NORTHWATER

June 7, 2002

John Stevenson, Secretary
Ontario Securities Commission
20 Queen Street West
19th Floor
Toronto, Ontario M5H 3S8

and

Denise Brousseau, Secretary
Commission des valeurs mobilières du Québec
800, square Victoria
Tour de la Bourse
Montréal, Québec H4Z 1G3

Mr. Stevenson and Ms. Brousseau:

Re: "Striking a New Balance: A Framework for Regulating Mutual Funds and their Managers" (the "Concept Proposal")

Introduction

We are taking the opportunity to respond to one of the issues for comment raised in the Concept Proposal, namely, issue 04.

Issue 04 states as follows:

> "Which parts of our renewed regulatory framework should be extended or not extended to other investment vehicles – and which investment vehicles? Why do you believe the particular regulation should or should not be extended? What is the essential difference – or similarity- between the particular investment vehicles that mean they should be regulated differently or the same?"

We are singling out this issue because it suggests to us a regulatory direction that we believe is at odds with the public interest mandate with which the CSA and the Commission are charged and that is inconsistent with other capital markets initiatives announced by the CSA and the Commission.

Northwater Capital Management Inc.

Before addressing this issue directly it is perhaps appropriate for us to highlight for you Northwater Capital Management Inc. ("Northwater") and its businesses.

Since its founding in 1989 as Newcastle Capital Management Inc., Northwater has grown its assets under management to approximately C$8.3 billion. We believe that much of this growth can be attributed to Northwater's success in creating and managing highly efficient, sophisticated investment strategies — strategies that can be combined to optimize portfolio performance.

Northwater is registered in Ontario under the *Securities Act* (Ontario) as an adviser in the categories portfolio manager and investment counsel. Northwater is also registered under the *Securities Act* (Ontario) as a dealer in the category limited market dealer. Northwater is also registered in Ontario under the *Commodity Futures Act* (Ontario) as an adviser in the category commodity trading manager. Northwater is registered in Québec as a securities adviser with unrestricted practice and has a number of other registrations pending in other provinces in Canada.

In the United States, Northwater is registered with the U.S. Securities and Exchange Commission as an investment adviser under the *Investment Advisers Act of 1940* and with the U.S. Commodity Futures Trading Commission as a commodity trading adviser and commodity pool operator under the *Commodity Exchange Act*. Northwater is also a member of the U.S. National Futures Association.

Northwater is primarily involved in managing the assets of large pension funds and other institutional investors, including the pension funds of major corporations in Canada, the United States and Europe. Northwater also manages pension assets for a number of universities and public sector institutions. In doing so, Northwater provides its clients with synthetic indexing for diversified index returns, funds of market-neutral hedge funds for diversified "alpha" and enhanced indexing for diversified "index plus alpha". Northwater manages its clients' assets primarily in pooled fund vehicles but also manages some segregated accounts.

As such, Northwater is a pioneer in Canada in using derivatives to replicate index returns (synthetic indexing) and in constructing portfolios using funds of hedge funds. Northwater is one of the larger fund of hedge funds managers in the world.

Extending mutual fund regulation to the exempt market

The statement is made in the Concept Proposal that "[W]e know that as we move forward, we must keep in mind the broader continuum of investment vehicles that we do not regulate as mutual funds." The continuum is stated as including "pooled funds, including hedge funds, that are sold to investors under an exemption from prospectus requirements" as well as "closed-end funds listed on stock exchanges". Nowhere in the Concept Proposal is a rationale given for the assumption that the mutual funds rules could or should be extended to these other forms of investment nor is any reasoning provided for extending such rules into the relationship between institutional clients and their advisers in the exempt market.

Adopting the approach envisaged in the Concept Proposal would ignore the importance that regulators both here in Canada and in the United States have long placed on the relative sophistication of the purchaser. Indeed in recommending that Congress adopt a "Qualified Purchaser" exemption from the application of the *Investment Company Act*, the SEC's Investment Company Division stated that the new exception "would be premised on the theory that "qualified purchasers" do not need the Act's protections because they are able to monitor such matters as management fees, transactions with affiliates, corporate governance and leverage." This premise is as well founded in a Canadian context as it is in the U.S. market.

