Regulation of Mortgage Investments: Who has it right - FSCO or the OSC?

By Jonah Bonn

Jonah Bonn
Chief Operating Officer
Ontario Wealth
Management Corportion
www.owemanco.com

In the wake of the 2008 financial crisis many Canadians turned to alternative investment strategies, and more specifically private mortgage investments, which offered attractive risk-adjusted returns and a low correlation to public financial markets.

The private mortgage market has become a multi-billion dollar industry in Canada and is characterized by a wide range of activity ranging from individuals or syndicates of investors funding specific mortgages to professionally managed mortgage funds that pool investor capital.

The concept of a mortgage is relatively simple. It is the conveyance of an interest in real property through registration of a charge on title in favour of a creditor. A mortgage is, by law, a security placed on property. It would follow that regulation of mortgage investments would be the domain of the Ontario Securities Commission (**OSC**) and the other provincial securities regulators, but this is not always the case.

The OSC's role is limited to the regulation of pooled mortgage investment entities (**MIEs**), more commonly referred to as mortgage funds. Mortgage syndication is considered a mortgage brokering activity and as such it is regulated by the Financial Services Commission of Ontario (**FSCO**) through the Mortgage Brokerages Lenders and Administrators Act, 2006 (**MBLAA**) which came into effect on July 1, 2008. A person or company that is licensed under the MBLAA is exempt from the requirement to be licensed as a dealer under the Securities Act (Ontario) and to file a prospectus when trading in syndicated mortgages.

As I was writing this article I received an email from a mortgage broker with the subject line: "RRSP-Eligible

Alternative Investment Opportunity". While my index finger was twitching to strike the delete button, I decided to open the message. Here is what I read:

"*Given the challenges of identifying investments in this marketplace that produce rates of return that can make a substantial difference in helping you reach your retirement goals, I would like to bring an investment opportunity that may be of interest to you. I've been able to structure a syndicated second construction mortgage investment that is offering a 14% per annum rate of return. The total investment amount for the project is $810,000, structured through a syndicated mortgage, with the minimum investment being $25,000*."

Ontario Regulation 188/08 under the MBLAA sets out the disclosure requirements with respect to a mortgage that a brokerage presents for the consideration of an investor. The most significant of these requirements is a completed disclosure form, in a form approved by the Superintendent, signed by a broker. The disclosure requirements do not apply if the lender or investor is a member of a designated class of lenders and investors. The "designated class" term essentially describes a set of criteria that mimic those of an "accredited investor".

FSCO has also produced a presentation entitled "Duty to Ensure Product Suitability and Duty to Disclose Risks" which provides that the mortgage brokerage must "take reasonable steps to present a suitable mortgage product, having regard to the needs and circumstances of the borrower, lender or investor and to disclose material risks in writing, using plain language that is brief and clear". These concepts are also embedded in a series of compliance checklists that FSCO has created to assist mortgage brokerages in achieving the mandated standards of practice under the MBLAA.

This would seem to be a reasonable approach as it gives the brokerage the latitude to make a judgement as to whether a syndicated mortgage investment meets the needs and circumstances of the investor:

- There is no requirement for the investor to be accredited or part of a designated class.
- There is no minimum investment amount.
- And there are no rules or guideline pertaining to concentration risk.

Is FSCO's approach to regulating syndicated mortgage investments far too lax?

Let's refer back to the example above of the 14% second mortgage investment opportunity on the construction project. An interesting twist on this transaction is that the first mortgage on this project was not in favour of a bank, but rather a private mortgage investment corporation (**MIC**) which is a form of MIE that raises money pursuant to an Offering Memorandum through an EMD.

What is wrong with this scenario? Even though the syndicated second mortgage is objectively a riskier investment than the 1st priority charge held by the MIC, the EMD that sells units in the MIC is held to a much higher standard by the OSC than the mortgage brokerage that raises money for the subordinated position debt under FSCO's regulations. The EMD cannot offer a $25,000 investment in the MIC to an investor who is not accredited. The mortgage brokerage; however, can offer a $25,000 syndicated share of a mortgage to an investor who is not accredited.

