TMC Bonds

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November 14, 2018

Submitted Electronically

Ronald W. Smith
Corporate Secretary
MSRB
1300 I Street NW
Washington, D.C. 20005

Re: Request for Comment on Draft Interpretive Guidance on Pennying and Draft Amendments to Existing Guidance on Best Execution

Dear Mr. Smith:

TMC Bonds ("TMC") is pleased to present its comments, with respect to "Interpretive Guidance on Pennying and Draft Amendments to Existing Guidance on Best Execution."[1] TMC Bonds is a registered Alternative Trading System ("ATS"),that was recently acquired by the Intercontinental Exchange that has been conducting Bids Wanted ("BW") auctions for the past 18 years on behalf of its users in municipal securities as well as other asset classes on an anonymous basis. TMC runs approximately 4,500 daily municipal BW auctions.

The Municipal Markets Would Benefit from Additional Clarity on Pennying

The proliferation and use of multiple venues to run BWs has introduced valuable competition into the marketplace, but has also led to a lack of transparency in auction methodology and a diminished ability to detect market practices.

Our TMC user feedback regarding concerns of "last-looks" or "pennying" supports the idea that greater transparency and control of the TMC auction process, including guidance around pennying practices, would promote fair and competitive markets.

To help frame the magnitude of potential "last looks" or "pennying", TMC conducted a study of its municipal BW auctions for the month of January 2018. TMC had for the bid approximately 96,000 items of which 22% traded. Of the executed BWs, only 524 (.5%) had prices entered by the requestor after the Bid-by time, indicating that requestors utilizing the application were not systematically viewing auction results before entering their bids, as Firm-Time BW bids are not viewable until after the collection period. TMC believes that post collection period bids should be allowed for various administrative reasons, but not allowed for non-competitive market purposes.

However, as there is no requirement for a requestor to enter a bid in the auction, the auction results could have been used by requestor to trade away from the platform. To assess the magnitude of this

[1] http://msrb.org/~/media/Files/Regulatory-Notices/RFCs/2018-22.ashx??n=1

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possibility, TMC examined the MSRB price feed for matched trades that occurred after the item was for the bid where there was a single dealer buy reported from the customer. Approximately 5.2% of the auctions that did not trade on TMC had a subsequent purchase from the customer with no corresponding dealer trade as reported by the MSRB. Because the requestor's bids were not known, there was no transparency as to how or when the requestors' bids were determined.

Additionally, a number of RFQ's TMC has for the bid traded away from the platform. A number of these trades were reported as dealer to dealer trades giving the appearance of a trade lost to a competitor, but in actuality these are really not trade aways, but "stock" trades as certain dealers settle transactions via intra-company transfers which results in an extra dealer trade report to the MSRB. This type of delivery unintentionally masks the universe of potential "penneyed" transactions as the "away from market" indicator is seldom observed by the market. An in-competition bid would help instill the integrity of the auction process as firms would know the full stack of bids.

There has been some discussion by industry participants that if a last-look price improvement was sufficient, then "pennying" did not occur. TMC believes the use of the term "pennying" fosters this belief and should be sufficiently defined as to discourage systematic use of auction results to improve a dealer's own bid for non-competitive use. For context, TMC examined the variance of the reported trade price to the BW auction's high bid as a barometer of possible pennying. 47% of the time, the improved price to the customer was less than $1.00/bond better than TMC's high bid. Again, while there are reasonable scenarios where this would be acceptable, these types of occurrences leave a bad taste with liquidity providers. Furthermore, systematic price improvement of prices by a greater amount can also affect the integrity of the auction process. A requirement for in-comp bids would help eliminate the potential conflict and provide the market with greater confidence of fair dealing.

Approximately 19% of the items TMC had for the bid traded away from TMC to other dealers. This highlights the fact that many of TMC's BW's are being placed on multiple venues including broker's brokers. The use of multiple vendors may foster a sense of market uncertainty as there is not a centralized auction book. Differences in fee schedule and whether the price maker or taker results in different rankings of bid stacks between vendors. For example, some vendor's bill monthly versus time of trade and/or may charge the bidder versus the seller. As multiple auction venues may be involved, it's difficult for both a dealer and auction agent to ascertain a comprehensive view of the results.

Best Execution is Negatively Impacted by Posting BWs on Multiple Trading Platforms

As both the growth in electronic trading and the requirements of Best Execution (G-18), have encouraged market participants to utilize efficient means for exposing Request for Quotes (RFQs) to the market, ATSs have played a significant role in helping firms receive competitive pricing for their clients. The proliferation of items available for the bid has also opened the door for new types of players to enter the market, such as "Algos", who stand ready to commit their capital as market makers. On a typical day, TMC will manage 4,500 BW items and receive approximately 5.38 bids per item, a combination of both trader and machine-algo bidding. It is not unusual to have a double digit number of bids on more liquid names.

