

FAIR

Canadian Foundation *for*
Advancement *of* Investor Rights
Fondation canadienne *pour* l'avancement
des droits *des* investisseurs

June 13, 2018

Alberta Securities Commission
Autorité des marchés financiers
British Columbia Securities Commission
Financial and Consumer Affairs Authority of Saskatchewan
Financial and Consumer Services Commission (New Brunswick)
Manitoba Securities Commission
Nova Scotia securities Commission
Nunavut Securities Office
Office of the Superintendent of Securities, Newfoundland and Labrador
Office of the Superintendent of Securities, Northwest Territories
Office of the Yukon superintendent of Securities
Ontario Securities Commission
Superintendent of Securities, Department of Justice and Public Safety, Prince Edward Island

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RE: CSA Notice and Request for Comment on Proposed Amendments to National Instrument 45-106 Prospectus Exemptions and National Instrument 31-103 Registration Requirements, Exemptions and Ongoing Registrant Obligations relating to Syndicated Mortgages and Proposed Changes to Companion Policy 45-106CP Prospectus Exemptions

FAIR Canada is pleased to offer comments on the CSA Notice and Request for Comment (the "Consultation

Document”) on Proposed Amendments to National Instrument 45-106 Prospectus Exemptions and National Instrument 31-103 Registration Requirements, Exemptions and Ongoing Registrant Obligations relating to Syndicated Mortgages and Proposed Changes to Companion Policy 45-106CP Prospectus Exemptions (hereinafter the “Proposed Amendments”).

FAIR Canada is a national, charitable organization dedicated to putting investors first. As a voice for Canadian investors, FAIR Canada is committed to advocating for stronger investor protections in securities regulation. Visit www.faircanada.ca for more information.

1. General Comments

- 1.1. FAIR Canada welcomes the introduction of increased investor protections related to the distribution of syndicated mortgages and increasing the level of harmonization regarding the regulatory framework for syndicated mortgages across all CSA jurisdictions.
- 1.2. We believe that the Proposed Amendments are a step in the right direction and we provide recommendations to ensure adequate investor protections relating to syndicated mortgage investments.
- 1.3. In the last few years FAIR Canada has become seriously concerned about the increasing number of frauds and misrepresentations involving the sale by mortgage brokers of syndicated mortgage investments to retail investors, which were sold on the basis that they were safe investments, secured against real property, low- or risk-free and paid high annual fixed rates of interest (8 or 10% and often on a quarterly basis). We urged that the regulation of these investments in Ontario be transferred from the Financial Services Commission of Ontario (“FSCO”) to the Ontario Securities Commission (“OSC”)¹ and were pleased by the recommendation of the Expert Advisory Panel Final Report on the Mandates of FSCO, The Financial Services Tribunal and the Deposit Insurance Corporation of Ontario that syndicated mortgages be regulated as securities,² and the Ontario Government’s later announcement that regulation of syndicated mortgages would be transferred to the OSC.³
- 1.4. In addition, and more broadly, FAIR Canada has called for risks to investors from real estate investments to be a specific focus of the OSC and other regulators across Canada in order to develop appropriate mechanisms to protect investors and close regulatory gaps.⁴
- 1.5. Several investors have contacted FAIR Canada in search of assistance when the interest

¹ FAIR Canada Comments on Preliminary Position Paper on the Review of Mandate of FSCO (14 December 2015), online: <http://faircanada.ca/wp-content/uploads/2015/12/151214-Final-Letter-to-Expert-Panel-on-Preliminary-Panel-Recommendations_signed1.pdf> at 7.

² Review of the Mandates of the Financial Services Commission of Ontario, Financial Services Tribunal and the Deposit Insurance Corporation of Ontario (31 March 2016), online: <<https://www.fin.gov.on.ca/en/consultations/fSCO-dico/mandate-review-final-report.pdf>> at 27.

³ 2017 Ontario Budget, online: <<https://www.fin.gov.on.ca/en/budget/ontariobudgets/2017/ch2.html#ch21>>.

⁴ FAIR Canada Comments on Ontario Securities Commission Notice 11-777 – Statement of Priorities (23 May 2017), online: <<http://faircanada.ca/wp-content/uploads/2017/05/170523-FAIR-Canada-Comments-on-OSC-Statement-of-Priorities-2017-2018-Final.pdf>> at 10.

payments on their syndicated mortgage investments have suddenly stopped and their attempts to make contact to get their money back end with no success. Several media articles have highlighted significant risks in this area⁵ for retail investors and the lack of effective oversight and enforcement.⁶ Reforms to how syndicated mortgages are distributed and regulated are, therefore, much needed.

