

# Mortgage Investment Corporations



## In a Nutshell



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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?**

**Are you concerned about the proposed amendments to the syndicated mortgage regime?**

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 Entities (MIEs) and Mortgage Investment Corporations (MICs)?**

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 that slice, dice and repackage (securitize) mortgages in ever more complex structures, the mortgage business itself is not that hard 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 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 (MICs), occupy. An MIE can be thought of as an alternative private lender that provides mortgage financing. An MIE 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 MIEs, typically operating in the space 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.

With respect to terminology, a MIC is a sub-category of an MIE that meets certain criteria in the Income Tax Act which we discuss in more detail below. So all MICs are MIEs but not all MIEs are MICs.

However, the industry commonly uses the term MIC, whereas MIE is the term often used by financial sector regulators. Accordingly, references in this document to MIEs are in the context of statements made by financial sector regulators. Otherwise we use the term MIC.

## How Do MICs 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 corporation that is a MIC throughout a tax year is a flow-through vehicle in that it 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 throughout the applicable taxation year, it is entitled to deduct, in computing its income for a taxation year, taxable dividends paid to shareholders during the year (such dividends are required to be included in shareholders' income as interest). 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 will be liable to pay tax on its interest income and can only pay dividends to its shareholders on an after-tax basis.

## How Do You Qualify as a MIC for Tax Purposes?

There are a number of conditions that a corporation must meet to qualify as a MIC throughout a taxation year. The key conditions that must be satisfied throughout the applicable taxation year are:

<b><i>Residency</i></b>	The corporation must be a Canadian corporation
<b><i>Passive Investing</i></b>	The corporation's only undertaking is the investing of its funds. A MIC cannot be actively managing or developing real property.
<b><i>Prohibition on Foreign Investments</i></b>	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.
<b><i>Not Closely Held or Controlled</i></b>	The corporation must have at least 20 shareholders. No one shareholder, together with related persons, may own at any time, directly or indirectly, more than 25% of the issued shares of any class or series of the corporation. 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.
<b><i>Focus on Housing</i></b>	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 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 generally be purchased by Registered Retirement Savings Plans (RRSPs), Registered Retirement Income Funds (RRIFs) and other registered plans.

## **How Are MICs Regulated by Financial Sector Regulators?**

Generally, for businesses trading or advising in securities, registration with a securities regulator will likely be required. Firms must register with a securities regulator if the firm trips the “business trigger” for registration, meaning it is in the business of trading in, or advising on securities. There is a different registration trigger for investment fund managers (IFM). The registration requirement for an investment fund manager turns on whether the firm directs the business, operations or affairs of an investment fund. With respect to prospectuses, securities offered to the public generally must be offered under a prospectus. However, there are many exemptions that allow securities to be offered without a prospectus.

Although a mortgage is a debt instrument that is a “security”, trading in mortgages generally is carved out of securities legislation. In Ontario, such trading is regulated by the *Mortgage Brokerages, Lenders and Administrators Act* ([MBLAA](#)), which is administered by the Financial Services Commission of Ontario (FSCO). 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. Whether a firm needs to register with a securities commission will differ depending on its circumstance, but we believe that the Ontario Securities Commission (OSC) generally will take the view that any widespread distribution of MIC shares trips the business trigger. In other words, a MIC that 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 IIROC dealer (for public or private MICs) or an exempt market dealer (EMD) (for private MICs), and it can be an arm’s-length third party distributor or the manager of the MIC itself or other affiliated entity. Specifically, in February 2016, the [OSC warned](#) the industry that businesses involving trading in securities such as units or common shares of MIEs may require registration with the OSC in addition to registration with FSCO.

## **What about IFM / PM Registration?**

This is an 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 OSC [have stated](#) that an 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 IFM registration is generally required for a manager or operator of an MIE (except, as noted below, in

Alberta). Although the CSA guidance is slightly less ambiguous regarding portfolio manager (PM) registration, in practice, few (if any) managers of MIEs have been required to register as PMs in order to manage the mortgage portfolio of their MIEs.

### **Alberta - Investment Fund Manager and Portfolio Manager Registrations**

Alberta differs from the other jurisdictions in that it takes the view that managing a pooled MIE does indeed trigger a requirement to register as an IFM. Furthermore, anyone that advises the pooled MIE is considered to be carrying on registrable 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. Dealer registration is required in Alberta, like all other jurisdictions (except, as noted below, in British Columbia).

As well, the Alberta authorities have determined that the distribution of MIEs' securities in reliance on the OM exemption (for the distribution of securities without a prospectus) is permitted. This is set out in a "[designation order](#)"<sup>1</sup> under which certain MIEs operating in Alberta are designated *not to be* NRIFs. An MIE that fits within the designation order can use the OM exemption to sell securities to non-accredited investors without having to file a prospectus with the regulator and provide that prospectus to investors.

### **British Columbia – Dealer Registration**

British Columbia is an outlier when it comes to distributions of MIE securities and the dealer registration requirement. As stated, there is general consensus among most Canadian securities regulators that the distribution of securities of MIEs (including 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 and not additional continuous disclosure obligations as they would in some other jurisdictions. The net result is that there is a materially different regulatory regime for MIEs in Canada's westernmost province.

## **Are Syndicated Mortgages "Securities"?**

As we mentioned earlier, 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 in connection with dealer registration. However, in Alberta, British Columbia, Manitoba, Québec and Saskatchewan, there is no carve-out and securities legislation does apply to trades in syndicated mortgages.

In the Ontario provincial budget of 2017, the government stated that it planned to transfer regulatory oversight of syndicated mortgage investments from FSCO to the OSC. In the meantime, it has [amended Regulation 188/08 Mortgage Brokerages: Standards of Practice](#) so that brokerages which deal with non-qualified, syndicated mortgage transactions will have to meet expanded requirements beginning on July 1, 2018.

On March 8, 2018 the Canadian Securities Administrators published [proposed amendments to National Instrument 45-106 Prospectus Exemptions and National Instrument 31-103 Registration Requirements, Exemptions and Ongoing Registrant Obligations](#) to, among other things, remove the current prospectus and registration exemptions for syndicated mortgages that are currently available

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<sup>1</sup> The full title of the designation order is *Certain mortgage investment entities designated not to be non-redeemable investment funds (except for registration)*, 2014 ABASC 370 Date: 20140922

in Newfoundland and Labrador, the Northwest Territories, Nova Scotia, Nunavut, Ontario, Prince Edward Island and Yukon. This will bring the regulatory framework in these jurisdictions into alignment with the rest of Canada. For more information on the proposed changes to the regulation of syndicated mortgages see our recent [bulletin](#).

### Can Securities of MICs be Sold by an Offering Memorandum?

Generally, MIC securities can 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 should not apply.

### 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 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.



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