RBC Capital Markets®

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November 22, 2013

Via Electronic Mail
Ms. Elizabeth Murphy, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-0609

Re: Comments Regarding Potential Equity Market Structure Initiatives

Dear Sirs and Madams:

We applaud the recent actions of the SEC to address challenges facing our nation's equity market structure. The recent remarks of Chair White, the launch of the SEC's Market Structure Data and Analysis website, and the relevant expertise of Commissioners and Commission staff will, we believe, help advance much-needed market structure reforms.

In keeping with the SEC's recent market structure-related actions, and following on recent discussions of market structure issues between Commission officials and RBC Capital Markets, we hereby respectfully submit some initial comments regarding potential equity market structure reform initiatives that the SEC might want to consider pursuing.

RBC Capital Markets LLC ("RBCCM"), is a part of the investment banking platform of Royal Bank of Canada. RBCCM is a U.S. registered broker-dealer engaged in, among other things, providing equities trading and execution services to retail and institutional investors. Included in the latter are large investment managers with trillions of dollars of assets under management—assets of employee pension funds and other vehicles representing individual investors across the nation.

RBCCM believes that while the evolution of the U.S. equity markets has introduced positive developments into those markets and the economy as a whole, the current market structure has inappropriately shifted full reliability of those markets away from the long-term investor. Investors have experienced, and increasingly grown concerned with, decreasing transparency of markets, including the reliability of quotes and viability of apparent liquidity. We, and our clients, are concerned that the market may be increasingly disadvantaging long-term investors who are interested in fundamental value.

To be sure, there are those who would offer even expert opinion that increases in trading volumes correspondingly have resulted in increased liquidity, ultimately to the benefit of investors. Yet, given the markets' experience with "flash crashes" and other high volatility events, it should be abundantly clear that growth in trading volume does not necessarily indicate an increase in the number or capacity of liquidity providers available to take the other side of investor transactions. We submit that numbers of quotes or orders alone are not the correct measure of liquidity.

In addition, the proliferation of trading venues over the past decade has heightened competition among exchanges and other infrastructures to such an extent that these venues no longer may be dedicated solely to objectives of fairness and transparency; in order to attract trading volume, they offer rebates to broker-dealers and other professional traders. Unfortunately, a practice has developed whereby certain professional traders find it profitable to trade in order to make money from collecting rebates.[1] Such trading contributes to volume but accomplishes little in the way of true price discovery or best execution. In other words, it does not help the individual investor.[2]

Exchanges and other venues that offer rebates are employing the "maker/taker" pricing model; it is one feature of the current U.S. market structure that, we submit, should be studied for whether it has a deleterious effect on the overall market.

While we understand the history of and rationale for maker/taker pricing, it has perhaps inadvertently introduced a number of dynamics into the market that are inconsistent with the goals of transparency, efficiency, and liquidity.

First, it reduces transparency by distorting the price-discovery process. It does so by spawning a proliferation of rebates and fees that are opaque to many market participants, and that are not disseminated in displayed quotes. In so doing, maker/taker artificially narrows and widens displayed spreads but not actual spreads, because displayed spreads don't include access fees and rebates.

Second, maker/taker pricing has compromised efficiency and liquidity, predominantly by incentivizing some market participants to trade primarily, if not solely, to profit from collecting rebates. These rebates are typically paid by investors seeking to access liquidity. The consequences are several, and mainly negative:

- The length of exchange queues has increased, making it less likely for other market participants to provide passive liquidity with optimal execution;

- Passive market participants are forced to trade more aggressively to access liquidity;

- Liquidity is often fleeting – that is, it may disappear in times of market stress, particularly for less liquid, less widely known stocks; and

- Myriad order types, rebates, and fees proliferate as trading venues seek to capture market share, resulting in excessive fragmentation of order flow.

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[1] "Commencing with the late 1990's, matching venues started the practice of rebating fees for large volume. . . . The competition became so intense that in some venues the 'rebates' for posting orders to buy and sell became profitable to the traders." (See "Cracks in the Pipeline Part Two: High Frequency Trading", Wallace Turbeville, March 8, 2013.)

[2] "Apparent liquidity was a function of orders rather than transactions. Thus the firms that benefited from harvesting rebates placed many orders that they had no desire to turn into transactions…[and] higher than necessary fees meant that the bid/ask spread no longer told the entire story for the common market participant." (Ibid.)