- 1.6. FAIR Canada is also concerned about the regulatory framework for mortgage investment corporations (“MICs”), and the investor losses and risks associated with MICs that have been highlighted in media reports⁷ and an independent report prepared by Fundamental Research Corp. in 2015 for the Canada Mortgage and Housing Corporation (CMHC) (“Independent Report”).⁸ Adequacy of the existing mortgage investment regulatory framework in the various provinces and territories needs to be examined, including the repeal of BC Instrument 32-517 which permits an exemption from the dealer registration requirement in BC for securities of mortgage investment entities so long as the person is not registered and does not advise, recommend or represent that the security is suitable for the purchaser.
- 1.7. The amount of money invested in mortgage investments is significant. While there does not appear to be accurate data on the mortgage investment industry in Canada, it is estimated to be up to be as high as \$26 billion⁹. The amount of money invested in syndicated mortgages has risen considerably, going from \$1.5 billion in 2009 to \$4 billion in 2014¹⁰, and to \$6.6 billion in 2016 in the Province of Ontario alone¹¹. The value of mortgages funded by MICs grew by 42 per cent from 2014 to 2016 to US\$4.4 billion. The Independent Report states that their database of 72 MICs held at least \$6.7 billion in mortgages as of December 31, 2014 or June 30, 2015.¹² According to estimates, there are 200-300 MICs operating in Canada. There is no data provided in the Consultation Document to indicate the amount of money involved in these

⁵ Dana Flavelle, “The high-risk world of syndicated mortgages” *Toronto Star* (29 April 2016), online: <<https://www.thestar.com/business/2016/04/29/the-high-risk-world-of-syndicated-mortgages.html>>; Janet McFarland, “Ontario regulator revokes broker licenses in syndicated mortgage case” *The Globe and Mail* (31 January 2018), online: <<https://www.theglobeandmail.com/report-on-business/ontario-regulator-revokes-broker-licenses-in-syndicated-mortgage-case/article37802438/>>

⁶ Matt Scuffham, “Special Report: Canada regulator ignored warnings on risky mortgage investments” *Reuters* (30 November 2017), online: <<https://ca.reuters.com/article/domesticNews/idCAKBN1DU1YP-OCADN>>.

⁷ Tamsin McMahan and Tim Kiladze, “How to lose money in real estate” *The Globe and Mail* (12 November 2017), online: <<https://www.theglobeandmail.com/report-on-business/mortgage-investment-corporation-canada-real-estate/article34526694/?1493592020079>>.

⁸ Fundamental Research Corp. “Growth and Risk Profile of the Unregulated Mortgage Lending Sector”, prepared for Canada Mortgage and Housing Corporation (CMHC) (9 October 2015), online: ftp://ftp.cmhc-schl.gc.ca/chic-ccd/Research_Reports-Rapports_de_recherche/eng_unilingual/RR_Growth_w.pdf [“Independent Report”].

⁹ Tamsin McMahan and Tim Kiladze, “How to lose money in real estate” *The Globe and Mail* (12 November 2017), online: <<https://www.theglobeandmail.com/report-on-business/mortgage-investment-corporation-canada-real-estate/article34526694/?1493592020079>>.

¹⁰ Dana Flavelle, “The high-risk world of syndicated mortgages” *Toronto Star* (29 April 2016), online: <<https://www.thestar.com/business/2016/04/29/the-high-risk-world-of-syndicated-mortgages.html>>

¹¹ Alexandra Posadzki and James Bradshaw, “OSC flags concerns about growth of alternative mortgage lending” *The Globe and Mail* (15 May 2018), online: <<https://www.theglobeandmail.com/business/article-osc-flags-concerns-about-growth-of-alternative-mortgage-lending/>>.

¹² Independent Report at 7.

investments throughout Canada.

