



**CPP
INVESTMENT
BOARD**

May 6, 2005

British Columbia Securities Commission
Alberta Securities Commission
Manitoba Securities Commission
Ontario Securities Commission
c/o John Stevenson, Secretary
Ontario Securities Commission
20 Queen Street West
Suite 1903, Box 55
Toronto, Ontario M5H 3S8

RE: CONCEPT PAPER 23-402: *BEST EXECUTION AND SOFT DOLLAR ARRANGEMENTS*

Dear Sirs and Mesdames:

The CPP Investment Board is a professional investment management organization based in Toronto. Our purpose is to invest funds received from the Canada Pension Plan with the objective of maximizing returns without undue risk. Income from the money that we invest today will be used by the Canada Pension Plan to help pay the pensions of working Canadians who will begin retiring 17 years from now. We were incorporated as a federal Crown corporation by an Act of Parliament in December 1997 and made our first investment in March 1999.

According to the 21st Actuarial Report of the Canada Pension Plan that was tabled in Parliament on December 8, 2004, the Chief Actuary of Canada expects that our assets will grow to \$147 billion by the end of 2010 and \$332 billion by the end of 2020, primarily due to sizeable cash inflows that we invest in various markets around the world. We are a major participant in the Canadian marketplace, and as such, we are interested in assisting in efforts to ensure that the regulatory structure of the Canadian marketplace reflects global best practices, especially on issues as complex as best execution.

Our mandate and objectives

The mandate of the CPP Investment Board is to invest in ways that continuously improve total portfolio efficiency, having regard to the immediate and long term financial obligations of the CPP. Implicit in this mandate is to achieve best execution when we transact in the financial markets. To us, "best execution" means the transaction which results in the best total trade price, taking into consideration all relevant factors, including but not limited to trading volume, liquidity, number of securities involved, size of transaction, potential for information leakage, and costs (including but not limited to commissions and fees). We are encouraged that our definition is similar to the one proposed in the Concept Paper¹.

¹ Per Section 3(c) of *Concept Paper 23-402: Best Execution And Soft Dollar Arrangement*. "Best execution means the best net result for the client, considering the relevant elements (including price, speed of execution, certainty of execution, and total transaction cost) in light of the client's stated investment objectives."

An effective, practical definition of best execution would describe a process, rather than focusing merely on price². It is up to each market participant to consider factors in the decision process which fulfill their particular investment mandate given market realities. Such a definition needs to be flexible enough to cope with the differing needs of both institutional and retail investors. As such, we caution against any attempt to focus assessment of execution on a single variable (e.g. price) as it is likely to be increasingly inappropriate in a market developing towards multiple trading venues that includes participants with a wide range of investment objectives.

One question posed in the Concept Paper related to whether any regulatory initiatives would be worthwhile to pursue in line with those of other jurisdictions. Due to the fact that there is no single unconditional standard of best execution, more prescriptive rules would create additional and unnecessary regulation. This may, in fact, prohibit best execution in some instances. In our opinion, “best execution” policy is better addressed as a “best practice” by market participants rather than centrally via rigid rules.

We have included our response to the other questions raised in the Concept Paper in the Appendix to this letter.

Thank you for providing us with an opportunity to comment.

Respectfully submitted on behalf of the CPP Investment Board,



Daniel Chiu
Director – Capital Markets
CPP Investment Board

² Focusing on price alone may not take into consideration other factors of importance to institutional investors (e.g. certainty of trade, liquidity, etc.)

Appendix: Response to Questions from Concept Paper 23-402: Best Execution and Soft Dollar Arrangement

Question 1: Are there any changes to current requirements that would be helpful in ensuring best execution? Do you think that clients are aware of their role in best execution or would some form of investor education be helpful?

Canadian requirements acknowledge that best execution is an outcome of a particular process and not an unconditional standard to be implemented on a trade by trade basis. The most important conceptual obstacle of a best execution standard is that best execution should be defined relative to investor intentions and expectations. While there is always room for improvement with any set of guidelines, particularly with the notion of trade throughs, the current requirements provide enough flexibility and guidance to ensure the long run viability of Canadian financial markets. Written Best Execution requirements should address factors for selecting brokers, criteria used to measure these factors and the consideration of alternative markets in order to allow transparency to prevail.

