the corporate and municipal bond markets that should inform how FINRA coordinates with the MSRB on pennying.

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Attachment

endnotes

[1] *See* FINRA, Corporate Bonds, FINRA Notice 20-29 (Aug. 17, 2020), *available at* https://www.finra.org/rules-guidance/notices/20-29.

[2] *See* SEC Income Market Structure Advisory Committee, Recommendations Regarding the Practice of Pennying in the Corporate and Municipal Bond Markets (June 11, 2019), *available at* https://www.sec.gov/spotlight/fixed-income-advisory-committee/fimsac-pennying-recommendations.pdf. The FIMSAC also recommended that the SEC (i) issue a statement disapproving of pennying in the corporate and municipal bond markets on electronic trading platforms; and (ii) specify that using last look to provide nominal price improvement should be infrequent and occur pursuant to clear policies and procedures.

[3] *See* MSRB, Request for Comment on Draft Interpretive Guidance on Pennying and Draft Amendments to Existing Guidance on Best Execution (Sept. 7, 2018) (requesting comment on dealers' pennying practices on alternative trading systems), *available at* http://msrb.org/~/media/Files/Regulatory-Notices/RFCs/2018-22.ashx; MSRB, Notice to Dealers that Use the Services of Broker's Brokers, (Dec. 22, 2012), *available at* http://msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G-43.aspx?tab=2#_4A63DB37-43D0-40E8-9F22-RF637D0D03E6C8.

[4] In FINRA's data sample, 70 percent of auctions resulted in an execution, of which 16 percent resulted in an internal execution by the initiating firm. FINRA also evaluated other aspects of the auctions with internal executions, including whether the initiating firm submitted its own bid "blindly," *i.e.*, without knowledge of the other bids collected. FINRA found that internal executions generally resulted from bids being submitted or updated by the initiating firm after receiving external bids.

[5] FINRA found that 28 percent provided no price improvement; 16 percent provided price

improvement of 5 bps or less; 7 percent provided price improvement between 5-10 bps; and 9 percent provided price improvement between 10-25 bps. The remaining 40 percent of those trades led to price improvement greater than 25 bps.