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INVESTMENT
BOARD

October 20, 2005

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Registrar of Securities, Yukon Territory
Registrar of Securities, Nunavut
c/o John Stevenson, Secretary
Ontario Securities Commission
20 Queen Street West
Suite 1903, Box 55
Toronto, Ontario M5H 3S8

and

Anne-Marie Beaudoin, Directrice du secrétariat
Autorité des marchés financiers
Tour de la Bourse
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Montréal, Québec H4Z 1G3

RE: CSA PAPER 23-403: *MARKET STRUCTURE DEVELOPMENTS AND TRADE-THROUGH OBLIGATIONS*

Dear Sirs and Mesdames:

The CPP Investment Board is a professional investment management organization based in Toronto. Our purpose is to invest the assets of the Canada Pension Plan to maximize returns without undue risk. We were incorporated as a federal Crown corporation by an Act of Parliament in December 1997 and made our first investment in March 1999. 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 begin retiring in 2022.

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 continue to grow to $147 billion by the end of 2010 and $332 billion by the end of 2020, due in large part to sizeable cash inflows that we invest in various markets around the world.

As a major participant in Canada's capital markets, we support initiatives that promote market fairness and transparency as well as evolutions in market structure that help us meet our best execution obligations[1]. As such, contributing to the debate surrounding trade-through regulation is of particular interest. We are encouraged that the CSA has chosen to take a holistic view by asking key questions: what are the objectives we are trying to achieve and the problems we want to avoid to minimize with the trade-through obligations?

Clearly, different market participants will have different answers. Of the four objectives cited by the CSA as factors that should be considered in identifying the appropriate structure and requirements for Canada, we believe encouraging innovation[2] can lead to meeting the other three objectives. This is because innovation is shaped by market forces. If it becomes evident that "balancing regulation and competition among all types of marketplaces," or "recognizing and supporting the role of retail participation in the market," or "promoting greater order interaction and displayed depth is important to the market," market innovation will cause structural evolutions to meet these needs.

We believe innovation is incompatible with regulations that are difficult to adhere to. Specifically, creating a complex regulatory regime to address trade-through problems that have yet to materialize in any material way seems short sighted and stifling at a time when, as the CSA states, "the introduction of the ATS Rules has facilitated competition and innovation in the Canadian market by accommodating new marketplaces that have diverse models of trading." These diverse models of trading are valued by at least several major market participants, or they would not have achieved critical mass to become operational. Innovation, perhaps via new alternative trading systems, could result in added liquidity to the Canadian market place which would be beneficial for all participants. We believe it is important to give new marketplaces time to mature and determine whether problems (which could end up being about more than just trade-through) develop.

The CPP Investment Board does not support the imposition of a trade-through obligation for several reasons.

- It has the potential to stifle the development of alternate marketplaces that may offer solutions to problems that have not been addressed by current market structure and regulation, and may ultimately reduce the incremental liquidity potential in the Canadian marketplace.
- It may expose certain market participants to the risk of information leakage.

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[1] Discussed in our May 6, 2005 submission in response to a request-for-comment re: *Concept Paper 23-402: Best Execution And Soft Dollar Arrangements (http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part2/Comments/23-402/com_20050506_23-402_chiud.pdf)*

[2] *Innovation* is one of seven values which CPP Investment Board identified as being central to its culture: *"We will not be satisfied with the status quo or even current "best" practices, but will continually seek to find new and innovative ways to strengthen our competitive position and improve our performance. While we will not seek innovation for its own sake, we do expect to be on the leading edge of developing and introducing new ways of adapting to an ever-changing environment."*

- It is an obstacle to achieving best execution.
- It has not yet been demonstrated that it will enhance investor protection for all market participants.
- We also believe that such regulation will increase the cost of transacting in the Canadian equity market.

1. Locked or Crossed Markets

Regulatory bodies are concerned that in the absence of trade-through regulations, markets may remain locked or crossed, for extended periods of time.

Locked markets are generally nothing more than a theoretical possibility, and in the worse case, when they actually occur, it is often just a temporary situation. It is worth noting that NYSE-TSX cross-listed securities are almost never locked, in spite of the absence of trade-through regulations, because investors active in those stocks monitor all markets simultaneously. Crossed markets are even rarer than locked markets. In fact, arbitrageurs systematically take advantage of crossed markets and contribute to market efficiency and information dissemination.

We believe regulations attempting to prevent locked or crossed markets would be of little value.

2. Cost of Regulation

Regulations are costly to market participants. Apart from the operational costs, they also impose legal and compliance costs. In the absence of a well documented case against trade-through, regulatory authorities should refrain from imposing burdensome obligations on market participants.

3. Information Leakage

For institutional investors, the quantity discovery process is tied to the price discovery process. In the upstairs market model in general (and with less liquid stocks in particular), the greater the need for quantity discovery, the greater the order information disclosure required. The alternative to providing that disclosure is simply not to put that order to work in the market. That order becomes latent liquidity, doing nothing for market liquidity or capital formation in Canada.

Our major concern with a trade-through obligation is that it could actually prevent the quantity discovery process from occurring and/or expose participants to the possibly significant information leakage. For example, two investors are negotiating a block of XYZ on the ATS. An order to sell comes into the TSX book at a price better than the block seller's offer bid but unfortunately it is relatively small in size. If the buyer is required to first take out the seller on the TSX, the buyer is exposed to several risks:

1. The buyer incurs the cost of moving the market and reveals to the entire market that there was interest to buy a large block at a price greater than the one just paid on the TSX, creating the price impact he just was trying to avoid.

