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Why MSRB is Concerned About `Pennying'

WASHINGTON – The Municipal Securities Rulemaking Board is requesting comment on draft guidance regarding "pennying" and best execution, giving the market the chance to weigh in before publishing information that could be influential in industry practices.

The MSRB released the request Friday, about five months after suggesting earlier this year that it would seek comment on the subject of pennying.

The request for comments on both sets of guidance is part of a formal process that could lead up to the formal adoption of that guidance.

The best execution rule guidance would actually be amendments to existing guidance on the relatively new rule, which took effect in March 2016.

The MSRB is seeking comments by Nov. 6.

Pennying, which is sometimes called "last look," occurs when a dealer places a retail client's bid-wanted out to the market and determines the winning bid, but then rather than executing the trade with the winning bidder marginally outbids the high bid and buys the bonds for its own account. The MSRB raised concerns about pennying in a letter to the Securities and Exchange Commission in October, and said following its April board meeting this year that it would request comment on the issue.

While the practice can appear beneficial in isolation because the dealer technically provides the customer a price equal to or better than the best bid, the MSRB is concerned that widespread pennying disincentivizes participation in the bid-wanted process, discourages bidders from giving their best price in a bid-wanted and "may impact the efficiency of the market."

A recent study of similar behavior in the equity market demonstrated an impaired market quality, the MSRB said.

The draft interpretive guidance states that using the bid-wanted process, whether via a brokers' broker or an alternative trading system solely for the purposes of price discovery could be a violation of the board's Rule G-17 on fair dealing.

The MSRB wants to know about the prevalence of pennying, whether dealers would bid more aggressively if they were confident pennying was not widespread, and how often dealers post the same bid-wanted simultaneously on multiple trading platforms.

The draft amendments to Rule G-18 on best execution provided a clarification that dealers need not necessarily put a bid-wanted out on multiple ATSs to fulfill their obligations to use "reasonable diligence" in seeking the best deal for their customer.

The amended language states that use of ATSs and brokers' brokers can create exposure to multiple dealers, each of which can constitute a separate market. However, the amendments state, if a dealer

uses only one ATS or brokers' broker then its policies and procedures should be clear about the facts and circumstances that make that one venue sufficient to comply with the firm's obligations under the rule.

Securities Industry and Financial Markets Managing Director, Associate General Counsel, and Co-head of Municipals Leslie Norwood said SIFMA would be responding to the requests and appreciates the amendments on best execution.

"SIFMA and its members believe it is important for all market participants to be able to rely on fair and efficient markets," Norwood said. "With that in mind, SIFMA is reviewing the request for comment in anticipation of submitting a comment letter. Further, SIFMA believes that an unintended consequence of the best execution rule was an increase in firms believing it was necessary to put the same bond offering out to multiple ATSs and broker's brokers to comply with that rule. We appreciate the clarification that a single ATS or broker's broker captures offers/bids from multiple dealers, each of which can constitute a separate market."

By Kyle Glazier

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