Legislative Proposal Submitted by Royal Bank of Canada

To Chairman Mike Crapo (R-ID) and Senator Sherrod Brown (D-OH)

U.S. Senate Committee on Banking, Housing, and Urban Affairs

April 14, 2017

I. Brief description of the proposal

This proposal would direct the SEC to establish a pilot program to study the impact of "maker-taker" pricing – specifically, the payment of rebates or the provision of comparable inducements to trade – on transparency, efficiency, conflicts of interest, and capital formation in US securities trading venues.

II. Impact on Economic Growth

Capital formation is essential to economic growth in our economy. It occurs to a significant extent in and through US securities markets, where investors make capital available to publicly traded companies.[1] Those companies utilize that capital to expand and contribute to overall economic growth. The proposal will, in our view, provide data that will ultimately help policymakers make US capital markets more efficient, transparent, and fair. In so doing, the markets will be strengthened in their ability to perform the function of capital formation that is an essential component of economic growth.

III. Impact on the Ability of Consumers, Market Participants, and Financial Companies to Participate in the Economy

US securities markets remain among the most deep and liquid markets in the world. However, there is growing evidence that maker-taker pricing adversely affects transparency, efficiency, and alignment of interests between brokers and investors.[2,3,4,5] Ultimately, these adverse impacts may be contributing factors to the diminution in recent years of investor confidence in the markets, as well as to the relative reduction in the number of IPOs on US exchanges.[6] A well-conceived and implemented pilot study of maker-taker pricing will help to provide policymakers with additional data on the impact of maker-taker pricing on US securities markets and help them to make policy reforms that – by ensuring greater transparency, efficiency, and alignment of interests between brokers and investors – will help strengthen capital formation and its essential contribution to economic growth.

IV. Legislative Language

To require the Securities and Exchange Commission to carry out a pilot program to examine maker-taker pricing, and for other purposes.

(a) IN GENERAL.—Not later than 90 days after the date of enactment of this act, the Securities and Exchange Commission shall begin a 1-year pilot program to examine the impact of maker-taker pricing, under which the Commission shall—

(1) identify a random sample of 50 issuers (the "sample group") out of the 100 issuers with the most frequently-traded securities in the S&P 500 index;

(2) during such 1-year period, prohibit the payment of rebates (or the provision of comparable inducements) on any trade of securities of the issuers in the sample group; and

(3) compare the effects of such prohibition on the issuers in the sample group compared to the 50 issuers not so chosen (the "control group").

(b) REPORT.—

(1) IN GENERAL.—Not later than 6 months after the end of the program required under subsection (a), the Commission shall issue a report to the Congress containing all of the findings and determinations made in carrying out such program, along with any legislative or regulatory recommendations the Commission may have.

(2) FACTORS TO CONSIDER.—In preparing the report required under paragraph (1), the Commission shall consider factors relevant to the impact of rebates (or comparable inducements) on equity markets, including—

(A) whether maker-taker pricing creates a conflict of interest between brokers and their clients by incentivizing brokers to use routing that may be cost-effective for them, but which may not be the best method of execution for their clients;

(B) whether maker-taker pricing reduces, or potentially reduces, market transparency and distorts price discovery insofar as rebates and fees are not disclosed in displayed quotes, thereby causing displayed spreads to be narrower or wider than actual spreads; and

(C) whether maker-taker pricing compromises, or potentially compromises, efficiency and liquidity by—

(i) contributing to increased length of exchange queues;

(ii) causing passive market participants to trade more aggressively to access liquidity;

(iii) contributing to a reduction in liquidity in times of market stress, particularly for less liquid securities;

(iv) incentivizing a proliferation of order types, rebates, and fees, thereby resulting in increased fragmentation of order flow; and

(v) fostering excessive intermediation by certain market participants that trade in part or in whole to capture rebates (or comparable inducements) or avoid fees.

(c) COMMISSION AUTHORITY.—The Commission may make such adjustments to the pilot program under this section as the Commission considers necessary or appropriate to ensure that such program can provide statistically meaningful or reliable results.

(d) DEFINITIONS.—For purposes of this section:

(1) MAKER-TAKER PRICING.—The term “maker-taker pricing” means any pricing model by any trading venue that provides rebates (or comparable inducements) or fees to market participants to either provide liquidity to, or to take liquidity from, that trading venue.

(2) REBATES.—The term “rebates” means funds provided by a trading venue to certain participants in a transaction on that venue.

(3) COMPARABLE INDUCEMENTS.—The term “comparable inducements” means items or services of value (other than rebates) provided by a trading venue to certain participants in a transaction on that venue, including but not limited to free or reduced-cost market data, connectivity ports, co-location space, or technology services.

V. Additional Background Material

The attached documents provide further information in support of a well-designed and well-implemented pilot study of maker-taker pricing. Notably, they include a 2016 letter sent by Chairman Crapo and Sen. Warner to former SEC Chair White, encouraging her to bring before the Commission a proposal to establish and implement a maker-taker pilot. The documents also include an excerpt from the March 2017 confirmation hearing of Jay Clayton to Chair the SEC, during which both Chairman Crapo and Sen. Warner referenced the issue of maker-taker pricing and, in Sen. Warner's case, the continued need for a maker-taker pilot. In addition, the documents include comment letters, hearing testimony, and research submitted to policymakers.

