January 31, 2025

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OSC Consultation Paper 81-737 – Opportunity to Improve Retail Investor Access to Long-Term Assets through Investment Fund Product Structures

I greatly appreciate the opportunity to provide comments on subject consultation.

The proposal attempts to create a quasi-illiquid mutual fund that would provide unsophisticated retail investors access to higher risk illiquid assets that have historically been limited to accredited investors. (individuals who have the wealth to absorb large losses)

The Ontario Long-Term fund (OLTF) would only be sold to Ontario residents. The OSC has proposed a product design that would be run by professionals, allow limited withdrawals and be subject to an annual independent valuation check.

The Proposal is aimed at enhancing the experience of individual investors. The consultation doesn't make its case. Investors will be exposed to risky illiquid assets , their savings locked up for extended periods of time , all the while paying fees to a team that will spend considerable time managing liquidity.

The fees continually eat into the cash reserves that could be used to buy assets. As little as 50% of the fund's cash could be held back to deal with withdrawals instead of investing in assets. If a mismatch occurs, redemptions can be suspended altogether but fees will continue on. In addition to direct asset risks, external forces can cause troubles for the investment- a leapfrog technology, a change in tax rules or govt. policy, or even an increase in tariffs on Canadian exports during the extended lockup period. There would be no way to reduce the damage.

The fund could unwind and sell assets at fire sale prices all the while charging fees. No matter what happens, the only people exposed to losses are investors -everyone else prospers. What part of this scenario is enhancing the investor experience?

For me, the issue is clear. Despite the mutual fund wrapper, the underlying assets involve high risk adventures like private equity, venture capital etc. and serve no purpose to enhance retirement savings.

The need to use this fund to diversify small investor portfolios and potentially gain the premium associated with illiquid assets is questionable. There are an abundance of ways to diversify a portfolio. Furthermore, any premium that might be associated with liquidity will be gobbled up by the fees associated with the complex structure.

The premise that private market investments systematically deliver an illiquidity premium is far from settled. While some academic studies suggest that less liquid assets may command higher expected returns, others have found that any such premium is inconsistent, variable across market cycles, and often eroded by other risk factors. Even if the premium exists, it would only apply to the amount of the fund that is actually invested in illiquid risky assets. The more cash held in reserve, the less premium potential. In addition, because of the mutual fund structure, fund fees constantly eat away at investable reserves and fund returns.

In any event, Canadians indirectly have exposure to illiquid assets via the CPP. Blackrock, a firm that works with the CPPIB, already owns $14 billion in Canadian real estate.

Empirical studies show that, net of fees, private equity frequently underperform public market equivalents. Research from sources such as the SEC, the CFA Institute, and independent academics has raised concerns about whether investors actually receive excess returns commensurate with the risks undertaken. Retail investors, who lack the bargaining power of large institutions to negotiate reduced fees, will likely face even worse net returns.

Private Equity (PE) have achieved some successes but there is a dark side.
"PE *firms have also been accused of lacking ethics, particularly because of how they acquire companies. Commonly, they will use a leveraged buyout to purchase a company. It will invest say 10 per cent of the value of the company and then take out a loan on or leverage the rest of the cost. But the firm isn't taking on the risk itself; it's saddling the company it's purchased with that debt. It then cuts costs to deal with debt, pays itself consultant fees and sells the companies at a profit, often at the expense of its clients and employees. This can become a life-and-death situation, for example, when PE firms purchase long-term care homes. "*
The pitfall of private equity: National Association of Federal Retirees
https://www.federalretirees.ca/en/news-views/news-listing/april/the-pitfalls-of-private-equity#:~:text=Deals%20or%20agreements%20with%20PE,firms%20are%20also%20often%20exorbitant .

In November 2024, Private real estate investor KingSett halted distributions and redemptions on its $1.9-billion flagship fund for one year. This is the kind of event that can stress out small investors long after the illiquidity dream has faded.

Some suggestions

Given the government's determination to proceed with OLTF I offer some ideas to protect retail investors:

Performance of the fund will depend on the individuals managing the money. Their qualifications and experience should be disclosed in the prospectus. Conflicts of interest must also be contained. A Board comprised of a majority of independent directors appears to be the best solution, albeit not without added costs. The fund's marketing, disclosure and business practices should meet enhanced OSC standards. The OSC should be prepared to devote resources to monitoring this aspect of OLTF operations. Other ideas include:

- A plain language prospectus that explains the structure of the fund, fees and risks.
- Forthright retail investor educational materials on investing in OLTF
- Disclosure of Board /manager holdings (or not) in the fund ("skin in the game")
- At least semi-annual independent valuations
- At least 75% invested in illiquid assets
- Periodic liquidity stress testing
- Transparency of valuation methodology
- A digital based system for clients effecting withdrawals
- A behavioural science validated Fund Facts. Report of Fund Performance.
- A cap on fees during the lockup period and reduced fees during redemption freezes
- Redemption available in event of client death or relocation outside of Ontario

Advisors must consider client time horizon, cash flow needs, size of the emergency fund, risk profile, correlated risks, impact on portfolio rebalancing, the attractiveness of the fund, the specific risks of the asset class, investment fund fees, advisor fees and the client's willingness and ability to live with illiquidity, possibly for an extended period of time. And then size their portfolio allocation appropriately to match client KYC objectives**.**

- Professional, experienced advisors with analytical skills
- An enhanced KYP, KYP and suitability determination process
- A behavioural science derived test for client assessing illiquidity tolerance

The normal method of fund compensation is via a trailing commission. This of course creates conflict- of-interest. It is a real question mark because once sold, the lock up period constrains what advice can be provided. Portfolio management is paramount suggesting that an F series of the fund is needed.

Conclusion

It is not clear why the development of a new Category of mutual fund made it on the OSC 2025-26 priorities list. If slick marketing like the *democratization of financ*e is used, retail investors may be seduced into buying into the liquidity principle. This would divert money away from well-regulated markets thereby weakening public markets. Is this a positive development for markets?

Investors should be made fully aware of gating provisions, liquidity rights, and whether it matches their time horizons before they decide to invest in illiquid assets. There's a chance of outperformance but is all the stress worth it?

Recommended Reading

Should investors discount the possibility of an illiquidity premium – potentially significantly? Fiduciary Wealth Partners https://search.app/uFU3ZQ7owVZxUdMb8

Lessons for investors from Walton Capital's woes | Morningstar Canada
https://www.morningstar.ca/ca/news/185708/lessons-for-investors-from-walton-capitals-woes.aspx

Canada's private debt funds face a reckoning after retail investors jolted by redemption freeze: G&M March 2022
https://www.theglobeandmail.com/business/article-canadas-private-debt-funds-face-a-reckoning-after-retail-investors/
How Illiquid Open-End Funds Can Amplify Shocks and Destabilize Asset Prices: IMF
https://www.imf.org/en/Blogs/Articles/2022/10/04/how-illiquid-open-end-funds-can-amplify-shocks-and-destabilize-asset-prices

Private Real Estate Fund Categories: A Risk/Return Assessment |CFA Institute Enterprising Investor
Based on the risk-adjusted performance of all three categories of private real estate funds, investors are paying billions in economically unwarranted fees.
https://blogs.cfainstitute.org/investor/2019/12/12/private-real-estate-fund-categories-a-risk-return-assessment/

Value-Added [private] funds have, on average, generated an [negative] alpha of –3.26%."https://blogs.cfainstitute.org/investor/2019/12/12/private-real-estate-fund-categories-a-risk-return-assessment/

Dangers abound in private equity | Financial Post
https://financialpost.com/investing/dangers-abound-in-private-equity