2. Specific Comments

Mortgage Exemptions

- 2.1. We welcome the removal of prospectus and registration exemptions under sections 2.36 of NI 45-106 and 8.12 of NI 31-103 for securities that are syndicated mortgages (the “Mortgage Exemptions”) in Ontario, Newfoundland and Labrador, the Northwest Territories, Nova Scotia, Nunavut, Prince Edward Island and Yukon. This harmonizes those jurisdictions with the rest of Canada. In light of the experience of retail investors who have been sold syndicated mortgages, it is essential that these investments be regulated like any other securities investment.
- 2.2. As a result of these changes, exempt syndicated mortgages will have to be sold pursuant to other prospectus exemptions. The Consultation Document indicates that they would most likely be offered primarily under the Accredited Investor Exemption, the OM Exemption or the Family, Friends and Business Associates (“FFBA”) Exemption.
- 2.3. FAIR Canada believes that measures need to be taken to compel compliance with the existing rules that govern prospectus exemptions, as non-compliance is a serious and persistent problem. Non-compliance harms investors and weakens confidence in the exempt market and our capital markets generally. Regulatory resources, including enforcement, must be deployed and applied to ensure compliance with existing rules – there is little point in having rules if they are consistently disregarded. In addition, simply placing a heavy emphasis on disclosure cannot provide adequate protection to individual investors.¹³
- 2.4. Recent reports by CSA members summarizing compliance reviews have emphasized that non-compliance in the exempt market continues to be commonplace. For example, the Alberta Securities Commission’s Notice 33-705 *Exempt Market Dealer Sweep* from May 2017 provided results from a sweep of exempt market dealers identifying numerous compliance deficiencies.¹⁴ The OSC also produced a report in July 2017 identifying “current trends in deficiencies from compliance reviews” of exempt market dealers.¹⁵ A summary of the deficiencies identified in these two reports can be found in our letter to the CSA dated September 8, 2017.¹⁶ We do not

¹³ Behavioural economics research indicates that disclosure is ineffective and may result in unintended and even perverse consequences. We urge the utilization of other measures to ensure adequate investor protection.

¹⁴ Alberta Securities Commission Notice 33-705 *Exempt Market Dealer Sweep* (10 May 2017), online: <http://www.albertasecurities.com/Regulatory%20Instruments/5331553%20_%20EMD_Project_Staff_Notice%2033-705.pdf> . Out of 69 firms that were reviewed by ASC staff (of which 66 were completed), regulatory action or other steps were taken in 26 cases. In addition, “[ASC staff] identified deficiencies in compliance with regulatory obligations in all areas tested” at 3.

¹⁵ OSC Staff Notice 33-748 *Annual Summary Report for Dealers, Advisers and Investment Fund Managers* (11 July 2017). The British Columbia Securities Commission also produced a report in June 2014, *Private Placement Review Program*. The Report stated: “staff found that companies have a poor understanding of the exemptions, do not keep adequate records of their private placements, and use professional advisors who do not have specialized knowledge of the securities industry and the private placement market” at 6.

¹⁶ FAIR Canada Comments on Proposed Amendments to National Instrument 45-106 Prospectus Exemptions relating to Reports of Exempt Distribution (8 September 2017), online: <<http://faircanada.ca/wp-content/uploads/2017/09/FAIR-Canada-Submission-re-NI-45-106-Prospectus-Exemptions-Final-Sept-8-2017.pdf>>.

have confidence that the repeated compliance problems that have been previously identified in the exempt market have been addressed.

- 2.5. **FAIR Canada recommends that securities regulators review a certain percentage of Offering Memorandum involving the distribution of syndicated mortgages to ensure that market participants are complying with their disclosure obligations. We believe this would improve the level of compliance and would also deter fraudulent activity.**
- 2.6. Many retail investors are unable to understand the disclosure that is provided to them, so the provision of an Offering Memorandum, even if fully compliant, may not lead to an informed investment decision. Many retail investors lack sufficient financial literacy to be proficient in financial matters (that is, to understand an investment's costs, risks and features) and many do not read or pay sufficient attention to the disclosure provided, often because they simply rely on their advisor to tell them what they should know or because the sales process encourages them to regard disclosure as an inconsequential formality. While improved, plain language disclosure is beneficial, it cannot be viewed in isolation from the behavioural effects of the sales process. It also cannot be viewed as an antidote to incentives for mis-selling that exist.
- 2.7. **FAIR Canada recommends that securities regulators review the efficacy of the existing risk acknowledgement forms by applying behavioural insights.** Many behavioural biases, including confirmation bias, affect investor decision-making and the design and timing of information profoundly affects its impact and effect. We have seen no evidence that these considerations factored into the design of the risk acknowledgement form.
- 2.8. **FAIR Canada also recommends that CSA members gather information on whether the risk acknowledgement form actually can, and does, help investors make better investment decisions.** To that end, FAIR Canada recommends that CSA members: (a) obtain information on the investor experience with risk acknowledgement forms in the exempt market, and in particular with the OM Exemption; (b) publish information disclosing the effectiveness of the use of such forms in light of existing complaints, investigations and enforcement proceedings where such forms were used; and (c) conduct investor testing on the risk acknowledgement form to see whether it actually helps investors make better investment decisions and whether it can be improved upon or whether other, stronger investor protection measures are warranted.