Mortgage investment products are unfortunately not subject to a uniform regulatory regime

Let's explore this further. Let's say that a 55 year-old investor with a net financial worth of $850,000 and net income before taxes in each of the last 2 years of $175,000 has invested in syndicated mortgages for many years, but has recently suffered a loss of capital on a syndicated loan and would now like to invest in a fund. He has been referred by a friend to a local MIC that manages $75 million that is invested in first mortgages. The return to investors has been at least 7.5% in each of the last 3 years. He meets with the EMD to discuss a $100,000 subscription in the MIC. He is comforted by the fact that he will be investing in a pool of mortgages. But, there is a problem. The EMD will not accept a subscription from the investor as he is not accredited based on income thresholds and he is not ready to commit $150,000 to qualify under the minimum amount exemption. The investor leaves the EMD's office but later the same day he coincidentally hears about a syndicated mortgage investment opportunity on a local construction project that a mortgage brokerage is arranging. The interest rate is 14%. He gathers some information on the transaction and based on some limited due diligence he decides to invest $100,000 in this deal, notwithstanding his recent loss with a syndicated product. While the EMD adhered to securities law by turning away the non-accredited investor, the mortgage

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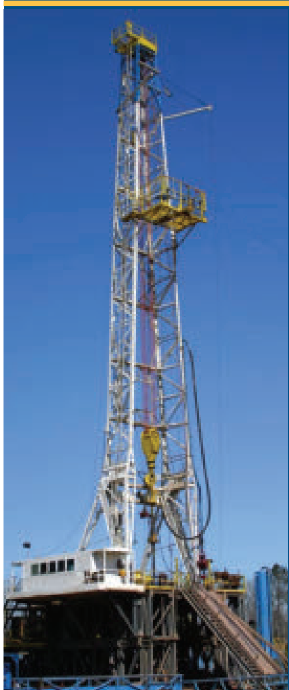

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brokerage was able to accept the investor and made a subjective determination as to the suitability of the investment.

The reality is that our 55-year old investor's objective is security of capital and a stable stream of interest income. The MIC was the ideal investment vehicle. The 14% second mortgage is far too aggressive and could put the investor's capital in jeopardy – but that was the end result for this investor.

It is evident that FSCO and the OSC do not have an open dialogue on how to effectively regulate the mortgage investment industry. Consequently there is a dangerous void in consumer protection. Investors who do not clear the significant hurdle to invest in a pooled MIE and who still want to participate in a private mortgage investment are only left with one option: a syndicated mortgage. This is a rather unfortunate outcome as a pooled MIE has certain fundamental advantages over syndicated mortgages:

a. The opportunity to participate in a diversified pool of mortgages that are managed by a professional team;
b. Insulation from the impact of default of any one particular mortgage; and
c. Consistent stream of income - unlike a syndicated mortgage, capital is not returned to the investor each time a mortgage is discharged.

Mortgage syndication existed for many years before the popularity of private mortgage funds. There are some highly professional and experienced mortgage syndicators who are able to structure investments that are entirely suitable for those with a low risk tolerance. There are also some prominent syndicated mortgage promoters who structure complex investments that are secured by subordinated charges on large development projects. These products, some of which offer deferred fees to investors are entirely inappropriate for anyone other than accredited investors, yet they are not subject to oversight by the OSC.

Who has it right? FSCO or the OSC? I would submit that they both have it wrong.

The OSC has overlaid the regulatory environment of exempt market products on pooled MIEs. While I believe that the OSC had the best of intentions in attempting to ensure consumer protection they have inadvertently driven non-accredited investors to riskier syndicated mortgage investments when, in fact, investment in pooled MIEs would be a preferable outcome. Accordingly a lowering of the minimum amount exemption for investment in pooled MIEs would, in fact, provide enhanced consumer protection. It would be an understatement to suggest that such an amendment would be an uphill battle but I firmly believe that attention should be drawn to this issue.

As for FSCO, I do not believe they have paid attention to the plethora of recently created syndicated mortgage products that are magnitudes greater in complexity and risk than those that existed just 5 years ago. There is no doubt that regulation of all syndicated mortgage products by the OSC would be an undesirable outcome. The mortgage industry was successful in staving off such an attempt after National Instrument 45-106 was released for public comment in December 2004. However, the time has come for FSCO, the OSC and industry stakeholders to have a frank discussion about how they can cooperate to achieve a level playing field with respect to the regulation of the diverse array of mortgage investment products.

For more information contact:
Jonah Bonn
jbonn@owemanco.com | 416.256.1555