SEC Chair nominee Jay Clayton's Senate confirmation hearing 23 March 2017
https://www.banking.senate.gov/public/index.cfm/2017/3/nomination-hearing (Senator Mark Warner: *"One of the things we pushed very hard for with the former Chair [Mary Jo White], but we've really not seen it, is to move forward on a maker-taker pilot so we can try to bring more clarity to make sure that all bidders in the market are going to get a fair shake."*)

Equity Market Structure Advisory Committee Comment Letter, 24 May 2016
https://www.sec.gov/comments/265-29/26529-70.pdf

Equity Market Structure Advisory Committee Comment Letter, 23 September 2016
https://www.sec.gov/comments/265-29/26529-86.pdf

Comments Regarding Potential Equity Market Structure Initiatives, 22 November 2013
https://www.sec.gov/comments/s7-02-10/s70210-411.pdf

H. R. 1216: "Maker-Taker Conflict of Interest Reform Act of 2015", 3 March 2015
https://www.congress.gov/bill/114th-congress/house-bill/1216/text

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End Notes:

1. David Weild, Edward Kim, Lisa Newport, Paper on "Making Stock Markets Work to Support Economic Growth: Implications for Governments, Regulators, Stock Exchanges, Corporate Issuers and their Investors", 2013 http://www.oecd-ilibrary.org/docserver/download/5k43m4p6ccs3-en.pdf?expires=1492090801&id=id&accname=guest&checksum=5B1BDF65A38D2A4974B7550B38A2B990 ("[S]tock markets that provide significant economic incentives to support small

companies and associated infrastructure in the aftermarket will create higher rates of capital formation that, in turn, will generate jobs, economic growth and tax receipts.")

2. SEC Chair Mary Jo White, Remarks on "Enhancing Our Equity Market Structure", 5 June 2014. https://www.sec.gov/News/Speech/Detail/Speech/1370542004312. ("When fees and payments are not passed through from brokers to customers, they can create conflicts of interest and raise serious questions about whether such conflicts can be effectively managed.")

   SEC Chair Mary Jo White, Statement to Equity Market Structure Advisory Committee Meeting, 15 May 2015. https://www.sec.gov/news/statement/optimizing-our-equity-market-structure.html. ("Complexity can, for example, result in instability if the sophisticated order routing and trading systems necessary to deal with a complex structure do not operate as they are intended to operate. It can create a lack of transparency for investors about how their orders are handled and executed. It can lead to unfair outcomes if professional traders, using the fastest, most sophisticated tools, are able to exploit the complexity in ways that disadvantage investors. Complexity can also make the always-difficult task of regulators in effectively overseeing the markets and enforcing the rules even more difficult.")

   SEC Commissioner Kara M. Stein, Remarks before Trader Forum 2014 Equity Trading Summit, 8 February 2014. https://www.sec.gov/News/Speech/Detail/Speech/1370540761194#. ("[W]e should explore how the maker-taker pricing model impacts liquidity and execution quality. Does the current rebate system incentivize or penalize investors? I have heard from many investors, and even exchanges, who are worried about the incentives embedded in the current system, and if there are proposals to explore alternative approaches, we should consider them.")

   Richard G. Ketchum, CEO, FINRA, Remarks on "Essential Elements of Sound Capital Market Structure", Exchequer Club, 17 February 2016. https://www.finra.org/newsroom/speeches/021716-remarks-exchequer-club. ("[C]ompetition and regulatory changes have also led to a more complex, fragmented market. In today's increasingly fragmented market, bad actors can consciously disperse their trading activity across markets, asset classes, and broker-dealers in an attempt to hide their footprints and avoid detection.")

3. "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.)

4. "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.)

5. Shawn M. O'Donoghue, Paper on "The Effect of Maker-Taker Fees on Investor Order Choice and Execution Quality in U.S. Stock Markets", 23 January 2015. http://people.stern.nyu.edu/jhasbrou/SternMicroMtg/SternMicroMtg2015/Papers/MakerTakerODonoghue.pdf. ("[M]aker-taker pricing has aggravated agency issues between brokers and their clients. Brokers are incentivized to direct non-marketable limit orders to the venue offering the highest rebate. However, this destination may not necessarily be the best for clients, if it offers a relatively slow execution speed, high nonexecution probability, or a high probability of execution outside-the-quote. Maker-taker pricing has increased the cost to brokers of executing marketable orders in the exchanges; consequently, brokers will internalize uninformed marketable orders whenever possible. As a result, non-marketable limit orders that are sent to the exchange are

more likely to execute when the price moves against them since the orders submitted there are disproportionately informed.")

6. America's Roster of Public Companies Is Shrinking Before Our Eyes, January 6, 2017 https://www.wsj.com/articles/americas-roster-of-public-companies-is-shrinking-before-our-eyes-1483545879.