As both the process by which most firms solicit RFQs has changed and the number of markets checked have increased, there are a number of consequences that have constrained the optimal functioning of the market and impaired the ability to efficiently process the volume of RFQs. First, dealers are now placing RFQ's out on multiple trading venues whereas historically there was only one auction agent. This evolution has, in turn, resulted in a proliferation of BW's as most dealers' feel compelled to gain as much exposure for the client RFQ as possible in order to comply with MRSB Rule G-18. For market makers, this practice of posting on multiple venues both ties up capital and creates unnecessary market noise as the manual (i.e. non-algorithmic) bidders attempt to sift through thousands of duplicate BW items, unsure if the BW was a duplicate or a unique item. While the MSRB has pointed out in past guidance letters such "Implementation Guidance on the MSRB-G18, on Best Execution" dated November 15, 2015, "there may be facts and circumstances under which it may be sufficient for a dealer to check only one such market and satisfy the best-execution obligation", the language is sufficiently vague which encourages dealers to cover their obligation via multiple postings.

Mandating the in-comp bid Would Improve Market Efficiency

Furthermore, the posting of an RFQ on multiple venues, and the corresponding loss of the auction agent knowing the RFQ seeker's bid, have fostered a sense of unfair dealing as other bidders do not feel they are competing on a level playing field. This loss of process by the auction agent results in participants either not bidding or placing a weaker bid than they otherwise would. In the voice-brokerage methodology, a broker would not release the bid to the dealer until the requesting dealer provided its bid. This protocol ensured that all participants were treated fairly and enabled the broker to properly monitor the bidding. TMC supports the MSRB mandating the in-comp bid and believes it would improve market efficiency on a number of fronts. First, market participants would know that all bidders would be subject to the same auction terms, which would foster a more competitive marketplace. Second, the in-comp bid would help regulators monitor auctions whereby patterns of systematic abuse for either pricing purposes (or "pennying") could be more readily identified. TMC believes that firms should have the ability to "last-look" as there are numerous examples where it is necessary. For example, the customer requests price improvement. Third, by having the in-comp bid, auction agents would have the ability to notify participants if their capital is being committed as firms who are not high bid, could be released from the BW auction during the firm time. This adjusted BW auction process would encourage the deployment of non-committed capital to other RFQs.

In mandating the in-comp bid, the MSRB would encourage a more competitive auction process. As questioned in the MSRB's Request for Comment, the MSRB would not have to mandate in-comp BW's with close second bids ("cover") that "pennying" did not occur as the existing G-43 guidelines require brokers to run a fair process and not allow late bids. An alternative to this interpretation would be for auctions with around-times where the RFQ requestor is able to see bids during the collection period. Under an around-time BW, the bid stack would be consistently viewable by the dealer and thus potentially influence its bid. Under a firm-time BW, a dealer checking multiple venues would essentially be collecting multiple bids just like a broker's broker, but with the discretion to use the stack. The MSRB may consider that, for the "around-time" auctions, the requestor would need to submit its bid with the initial request. Furthermore, it seems nonsensical that, according to G-43(c)(i)(F) a broker's broker must make a decision to notify the bidder/seller of the quality of a quote only versus predetermined parameters, but a dealer functioning in the same capacity when collecting from multiple venues, may use the auction data to change its own price, but is not under the same obligation of using pre-determined parameters. Harmonization between these ideas may improve the integrity of the process.

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Lastly, the use of requestor scorecards (conversion ratios) to assist bidders in ascertaining the likelihood of a particular item trading has resulted in mixed outcomes. While the metric helps bidders decide how to prioritize their time when deciding which items to bid, it may result in less than favorable outcomes for requestors with below average scores. As bidders are more likely to focus on bonds that are expected to trade, a firm with a low ratio will not necessarily see the same number or quality of bids, ceteris paribus, as a highly rated participant. This results in a bifurcated market where orders are exposed to the same marketplace, but treated differently. Whereas the requestor with low conversion ratio might receive a reasonable price, the retail customer may have not have gotten the best price. If a firm has artificially low conversion ratios due to their tendency to trade internally, then providing the in-comp bid to the auction agent will raise the firm's standing and thereby benefit its clients.

TMC greatly appreciates the MSRB proactively soliciting comments in this area and welcomes the opportunity for any further discussion.

Thomas S. Vales
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New York, NY