

Making sense of MICs



By Martin Aquilina

What brokers need to know about securities law issues for mortgage investment corporations

With the coming into force of *National Instrument 31-103 – Registration Requirements and Exemptions (NI 31-103)* on September 28, 2009, operators of mortgage investment corporations (MICs) now have additional reasons to worry about enforcement actions by securities regulators.

Although we are not aware of any such action being taken to date, this may be due more to a lack of resources on the regulators' part than to the strength of their legal position. Also, the rather good returns enjoyed by MICs, and the ensuing lack of complaints by investors, as well as their relatively small size and numbers, have probably helped to keep them off the regulators' radar.

Although this may come as a surprise to many MIC promoters, mortgages are, by law, securities. The relevance of this characterization lies in the fact that securities legislation imposes a registration (licensing) requirement upon individuals and entities that sell securities as well as an obligation to provide purchasers of securities with a prospectus explaining the attributes of the investment and the business of the issuer. The prospectus must be approved by local regulators and provided to investors by the issuer's dealer no later than 48 hours after the purchase of the investment.

As a general rule, mortgage brokers need not worry about the impact of securities laws on their daily activities as adherence to mortgage brokerage legislation is all that is required to stay

on the right side of regulatory laws. This fortunate result is due to the fact that mortgages are “exempt” securities, meaning, firstly, that those who trade in mortgages do not require registration under local securities laws and secondly, that a prospectus is not necessary for a person to present a deal to a lender or borrower, as long as the mortgage is on real property located in Canada and the person is licensed (or exempt from licensing) under the mortgage broker/dealer legislation of the jurisdiction in which the property is located.

Syndicated mortgages are an exception to the rule as those transacting them in the provinces of Alberta, British Columbia, Manitoba, Quebec and Saskatchewan must be registered as a securities dealer unless another exemption is available. Syndicated mortgages must also be qualified by prospectus unless an exemption is available.

The MIC angle

Where do MICs fit into all this? MICs of course are pools of mortgages held under a corporate structure through which lenders make their capital available to borrowers in return for shares in the corporation. The corporation is set up by the mortgage broker to hold the mortgages, and the shares held by the lenders represent their proportionate interest in the mortgage pool. Lenders mitigate their risk by spreading their capital across many mortgages, and borrowers are able to access large ready-made pools of money

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for loans they might not otherwise be able to get.

Everyone's happy, right? Well... everyone except the regulators! Shares are the most obvious form of securities, and while the underlying mortgages are exempt, the shares themselves are clearly not. This means that they must be sold under prospectus by registered securities dealers unless an exemption from both of these requirements is available. Exemptions that are available to MICs vary from one province to another and include the accredited investor exemption, the \$150,000 minimum purchase amount exemption, the offering memorandum exemption and the family, friends and business associates exemption.

Prior to the adoption of NI 31-103, a “limited market dealer” (LMD) registration was required in Ontario and Newfoundland to sell an exempt security notwithstanding the existence of a registration exemption. Under NI 31-103, the LMD category has been replaced with that of “exempt market dealer” (EMD), which will be required by the provinces east of Manitoba in order to sell or market securities that are not qualified by prospectus. In the rest of Canada, with the possible exception of Saskatchewan, an EMD registration may not be required in connection with the sale of MIC shares under any of the four exemptions above, subject to a number of conditions.

Registration requirements for EMDs are more stringent than those for LMDs. Generally speaking, EMDs are subject to the same rules as full-service dealers. This means that they must comply with proficiency, solvency, insurance and reporting requirements, as well as know-your-client, conflict of interest and client disclosure rules.

Investment fund manager

Moreover, NI 31-103 now requires that administrators of investment funds, meaning those that direct the business, operations or affairs of an investment fund, obtain registration as an investment fund manager (IFM).

Since all MICs, whether they restrict the right to redeem shares or process redemptions on demand, fall within the definition of “investment fund,” and since none of the three possible exemptions from the IFM requirement will be available to the typical MIC, it follows that an IFM registration is now needed to operate a compliant MIC. As is the case with those in the EMD category, registrants in the IFM category must meet certain insurance and capital requirements and appoint a chief compliance officer (CCO). One significant problem for MIC operators is that the proficiency requirements for CCOs are not designed to be met by those in the mortgage industry.

To make matters even more difficult, additional registration as a portfolio manager (PM) is needed to allow the management of a securities portfolio (which includes a pool of mortgages). As is the case with an IFM registration, exemptions from the PM requirement will not be readily available to the typical MIC promoter.

MICs were created by the feds in the early '70s to stimulate home ownership in Canada. However, the rules that govern them have been and continue to be in large measure those enacted by provincial legislatures and authorities for the regulation of securities. This is most unfortunate as it has been our experience that MICs are packaged and promoted by people in the mortgage industry rather than by those with a securities background. This has resulted in a regulatory regime which is, if not inadequate, then at least beyond the reasonable grasp of most MIC operators. With the move afoot to establish a single Canadian securities regulator administering a federal Securities Act the time may be ripe for reform. **BB**

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