Clients should be clear when communicating instructions to a dealer on how a trade is to be executed. This is not the case in all instances. For this reason, investor education and policies may provide additional insight to clients and allow for best execution to occur. An investor education program can help ensure that market participants are able to better interpret the information they receive about the execution arrangements of firms. There is a role for Canadian regulators in enhancing client awareness. Increased information will only be successful, however, if it is in line with market participants' expectations and needs. Regulators must ensure that information overload does not occur that could impede the entire process. It may be advantageous if a generic set of questions were provided in which market participants could ask their brokers about their market practices and execution strategies.

Question 2: Should there be more prescriptive rules than those which currently exist for best execution or should the methods for meeting the best execution obligation be left to the discretion of registrants?

While the Canadian guidelines provide a general template for the process of achieving best execution, best execution should be left to the discretion of the registrants. Best Execution is better addressed as a best practice by market participants rather than centrally. It is essential that registrants understand their own trading process and find any "leaks" that may be reducing trading efficiency. In a competitive market, registrants that do not offer best execution will lose their clientele. Leaving best execution up to the discretion of registrants will help to ensure that each execution process best suits an investor's particular needs, particularly in the context of less liquid securities or large trades. Each participant must include factors beyond simply price and commission charges. Due to the fact that there is no one unconditional standard of best execution, more prescriptive rules would provide additional and unnecessary barriers to overcome and may in fact prohibit best execution in some instances.

Question 3: Do you believe that there are other elements of best execution that should be considered? If so, please describe them.

It is clear from regulatory practices which have been implemented recently that the best execution obligation can be restructured so that it is flexible enough to cope better with the differing needs of both institutional and retail investors. Best execution is about more than just price. The diversity and sheer number of the considerations that should be considered in ensuring a complete best execution standard is limitless. This means that any attempt to focus assessment of execution on a single variable is likely to be increasingly inappropriate in a market which features a diversity of trading venues. However, as stated above, best execution must be seen as an outcome of a particular process and not an unconditional standard to be implemented on a trade by trade basis.

Question 4: If audit trail information is not in easily-accessible electronic form, how is the information used to measure execution quality? Is there other information that provides useful measurement?

We are not addressing this question at this time.

Question 5: Do you believe the suggested description emphasizing the process to seek the best net result for a client is appropriate and provides sufficient clarity and, if not, can you suggest an alternative description?

The statement suggesting that best execution is a process to seek the best net result for a client is appropriate and does provide sufficient clarity as it is in line with other definitions of best execution. Required is a flexible definition that calls for trade execution decisions to be well-reasoned, documented, and reportable. The ultimate goal is supporting price discovery while maintaining market integrity. Defining best execution as “the best net result” in a portfolio context encompasses all of these factors.

Question 6: Do you believe that there are any significant issues impacting the quality of execution for:

(a) Listed equities -- whether Canadian-only, inter-listed or foreign-only;

(b) Unlisted equity securities;

(c) Derivatives; or

Some derivative markets have significant depth and because of this it is possible to obtain competing price quotations from an assortment of different market makers and ensure best execution. Clearly, in some instances this is not possible and best execution takes on new meaning. While there are no significant concerns that hinder the quality of execution (where applicable) at the moment, regulation surrounding issues such as swap agreements, electronic trading and clearing systems, hybrid instruments and single stock

futures must be rigorously analyzed to assure that market participants are receiving their best execution requirements. The rapid evolution of the derivatives markets requires a regulatory approach that promotes greater legal certainty as well as innovative financial instruments. The recent credit derivatives fiasco in the United Kingdom can attest to this.

(d) Debt securities?

The difficulty with the duty of best execution in the context of debt securities is the general lack of real-time transparency and centralization of these markets. Nevertheless, a broker-dealer must endeavor to ensure that customers do receive best execution even when trading in fixed-income securities as principal. A broker-dealer that trades fixed-income securities at market prices and observes the fair mark-up/mark-down standards, absent unusual circumstances, would likely be fulfilling its duty of best execution.

As the duty of best execution evolves with market developments, however, firms should be aware of and monitor transparency initiatives in the fixed-income markets. As the market becomes increasingly visible and closer to real-time, broker-dealers offering fixed-income securities to their customers will most likely be subject to additional best execution scrutiny by their customers. To the extent a firm can incorporate tools and evaluation of best-execution compliance today, it should do so.

