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Are you using the syndicated mortgage exemption and find the related compliance obligations cumbersome?

Are you contemplating creating your own pool by setting up a mortgage investment corporation?

In this publication we discuss how a syndicated mortgage is treated under securities legislation, and what to keep in mind when structuring a mortgage investment corporation, such as dealer registration and other obligations.

What Are Mortgage Investment Corporations?

Lenders have advanced money on the security of real property for as long as anyone can remember. And despite the endless varieties and permutations of investment vehicles which slice, dice and repackage (securitize) mortgages in ever more complex structures, the mortgage business itself is not that difficult to understand. It is a “spread” business; to make money, you have to lend your capital out at a higher rate than you pay for access to that capital (your spread has to cover the cost of some defaults, plus the cost of administration and have something left over).

The vast majority of mortgage financing in Canada, both residential and commercial, is provided by regulated financial institutions (FIs): banks, trust companies, insurance companies, credit unions and pension funds. But there is a small space for private activity, for non-bank lenders to provide mortgage financing where the funding available from banks and other FIs is either not enough, or is not available on terms that meet the needs of the borrowers.

This is the space that mortgage investment entities (MIEs), including mortgage investment corporations, occupy. A mortgage investment corporation (commonly referred to as a MIC) can be thought of as an alternative private lender providing mortgage financing. A MIC pools capital raised from investors and uses that capital to provide loans to borrowers who, generally speaking, are unable to access conventional mortgage financing. The market for first mortgages on residential property is highly competitive and characterized by thin margins. Lack of profitability is exacerbated in a low interest rate environment. By contrast, many MICs, typically operating in the space vacated or unoccupied by conventional lenders, are able to charge borrowers a higher rate of interest, and thus produce an attractive yield for their investors, while taking on a different risk profile.

How Do They Work?

A MIC offers the benefits of pooling capital from many investors, where risk is reduced through diversification. Instead of a private lender being exposed to the credit risk of a single mortgage, a MIC investor spreads risk out over a portfolio of mortgages (different borrowers and different properties in different geographical locations). The mortgage portfolio can be managed and maturities staggered so that a steady income stream is produced and capital is more continuously utilized. If the MIC is open-ended, then investors enjoy liquidity to greater or lesser degrees, through requesting that their investment be redeemed.

A MIC is a flow-through vehicle which meets certain conditions prescribed under the *Income Tax Act* (Tax Act). A MIC must be a Canadian business corporation. A corporation that qualifies as a MIC can pass income through to investors without attracting tax at the level of the corporation itself. Specifically, as long as a corporation is a MIC for purposes of the Tax Act, it is entitled to deduct, in computing its income for a taxation year, taxable dividends paid to shareholders during the year. A MIC is also allowed to deduct half of any capital gains dividends paid during the year.

Since the focus of almost all MICs is to flow through ordinary-interest-income, we will leave the capital gains aside for now. By contrast, a corporation that is not a MIC would be liable to pay tax on its interest income and could only pay dividends to its shareholders on an after-tax basis.

How Do You Qualify as a MIC?

There are a number of conditions that a corporation must meet to qualify as a MIC. The key conditions are:

Passive Investing	The corporation's only undertaking can be the investing of its funds. A MIC cannot be actively managing or developing real property.
Prohibition on Foreign Investments	The debts must be secured by real property located within Canada. The rule is more complex, but the key constraint is that the real property that is the subject of the mortgage must be situated in Canada.
Not Closely Held or Controlled	The corporation must have at least 20 shareholders. No one shareholder, together with their related persons, may own at any time, directly or indirectly, more than 25% of the issued shares of any class or series. For this test, "related persons" includes a corporation and the persons who control the corporation (all persons within the control group), as well as an individual and the individual's spouse, common-law partner, or minor child. There are special rules for counting shareholders that are registered pension plans or deferred profit sharing plans.
Focus on Housing	The corporation is required to hold at least 50% of its assets in the form of money or debts secured on residential property. Again, the rule is more complex, but this is the gist. The original purpose of the legislation was to foster alternative sources of mortgage financing so that housing would be built and could be purchased even where conventional financing was difficult to secure.
Prescribed Ratios	In addition to the 50% asset test referred to above, the corporation must maintain a prescribed debt to equity ratio and must limit holdings in real property to under 25% of the cost amount of all of its property.

A common form of MIC is a business corporation with one class of common shares and one or more classes of non-voting, redeemable, retractable preferred shares. The common shares carry the right to vote and are held by persons who are related to, or friendly with, the manager of the MIC. The preferred shares are offered to passive investors.

A significant benefit of qualifying as a MIC is that the shares can be purchased by RRSPs, RRIFs and other registered plans.

How Are They Regulated?

Although a mortgage is a debt instrument which is a "security", trading in mortgages is generally carved out of securities legislation. In Ontario, such trading is regulated under another statute, the *Mortgage Brokerages, Lenders and Administrators Act* (MBLAA). However, trading in the shares or other securities issued by MICs or other MIEs is not trading in mortgages, and so the carve-out is not applicable. There is an internal logic to this – when an investor invests in a mortgage, the investor acquires an interest in the real property, and the transactions are conducted in compliance with the MBLAA. In contrast, when an investor purchases a share of a MIC, the investor's rights are as a shareholder, with no direct claim to the underlying mortgages.