2. As a result of the above, taking out the order on the TSX book would likely prevent the buyer from participating on the ATS as well because the remaining fill

quantity could be less than the minimum order size on an ATS with such a minimize size requirement, or the previously matched order may no longer work if the order on the ATS was changed or cancelled in the intervening period.

We strongly believe that information leakage is an issue that needs to be considered when debating the merits of the trade-through obligation.

4. Trade-Through Obligation: An Impediment to Best Execution

In some cases, the trade-through obligation can be an impediment to best execution and rapid order completion. <u>It is important to make the critical distinction between best price and best execution.</u> We see best execution as an execution path that simultaneously minimizes cost and risk, for a given level of risk tolerance. Because investors have varying risk tolerances, best execution is different for each market participant. A very risk-averse investor may wish to complete an order rapidly, in order to lock in a price. On the other hand, a more risk-tolerant investor will be willing to take more time in completing an order, so as to minimize market impact or take advantage of an expectation of more favorable prices in the future.

While pursuing best execution, investors may wish to trade at prices less favorable than the best available price, in the interest of prompt order completion. For instance, it is possible that an investor may wish to buy at a price above the ask price, if the desired transaction size is larger than the more favorably priced visible liquidity. In this case, we can say that the investor “buys” immediacy and price security.

Naturally, in the case of dealers acting as agents, it is important that trading-through be done only with the client’s knowledge. We do not believe regulation is required, at this stage of market structure evolution. Trading-through the market will only occur in cases of large and urgent institutional trades; institutional investors are more sophisticated and better at communicating their instructions than the average retail investor. Additionally, brokers will generally make an effort to understand their client’s needs and risk-aversion and to communicate their trading strategies.

In summary, a trade-through obligation is an obstacle to best execution because it eliminates the market for immediate execution of large orders.

5. Limit Orders

Regulatory agencies are concerned that in the absence of trade-through obligations, the incentive to place limit orders and the informational benefit they provide will be diminished.

This concern is unjustified, since no rational investor will transact at prices less favorable than those prevailing on the consolidated order book, if the entirety of the order can be completed by accessing the order book’s visible and more favorably priced liquidity. Trade-throughs occur because limit orders do not provide the necessary liquidity. Liquidity has a price, and investors seeking rapid order completion are willing to that price. Furthermore, in cases where the order exceeds the aggregate visible liquidity in the market, only a small portion of investors (who are likely very risk-averse) will transact at prices that are less favorable than prevailing market prices.

We agree with the view that limit orders are a necessary component of efficient, liquid markets and play an essential role in the price discovery process, but we reject the argument that investors will find that their limit orders are being regularly traded through and not filled. Hence, our assertion that regulatory effort to address a trade-through obligation is a solution searching for a problem.

6. Fairness and "Free-Riding"

Trade-throughs do not "free-ride" on limit orders and are not unfair to other market participants. On the contrary, trade-throughs can contribute to the price discovery process because large amounts are transacted at prices that differ from the prevailing market prices. This offers other investors a more accurate view of the true economic price.

Moreover, markets adjust to a trade-through situation with the result that all opposite side liquidity can benefit. For instance, we have observed that when a trade-through occurs above prevailing prices, the market (i.e. the TSX order book) quickly adjusts upwards and provides all sellers with more favorable conditions. Similarly, when a trade occurs at a price below a portion of the visible buying volume, the market will adjust downwards and provide buyers with more favorable conditions.

On this basis, regulations preventing trade-through can actually hamper the price discovery process and market efficiency.

7. Empirical Evidence

CPP Investment Board was involved in two instances of trade-through on September 21, 2005. At 12:06:09PM, we sold 25,000 shares of Angiotech Pharmaceuticals (ANP), an order representing 19.3% of the average daily volume, at a price of $15.62. At the time, there were 1,300 visible shares priced more favorably. Again, at 12:09:09PM, we sold 25,000 shares at $15.62, when there were 1,100 visible shares priced more favorably.

In both cases, the counterparty to our sell purchased a disproportionately large amount of shares without moving prices upward. The trade-through provided this investor with immediacy and risk-reduction. More importantly, the TSX order book adjusted upwards, after both trade-throughs.

The empirical evidence provided by our own trade-throughs, although anecdotal, supports our claim that markets adjust to trade-through and improve price-discovery.

8. RS's Trade-Through Proposal

We believe that there are many unclear issues with the RS proposal, including implementation issues. As outlined in your paper, the RS proposal would not eliminate trade-throughs. More troublesome, a trade-through obligation would be applied to non-dealers and dealers alike, and we are unsure of how the regulatory regime would address this.

We emphasize the statement from the CSA paper: "No analysis was provided about the cost of the proposal on Access Persons or the costs, generally, for RS to monitor and enforce such obligations on non-dealers. Placing the obligations on marketplace participants, including non-dealers, has practical implications for marketplace participants and for market structure, which have not been addressed." As such, it is hard to envisage how one can be supportive of such an effort when so many details are lacking.

Thank you for providing us with an opportunity to comment.

Respectfully submitted on behalf of the CPP Investment Board,

Dan Chiu

Daniel Chiu
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CPP Investment Board