With respect to execution quality, Canadian regulators must ensure that their mark-up/mark-down policies are in accordance with general market practices. The policies must be fair under the circumstances, taking into consideration the type of security involved, the availability of the security in the market, the price of the security (recognizing that such pricing may depend on the broker-dealers' inventories), the amount of money involved in the transaction, disclosure of the amount of a commission or mark-up/mark-down, the broker-dealer's pattern of mark-ups, and the nature of the member's business.

Question 7: How should dealers in Canada monitor and measure the quality of executions received from foreign executing brokers?

We are not addressing this question at this time.

Question 8: Do you think that internalization of orders represents an impediment to obtaining best execution?

Many who support internalization have argued that trading against their own book for a spread while still guaranteeing the best bid and offer satisfies all involved. With internalization, a broker makes the spread, while the client is assured of doing no worse than they would do on an exchange. Those who are in favor of the practice argue that clients aren't harmed because they do no worse than the national best bid and offer. What is never acknowledged is that the presence of these orders in the marketplace would often change the best bid and offer. However, it is important to note that whether or not a firm is internalizing, the competitiveness of the market should result in firms losing their customers quickly if they did not provide best execution. While some have raised

concerns over the lack of transparency posed by internalization and obviously this is a viable concern, internalizing firms, like all other firms, will be competing to provide best execution for their customers. Greater internalization can translate into wider spreads, particularly for less-liquid issues. Internalization could therefore be having a detrimental effect on prices. It should not impede best execution if proper constraints are put in place. Today, it is widely understood that the increased liquidity into the market that internalization provides must be balanced with the conflict of interest that may result which can potentially affect the price discovery mechanism.

Question 9: Should there be requirements for dealers and advisers to obtain multiple quotes for OTC securities? Should there be a mark-up rule that would prohibit dealers from selling securities at an excessive mark-up from their acquisition cost (similar to National Association of Securities Dealers, Inc. (NASD) requirements dealing with fair prices)?

No. There should not be specific requirements indicating that dealers and advisers should have to obtain multiple quotes for OTC securities. The less commoditized and the less organized a market, the more challenging is any concept of best execution. It is hard to see any benefit the regulatory objectives in applying the best execution rule to OTC markets where the only participants are wholesale users acting as principals. Dealers and advisers are already subject to best execution rules and requirements and as answer in question 2 dictates, more prescriptive rules would be detrimental in ensuring optimal execution quality for OTC.

Question 10: How is best execution tracked and demonstrated in a dealer market that does not have pre- or post-trade transparency such as the debt or unlisted equity market?

We are not addressing this question at this time.

Question 11: How does an adviser ensure that its soft dollar arrangements are consistent with its general obligations to its clients?

While the use of soft dollars is a common practice throughout the industry and one that is permitted under federal securities laws, questions have been raised about the possibilities for conflicts of interest or higher commission costs resulting from these arrangements. Opponents believe fund managers should pay for research at their own expense, not by using fund commissions. Proponents of using soft dollars point to the enhanced investment services they can provide to their clients and improved decision-making from the research they obtain with commission dollars. We believe that a more transparent mechanism for paying for research is in the best interest of clients and ultimately the industry. Advisors best practices for soft dollars are similar to their obligation to provide best execution. Advisers should ensure that the necessary processes are in place that allows them to document policies and procedures for each type of arrangement they are involved with. Advisers that participate in soft dollar arrangements also need a system of strong internal controls to check that they are obtaining only

appropriate products and services, meeting all necessary regulatory requirements, and making all proper disclosure to clients in order to make sure that they are meeting their general obligations and providing optimal execution. Advisors must limit the number of firms through which they obtain research using commission dollars and they must continue to explore ways of reducing their use of this practice without diminishing the quality of the advisory services they provide to the funds and their shareholders.

Question 12: Are there any other additional benefits or concerns with soft dollar arrangements that are not noted above?

The CPP Investment Board supports transparency and disclosure in paying for goods and services and unbundled pricing of goods and services. The CPP Investment Board will only consider Soft Dollar arrangements when direct payment for goods and services is not practical or when Soft Dollar arrangements are judged by Management to be in the best interests of the CPP Investment Board.

As with defining a central best execution standard, there are unlimited factors that can be considered when looking upon the benefits or concerns associated with soft dollars. It seems that in order for progress to be made with soft dollar arrangements, the major concerns and or benefits must be first addressed with respect to regulatory reform so to avoid any bottlenecks from occurring and impeding innovation. The concept paper clearly outlines all pertinent issues and concerns that are currently restricting the soft dollar issue from being resolved and therefore it would not be beneficial to stress other issues before these are dealt with.