Changes to the OM Exemption

Appraisals

- 2.9. The Proposed Amendments would require issuers to deliver an appraisal of the current fair market value of the property subject to the syndicated mortgage to prospective purchasers under the OM Exemption. This appraisal would be prepared by a qualified appraiser who is independent of the issuer. Another value of the property (expected market value on completion of the development for example) could be disclosed but would be required to have a reasonable basis and the issuer would be required to disclose the material factors and assumptions underlying that value and whether it was prepared by an independent, qualified appraiser.

- 2.10. **FAIR Canada recommends that the rules prohibit and projected future market value of the property (such as expected market value on completion) whether it is prepared by an independent appraiser or not. To permit this would be similar to permitting non-GAAP financial measures in financial reporting. Therefore we recommend that subsection 19.3 of section 2.9 of NI 45-106 be removed. A future expected value will undermine the efficacy of the current fair market value determined by an independent, qualified appraiser. Many investors will pay undue regard to the expected market value in relation to the appraised value given investor behaviour, and given the nature of real estate values in the last decade, where we have had, in areas of Canada, continuing increasing real estate values.**
- 2.11. **FAIR Canada recommends there be restriction on the volume of business any one appraiser's firm could provide to a given issuer group and/or mortgage broker so as to maintain independence. We also caution on placing undue reliance on appraisals as this may lead to undue reliance similar to the problems associated with undue reliance on ratings from credit rating agencies. Furthermore, we recommend that investors be provided with a plain language explanation of the main types of appraisal that can be generated (cost basis, comparable sales basis, economic value, fair value, etc) and their limitations in order to have a better ability to make an informed investment decision.**

Question 1: As proposed, an appraisal would be required in all cases where a syndicated mortgage is distributed under the OM Exemption. Should there be exemptions to this requirement? For example, should an appraisal be required if the property was acquired recently in an open market transaction with all parties acting at arm's length?

- 2.12. FAIR Canada does not believe there should be exemptions to the fair market value appraisal requirement as this is not unduly burdensome. In the event there was a recent transaction at arm's-length, the appraisal should be relatively straightforward and inexpensive.

Supplemental Disclosure Requirements

- 2.13. FAIR Canada supports the supplemental disclosure requirements that would include disclosure of development risks, prior obligations secured against the real property and the price paid by the developer to acquire the real property, and Form 45-106F2 and Form 45-106F18. These disclosure requirements will include information about the business and financial position of the borrower and certification by the issuer that there is no misrepresentation.

Mortgage Broker Requirements

Question 2: Are there circumstances where requiring additional disclosure by and a certificate from a mortgage broker would not be appropriate in connection with the use of the OM Exemption? If so, please explain why and whether there are other participants in the distribution that should be subject to these requirements?

- 2.14. A certification by the mortgage broker that there is no misrepresentation in the OM is a key investor protection mechanism for investors and FAIR Canada is not aware of situations where this would not be appropriate. **FAIR Canada recommends that purchasers in all jurisdictions**

should have a statutory right of action against issuers promoters, and mortgage brokers should the OM contain a misrepresentation, and that any marketing, promotional or advertising material be incorporated by reference into the OM.

- 2.15. FAIR Canada recommends that any mortgage brokers involved in the business of distributing syndicated mortgages be required to be registered as a registrant to ensure that they have the necessary integrity and fitness to participate in capital market activity and in order to facilitate oversight and enforcement or disciplinary action. FAIR Canada expects the CSA to require that market participants that are in the business of trading syndicated mortgages would be required to register and those entities engaged in repeated financing activities would be required to be registered as a dealer (and not simply expect some of them to register).

Question 3: Is it appropriate to require a mortgage broker to certify that it has made best efforts to ensure that the offering memorandum does not contain a misrepresentation with respect to matters that are not within its personal knowledge?

- 2.16. FAIR Canada recommends that the mortgage brokers be required to undertake commercially reasonable due diligence as part of its Know Your Product and Know Your Client obligations or otherwise and certify that to the best of our knowledge, information and belief, the Offering Memorandum provides disclosure of all material facts required under securities legislation of a specific jurisdiction and does not contain a misrepresentation. The CSA should issue guidance setting out the extent of the mortgage brokers' due diligence obligations.