Although there are a few public MICs, the great majority of MICs, at least in terms of sheer numbers, offer their shares on a private placement basis. Each situation will differ, but it is fair to say that securities regulators in Ontario will generally take the view that any widespread distribution of MIC shares trips the business trigger. In other words, a MIC which has an offering memorandum (OM), a marketing deck and fact sheet, is highly likely to be required to distribute its securities through a registered dealer. That dealer can be an IROC dealer or an exempt market dealer (EMD), and it can be an arms-length third party distributor, or the manager of the MIC itself or other affiliated entity.

What About IFM / PM Registration?

This is another unfortunate instance where there is a glaring lack of harmonization across Canada. In Ontario, as long as a MIC has certain characteristics, it is not considered to be an investment fund. Staff of the Ontario Securities Commission [have stated](#) that a MIE is not a “non-redeemable investment fund” (NRIF) and should not structure itself so as to fall within the technical definition of a NRIF. The Canadian Securities Administrators (CSA) have issued [guidance](#) under which, with one important exception, “pooled MIEs” including MICs, are not considered to be investment funds. Consequently, no investment fund manager (IFM) registration is required for a manager or operator of a MIC. Although the CSA Staff Notice is slightly less ambiguous regarding portfolio manager (PM) registration, in practice, few (if any) managers of MICs have been required to register as PMs in order to manage the mortgage portfolio of their MICs.

Alberta

Alberta differs from the other jurisdictions in that it takes the view that managing a pooled MIE does indeed trigger a registration requirement as an IFM. Furthermore, anyone that advises the pooled MIE is considered to be carrying on registerable activity as an adviser, and will have to be registered in such a capacity, or exempted on terms and conditions. Typically, the manager of an Alberta MIE is registered as an IFM and also registered as a restricted adviser, limited to advising in respect of the pooled MIE.

Further complicating matters, the Alberta authorities determined that the distribution of securities of MIEs in reliance on the OM exemption should continue to be permitted. Therefore, there is a “[designation order](#)” under which certain Alberta MIEs are designated *not to be* a NRIF except with respect to the registration requirement. By not being a NRIF, a MIC is able to make use of the OM exemption to distribute securities to non-accredited investors without having to file a prospectus.¹

British Columbia

British Columbia is an outlier when it comes to distributions of securities of MIEs. As stated, there is general consensus among Canadian securities regulators that the distribution of securities of MIEs (and MICs) should be carried out by registrants: either EMDs or IIROC dealers. [The exception is British Columbia](#). The British Columbia Securities Commission considers that it is “not contrary to the public interest” that MIEs be able to distribute their securities to the public without registration as a dealer or through intermediation of a dealer, subject to certain conditions. In addition, in British Columbia, the OM prospectus exemption is less restrictive than the Alberta model. A person wishing to offer securities of an MIE in British Columbia (at least for the time being) essentially need only prepare an OM. The net result is that there is a materially different regulatory regime for MIEs in Canada’s westernmost province.

Are Syndicated Mortgages “Securities”?

As stated, mortgages are indeed “securities”. A syndicated mortgage is in principle no different from any other form of debt syndication. A group of lenders agrees to advance an aggregate sum to the borrower in defined proportions. In Ontario, a syndicated mortgage is still a mortgage and carved-out from the application of securities legislation. However, in Alberta, British Columbia, Manitoba, Québec and Saskatchewan, there is no carve-out and securities legislation will apply to trades in syndicated mortgages.

Can Securities of MICs be Sold by an Offering Memorandum?

MIC securities are generally able to be distributed under the OM exemption. As discussed above, although most MICs feature the ability to redeem shares on a regular basis, they are not considered to be investment funds. In certain jurisdictions, the OM exemption is not available to investment funds unless they are already public (reporting issuers). However, since regulators have expressed the view that MICs are not investment funds, the restriction that prohibits investment funds from using the OM exemption will not apply.

¹ The full title of the designation order: Certain mortgage investment entities designated not to be non-redeemable investment funds (except for registration), 2014 ABASC 370 Date: 2014/09/22

Where Can I Learn More?

The regulatory rules that apply to the operation and distribution of securities of MIEs, MICs and syndicated mortgages are complex and characterized by an unusual degree of inconsistency across jurisdictions. We cannot always accurately predict what regulators will do, but we can assist in helping MIEs to understand the regulatory regime as it applies today and what has happened or been announced to date.

AUM Law has experience in the establishment and operation of MIEs, including MICs, and the distribution of their securities. If you have questions you would like to ask about mortgage investing and mortgage entities, please [contact us](#).

This nutshell is an overview only and it does not constitute legal advice. It is not intended to be a complete statement of the law or an opinion on any matter. No one should act upon the information in this nutshell without a thorough examination of the law as applied to the facts of a specific situation.