Question 13: If it is acceptable to pay for goods or services using soft dollars, which services should be included as "investment decision-making services" and "order execution services" and which services should specifically not be included?

We are not addressing this question at this time.

Question 14: Should there be additional disclosure requirements beyond those specified in OSC Policy 1.9 and AMF Policy Statement Q-20, National Instrument 81-101 and proposed in National Instrument 81-106? Should the disclosure requirements be the same for third party soft dollar payments and bundled commissions?

No, as mentioned earlier, more prescriptive rules would provide additional barriers in achieving best execution.

Question 15: What, if any, are the practical impediments to an adviser:

(a) splitting into their component parts commission payments that compensate for both order execution and "investment decision-making services" as a result of either third party soft dollar arrangements or bundled commissions; or

(b) making a reasonable allocation of the cost of "investment decision-making services" to the beneficiaries of those services (for example, allocating across mutual funds)?

We are not addressing this question at this time.

Question 16: If the split between order execution and "investment decision-making services" cannot be measured reliably, should the entire commission be accounted for as an operating expense in the financial statements? If it can be measured reliably, should the "investment decision-making services" portion of commission payments be accounted for as an operating expense in the financial statements

We are not addressing this question at this time.

Question 17: Would it be appropriate for the MER to be based on amounts that differ from the expenses recognized in the audited financial statements? For example, should the entire commission continue to be accounted for as an acquisition/disposition cost in the financial statements but the MER calculation be adjusted either to include all commissions or to include only that portion that is estimated to relate to "investment decision-making services"?

No. It would not be appropriate for the MER to be based on amounts that differ from the expenses recognized in the audited financial statements. However, if there were to exist any waived management fees which may be applicable and may impact the MER, it may be advantageous. It is important to note, though, that calculating the MER in a way that considers only the portion that is estimated to be relevant to investment decision making services could be used as a reference tool but should not be deemed as the final MER calculation.

Question 18: Should directed brokerage or commission recapture arrangements be limited or prohibited?

Though neither directed brokerage or commission recapture arrangements are considered contentious issues at the moment in Canada, it may be in the best interest of Canada to implement regulatory practices that would address these practices. Implementing regulatory reforms that would limit both directed brokerage and commission recapture with a promise to prohibit them at a later date would enable best execution to prevail. Although best execution is hindered when clients' stress which broker/dealer must be used for execution, prohibiting both issues right now without doing ample due diligence on the Canadian markets may in fact give rise to considerable ramifications that can take many years to overcome. While concerns about the possible conflicts of interest that can arise when brokers are selected for fund portfolio transactions based on sales of fund shares are present in Canada, prohibiting them right now may not be in line with the best interests of the Canadian markets.

Question 19: Should disclosure be required for directed brokerage or commission recapture arrangements?

Requiring mandatory disclosure for both directed brokerage and commission recapture arrangements will only help in achieving best execution and ensuring market efficiency. Mutual fund shareholders should not only receive complete, specific and clear information on how their commissions are being spent, but also should be required to affirmatively consent to any directed brokerage arrangements. Where disclosing commission recapture arrangements is concerned, divulging this information will ensure that the revenues will be returned to an asset pool and not used to pay the expenses of the fund administrator. This should eliminate the notion that soft dollars and commission recapture are essentially one and the same.

Question 20: Would any of these initiatives be helpful in Canada?

Initiatives similar to those adopted by the United States (Rule 11Ac1-5 and 11Ac1-6) may be advantageous to Canada if looking at the long term public interest of its population. These Rules were the best way that the United States could develop a method to measure best execution. The rules provide a more complete picture of Best Execution as they ensure improved public access to market data and educate the public on the effect execution quality has on trading, hence leveling the playing field. The idea is that greater disclosure allows for a more informed investor. In particular, the disclosure requirements, which apply to execution venues, are aimed at providing trade data to facilitate the selection by brokers of the appropriate execution venue to which the customer order should be directed. These rules also require broker-dealers who receive payment for order flow to provide customers with additional information regarding the value of the compensation received. Although some have argued that the rules have added to the already complex problem of interpreting and responding to best execution requirements, we believe such rules help to ensure the long-term viability of the financial markets.