Private Issuer Exemption

Question 4: Are there circumstances where the distribution of syndicated mortgages under the Private Issuer Exemption would be appropriate and reporting to the securities regulatory authorities would not be necessary? If so, please provide examples and explain why there are limited investor protection concerns in those circumstances.

- 2.17. The Consultation Document proposes to make the Private Issuer Exemption unavailable for the distribution of syndicated mortgages in part, because reports of exempt distribution are not required under the Private Issuer Exemption.
- 2.18. The Private Issuer Exemption allows a non-reporting issuer to distribute its securities to a maximum of 50 people who have certain specified relationships with the issuer, including specified family members of its executive officers, directors or founder. The historical rationale for the exemption is that this is the number of individuals who would fall within the requisite categories and have some relationship with the issuer allowing them to (a) gauge the issuer's principals' capabilities and trustworthiness, and (b) extract sufficient material information to avoid a large level of informational asymmetry.¹⁷ The fact of the relationship was also seen to reduce the likelihood of fraud since they would know the principals of the issuer.

¹⁷ For example, the OSC Staff Consultation Paper 45-710 states that "These types of investors are generally thought to have a relationship to the issuer that allows them to, at least partially, mitigate the risks of the investment because of the closeness of the relationship or the fact that they have access to information from the issuer" at 9.

- 2.19. We do not believe the problem that the Consultation Document is trying to address rests with the Private Issuer Exemption (more so than any other exemption). Accordingly, we would recommend that the Private Issuer Exemption be made available for the distribution of syndicated mortgages but in order for it to be used to distribute syndicated mortgage investments, a report of exempt distribution containing similar information to what is required under other prospectus exemptions be required to be filed with securities regulators.
- 2.20. We believe that reporting to the securities regulatory authorities so that better data can be collected in this area of the exempt market is of vital importance so we do not support providing relief from such reporting obligations.

Alternative Prospectus Exemptions

Question 5: Should alternative prospectus exemptions be provided to facilitate the distribution of specific classes of syndicated mortgages where the investor protection concerns may not be as pronounced?

- 2.21. FAIR Canada does not see any basis for concluding that there are distributions of syndicated mortgages where “investor protection concerns may not be as pronounced”. We are not aware of any situations where an investor will agree that they are well served having no investor protection requirements.
- 2.22. There are a sufficient number of prospectus exemptions available currently and a greater number of them will not be in the interests of investor protection or the fair and efficient markets and confidence in our capital markets. The existing prospectus exemptions are sufficient for issuers, borrowers and mortgage brokers to utilize and the associated costs with having to comply with registration requirements (including participation fees) are not unduly burdensome.

Question 6: Should we consider adopting an exemption for the distribution of syndicated mortgages on existing residential properties similar to the exemption for “qualified syndicated mortgages” under British Columbia Securities Commission Rule 45-501 Mortgages?

- 2.23. We do not support a qualified syndicated mortgages exemption that would permit the distribution of syndicated mortgages without requiring dealer registration or the need to meet the requirements of existing prospectus exemptions. Retail investors are advised to “check registration”¹⁸ (including disciplinary history) when considering making an investment in order prevent being defrauded. If such carve outs are allowed, this step is undermined. Such exemptions also undermine the ability of securities regulators to oversee the market and obtain information on this segment of the market. All such activity should be recorded on the books and records of a given dealer.

¹⁸ See CSA webpage “It takes only 10 seconds to check registration...as much time as it takes to read this headline” at <https://www.securities-administrators.ca/investortools.aspx?id=1128>. FAIR Canada believes that this headline is misleading as it is not an easy or quick process to adequately check the registration and disciplinary history of a purported financial services representative.

Question 7: Should an exemption be provided for the distribution of a syndicated mortgage to a small number of lenders on a property that is used for residential or business purposes by the mortgagor? If so, should the exemption be subject to conditions? For example, should the exemption be available only for a distribution (i) by an individual; and/or (ii) relating to a residential property; and/or (iii) involving a specified maximum number of lenders?

2.24.FAIR Canada disagrees that such an exemption should be provided given the investor protection concerns that would result.

We thank you for the opportunity to provide our comments and views in this submission. We welcome its public posting and would be pleased to discuss this letter with you at your convenience. Feel free to contact Frank Allen at [647-256-6693](tel:647-256-6693)/frank.allen@faircanada.ca, or Marian Passmore at [647-256-6691](tel:647-256-6691)/marian.passmore@faircanada.ca.

Sincerely,



Canadian Foundation for Advancement of Investor Rights