Third, maker/taker implicates a conflict of interest between brokers and clients. The conflict manifests by incentivizing brokers to use routing that may be most cost-effective for them, but which may not be the best method of execution for their clients.

For avoidance of doubt, please be assured that we do not suggest that our markets should "turn back the clock". We understand and support the changes to U.S. equity markets brought about by technology. Those changes have in many, though not all, respects benefited issuers and investors.

However, if the full benefits of new market technologies are to be fully realized by all market participants, we believe that some reform is not only appropriate, but necessary. Moreover, that reform must be supported by real market data.

To that end, we propose that the Commission consider an alternative to maker/taker pricing. Such an alternative would eliminate rebates (or comparable inducements), which are an essential feature of maker/taker pricing models, and mandate that trading venues be required to implement a rebate-free pricing structure.

The data required to justify this rebate-free pricing structure would have to show two central sets of results. The first set of data would have to demonstrate the aforementioned shortcomings of maker/taker pricing. Conversely, the second set of data would have to demonstrate the benefits of rebate-free pricing. In our view, the best way to compile both sets of data would be to, first, gather data from existing transactions on trading venues that use maker/taker pricing. In addition, data showing the comparative benefits of rebate-free pricing could be gathered through a pilot study. Such a study would subject a limited number of stocks, for a limited period of time, to trading on a rebate-free basis. Each trading venue on which the selected stocks are traded would be prohibited from providing a rebate to providers as well as takers of liquidity in the stocks traded on that venue. The incentive to initiate a transaction would be to profit from a move in the stock, not to collect rebates at the expense of other market participants.

In our view, both sets of data are likely to show that a rebate-free pricing structure will promote greater transparency, efficiency, and liquidity by eliminating the incentive to engage in rebate arbitrage. Further, it will reduce the likelihood of fleeting liquidity, mitigate conflicts of interest between brokers and their clients, and reduce market fragmentation caused by the proliferation of "rebate capture" order types created by exchanges.

In addition, we believe that, if implemented, this reform could result in reduced spreads and additional high-quality liquidity trading on displayed venues. This outcome would be a logical effect of significantly reduced exchange access fees, and accompanying positive order routing behavior of broker dealers (and other market participants) who currently incorporate access fees into their order routing processes. By narrowing the differential in access fees between many on- and off-exchange venues, we would anticipate less reliance on cost-effective routing, thereby incenting market participants to route orders based on the likelihood of an execution rather than on rebates or the avoidance of venues with high access fees. Trading with more desirable, more diverse order flow would likely offset any lost revenue by market participants who are accustomed to receiving a rebate for providing liquidity.

This scenario runs counter to the perception that eliminating rebates would de facto result in wider spreads. In addition, while some participants have suggested that a reduction in exchange access fees must be coupled with a Trade-At rule, ostensibly to the benefit of increased exchange-routed orders, we would not necessarily agree. In fact, we anticipate more order flow moving from dark to lit venues under this proposed maker/taker reform, even *without* an additional Trade-At component, as lower access fees would naturally promote more on-exchange trading. Simply stated, lower access fees stemming from the elimination of rebates would have the greatest affect on exchanges – the exact venues charging the most to post and take liquidity.

Commission officials have asked, understandably, whether the market itself can create a successful trading venue that market participants will pay to access, and that does not offer rebates as an incentive to provide liquidity. While that question cannot be answered definitively, it bears noting that at this time no such venue has developed on its own in a marketplace where rebates are permitted. Therefore, we believe that it is unlikely that such a venue will be established until and unless rules are in place to restrict rebates and other mechanisms that are inconsistent with market principles of transparency, efficiency, liquidity, and the avoidance of conflicts of interest. Moreover, were two or more venues to adopt similar policies regarding rebates, it would be reasonable to inquire as to whether that behavior in itself was anti-competitive.

In closing, the sooner this initiative is commenced, the sooner the Commission, and other policymakers, will have objective data that can serve as a basis for analysis and reform. We would be pleased to work with officials at the Commission to develop and implement the appropriate metrics – such as effective spread, volatility, and trade performance – that can be used to gather and analyze the data. We believe this will serve as the basis for reform that ultimately results in more transparent, more efficient and higher quality markets.

Thank you for the opportunity to comment and for your attention to this matter.

Sincerely,

Richard Steiner
Global Equities Liaison to Regulatory & Government Affairs
RBC Capital Markets

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