The body of mutual fund rules was adopted in the 1970s and 1980s to protect retail investors engaged in the purchase and redemption of interests in mutual funds. National Instrument 81-102 (the "Rule"), like National Policy Statement No. 39 that preceded it, is limited in its application to mutual funds that are offered by prospectus. It is for this reason that the Rule sets out the types of investments that mutual funds may purchase, rules for redemptions, and the types of sales communications that may be made, among other things.

Other types of investment vehicles, such as pooled funds and hedge funds are typically offered to investors that do not need the types of protections afforded to retail investors through existing exemptions from the prospectus requirements. These types of investment are, generally, free to adopt a wider set of investment objectives on the understanding that, in the first instance, adequate mechanisms exist for disclosing the risks incumbent in the investment strategy adopted or the investors themselves are capable of, or are able to retain experts who are capable of, evaluating the risks to which the proposed investment would be subject.

The adoption of Universal Registration in 1987 and the re-casting by the CSA of the "closed system" that resulted in the promulgation of Rule 45 – 501 clearly recognize the fact that large and sophisticated investors do not need many of the benefits provided by the protections afforded to investors by securities legislation. An extension of the mutual fund rules should not effect a complete re-regulation of securities legislation, removing exemptions that institutional investors have historically relied upon. The CSA's focus should, above all, remain on the retail investor.

A word about institutional investing

Unlike most retail investors, institutional investors typically invest on a portfolio basis. As a result, investments are selected depending on the metrics of the particular investment to be added and the portfolio itself. A risky asset added to a portfolio may, depending upon the metrics of both the asset and the portfolio, reduce overall portfolio risk. It is our view that, in this context, the investor and not the CSA is best placed to make the determination what investments can and should be made to realize a particular set of investment objectives.

Compromising institutional investors' ability to diversify their portfolios will hinder their ability to optimize the risk adjusted returns of the assets they are responsible for.

Modern Portfolio Theory contends that certain portfolios provide the highest expected return for each level of risk. These portfolios comprise *The Efficient Frontier.* Portfolios that are not on *The Efficient Frontier* fail to generate the highest expected return for the level of risk involved. Movement toward *The Efficient Frontier* is accomplished by diversifying asset holdings within and across asset classes. For example, a portfolio of banking stocks would not be on *The Efficient Frontier* because there are other more diversified portfolios that offer higher expected return for the same level of risk. The key to moving toward these more efficient, diversified portfolios is to add investments that tend to perform independently of banking stocks – aerospace, retail, and biotechnology stocks, plus corporate and government bonds, for instance.

Diversification ultimately results in *The Market Portfolio,* which, in theory, precisely represents the entire market and is the most efficient portfolio in the market. Staying fully invested in properly diversified portfolios is important because market timing can compromise the benefits of being on *The Efficient Frontier.* Although "market meltdown" can hurt even the most efficient portfolios in the short run, appropriate diversification across several asset classes can help soften and shorten the blow and help deliver the expected results over time. The whole is greater than the sum of its parts.

Adopting rules that would make it difficult for institutional investors to make investments that would tend to assist them in moving towards *The Efficient Frontier* and achieving the benefits of Modern Portfolio Theory benefits no one. Institutional investors should be permitted to adjust the proportion of "risk-free" versus "risky" investments to address their risk/ return requirements as Modern Portfolio Theory would suggest. Regulating pooled funds and hedge funds as mutual funds will undoubtedly result in institutional investors incurring undue risk or unnecessarily forfeiting return. Diversification can help optimize return. Diversification is the key risk management technique available to investors and the ability to diversify should not be compromised by regulation.

When focusing on the retail investor, the Commission should be careful not to foreclose opportunities now open to retail investors nor handicap them from being able to emulate the portfolio management techniques adopted by professional investors.

Investment vehicles

Of the types of investment vehicles enumerated, we are particularly concerned about the extension of the mutual fund rules to pooled funds, hedge funds and closed-end funds.

Pooled funds

Pooled funds assist in reducing the investment expenses that institutional investors would be otherwise subject to and make it easier for them to enter and exit various investment strategies. In Northwater's case, pooled funds are also used to assist in the structuring of innovative portfolios for its investors. Layering the mutual fund rules over this type of investment vehicle will compromise the ability of institutional investors to invest efficiently and will thereby result in increasing systematic costs without real benefits.

Many pension investors, for example, do not need daily or even weekly liquidity in their investments. They are long-term investors. Many pension investors are amenable to making investments in products that are not permitted by the Rule or pursue strategies that would be outside of the scope of the Rule. Applying the mutual fund rules in this context would fail to recognize that such factors as financial sophistication, net worth, knowledge, experience in financial matters do (or should) play a part in determining the level of regulation required. Failing to recognize this will inhibit the ability of institutional investors to adopt efficient portfolios and to respond to ever changing financial conditions.

Securities regulation should not preclude institutional investors from accessing any of the investment tools that might be available to them.

Hedge funds

Hedge funds serve to make markets more efficient by exploiting various mispricings that exist in the market to the advantage of their investors. The hedge fund market is a very large and sophisticated one and it is typically available only to large and sophisticated investors. Adding mutual fund regulation to this market will prohibit the availability of such strategies and will, therefore, serve to perpetuate market inefficiencies, forcing hedge fund managers to focus on markets and investors outside of Canada. Such an approach would deprive Canadian institutional investors of the benefits that would otherwise be available to them by investing in hedge funds. As an investor in hedge funds, Northwater is concerned that its ability to offer innovative investment products to its clients will be impaired by the imposition of the mutual fund rules to hedge funds.

Closed-end funds

Closed-end investment vehicles provide an alternative to mutual funds by offering investors the ability to invest in securities for which the mutual fund format is not practical. For example, real estate and hedge fund investments can each be pooled as closed-end funds, thereby enabling retail investors to further diversify their portfolios. Since the *Income Tax Act* (Canada) rules that apply to such vehicles require the portfolios themselves be diversified, investors get the best of both worlds – diversified portfolios and the ability to diversify their own portfolios.

In addition, institutional investors in privately offered closed-end funds have a long investment horizon and are willing to give up the benefit of frequent redemptions in order to capture a 'liquidity premium'.

If closed-end funds are to be re-regulated as mutual funds, the CSA will be closing a small but very valuable aspect of the Canadian capital markets, narrowing the investment options of investors and forcing them to look outside of Canada for such investments. It is our view that it would be in the public interest for Canadian investors to keep their investments closer to home.

Eliminating investment restrictions altogether

Mutual fund rules that restrict the types of investment that may be made by mutual funds skew investment choices that fund managers may make.

Prohibiting certain investment strategies further skews investment choices. While the rationale for doing so is laudable, the effect is that mutual funds and their investment managers must choose from a circumscribed list of investments and strategies. In effect, the regulator is making investment choices on behalf of the consumer. While the benefits of doing so on behalf of retail investors may outweigh the costs, it would be harmful to extend this approach to institutional investors who have the wherewithal and the sophistication to either make their own investment decisions or to retain managers with a demonstrated expertise in the area.

By extending the mutual fund rules to pooled funds, hedge funds and closed-end funds, the CSA is assuming some of the investment decision making authority if the end result is the imposition of investment restrictions or the removal of certain investment options from the menu of choices currently available. We would argue that, without knowing the risk tolerances and needs of each investor, the CSA should not be making such decisions. In particular, institutional investors do not need regulators to make investment decisions for them. Institutional investors typically rely on professional asset managers to make their investment decisions. Such advisors have the proficiency and a demonstrated expertise to make such decisions.

It is our view, therefore, that what is relevant in adopting a regulatory regime is not the nature of the investment product but to whom the product is being offered.

Individual pooled funds and individual hedge funds themselves exist on a very broad continuum and the CSA will do the investing public a great disservice if it assumes that they are all broadly similar to mutual funds and should be regulated in a like manner.

We would, of course, be pleased discuss these issues with you during the course of your deliberations and look forward to reading with interest the outcome of that process. We thank you for the opportunity to make our views known to you.

Yours sincerely,

James D. Sinclair
Vice President & Chief Legal Officer