



February 27, 2013

British Columbia Securities Commission  
PO Box 10142, 701 West Georgia Street  
Vancouver, BC V7Y 1L2  
**Attention: Mark Wang**

Re: Proposed Registration of Mortgage Investment Corporations as Exempt Dealers: BC Notice 2013/01

Thank you for providing the Mortgage Brokers Association of BC (MBABC) with an opportunity to comment on BC Notice 2013/01 which proposes to revoke:

- BC Instrument 32-513 *Registration Exemption for Trades in Connection with Certain Prospectus-Exempt Distributions* (the NW exemption) and
- BC Instrument 32-517 *Exemption from Dealer Registration Requirement for Trades in Securities of Mortgage Investment Entities* (the MIE exemption).

I write here to address this issue only in regards to mortgage investment corporations (MICs), as I have previously addressed issues relating to the revocation of registration exemptions for the mortgage syndicators in a separate letter. By way of background, the MBABC is a provincial association of mortgage brokers and lenders, which was established over 20 years ago. We recently held town hall meetings throughout the province to consult with the mortgage industry, including non-members, on the issues presented in BC Notice 2013/01. The industry spoke out with a relatively uniform message, which I shall articulate below.

It is our understanding that revoking the above noted exemptions will result in the requirement for MICs to obtain registration as an exempt market dealer (EMD) or to refrain from undertaking capital raising activities, except indirectly by referring MIC investors to an EMD who may then facilitate the MIC investment. I can advise that industry members overwhelmingly expressed concern that this proposal and that EMD registration in particular:

- Will not protect consumers as the EMD model forces MICs to act as general investment advisors and financial intermediaries. MICs are not capable of fulfilling this role as their

focus is on mortgage lending and managing their own mortgage portfolio, and they are not general investment experts; and

- Imposes excessive regulatory and financial burden on MICs which may force the majority of them to discontinue operations. This will hurt the public by potentially eliminating billions of dollars of mortgage capital from the BC economy, resulting in higher mortgage borrowing costs, higher borrower defaults, mortgage foreclosures and loss of employment.

In addition, MICs are already heavily regulated in British Columbia, and the proposal does not appear to identify any public harm which would justify a radical change in the way the BCSC regulates MICs. This does not mean of course that there are not some options for improving current regulatory rules for MICs. I will explain more about these issues below.

### Current Regulation of MICs

MICs are mortgage lending companies which acquire lending funds from the sale of its shares and MICs then pool these funds to lend to various mortgage borrowers. MICs are currently regulated by three different regulators under four separate pieces of legislation.

Most MICs provide tax relief for their investors as they are qualified investments under section 130.1 of the *Income Tax Act* of Canada. Section 130.1 subjects MICs to detailed and extensive requirements including:

- Multiple restrictions and rules on how dividends are paid to shareholders, including a requirement that 100% of net income flow through to shareholders;
- Requirements to maintain certain debt/equity ratios;
- Restrictions on ownership of and investment in foreign real estate;
- Restrictions on investments involving debt owed by non-residents of Canada;
- Requirements for a minimum of 20 shareholders, and limits on the percentage of capital which may be held by individual shareholders;
- Restrictions related to permissible liabilities;
- Limitations relating to developing land, engaging in construction or investing directly in real estate;
- Requirements for MIC assets to include at least 50% of their portfolio in residential mortgages and/or cash deposited in an insured financial institution; and
- A requirement for annual audited financial statements.

MICs also engage in activities involving mortgage arranging, administration and lending, which requires that they obtain a license under the *Mortgage Brokers Act* as “mortgage brokers”. MIC employees who engage in activities which trigger a registration requirement must also be registered as “submortgage brokers.” In addition, a Designated Individual must be responsible for ensuring compliance of the MIC with the requirements of the *Mortgage Brokers Act*, its

regulations and the policies and directives of the Registrar of Mortgage Brokers. Individual mortgage brokers and submortgage brokers must qualify for initial registration and registration renewal by taking mortgage related courses and satisfying a suitability review, including a criminal record check. MICs must further comply with certain consumer protection requirements afforded to the public under the *Business Practices and Consumer Protection Act*.

A failure of a MIC to not comply with the requirements of the *Mortgage Brokers Act* may result in the suspension of the MIC's mortgage broker registration, suspension or termination of related submortgage broker registrations, a monetary penalty or other remedies. In one instance, the Registrar cancelled the registration of a submortgage broker who was also the president and director of a MIC, after it was found that the submortgage broker facilitated substantial and improper loans from the MIC to another entity controlled by the submortgage broker (see *in the Matter of the Mortgage Brokers Act and Connaught Mortgage Investment Corporation et al.*, dated June 5, 2008). The MIC in this case had let its mortgage broker registration lapse. The regulatory regime imposed by the *Mortgage Brokers Act* is therefore robust and significant. It provides regulatory oversight of the MIC's mortgage related activity which is measured, geared for mortgage lending and capable of keeping bad industry players out of the market place.

MIC managers and employees become experts in mortgages as their business requires that they engage in mortgage arranging, lending and administration activities. Mortgages are fundamentally different from securities, in that they secure debt on real estate, which is tangible, immovable and has a unique value based on its physical characteristics, location, improvements, revenue stream, potential for upgrading and other factors. You can touch and feel real estate – unlike “securities”, which appear to be intangible, untouchable, loaded with hidden rights and restrictions and lacking a value which can be easily derived at through an appraisal. It is fair to say that most MIC managers and employees are not experts on investment products which are sold through financial intermediaries. Try asking a MIC manager to explain a “call feature”, “constrained share”, “debenture”, or a “derivative”. While some well versed MIC managers may readily know this information, you really need to be an expert on mutual funds, investment pools and other securities not only to provide competent advice on securities in general, but also to sell specific investment products to the public. This is why the previous system of regulation by the BCSC over MICs essentially worked and why the current proposal of the BCSC is doomed to FAIL.

Historically, the BCSC regulated MICs as exempt market dealers using a set of registration and prospectus exemptions (see NI 45-106). Commonly used prospectus exemptions included:

1. Accredited investor – section 2.3
2. Family, friends and business associates – section 2.5
3. Offering memorandum (OM) – section 2.9
4. Minimum amount investment – section 2.10

5. Additional investment in investment funds – section 2.19
6. Employee, executive officer, director and consultant –section 2.24

These exemptions were available as it was recognized that exempt market dealers, who are generally industry members selling their own products, need to raise capital quickly and efficiently and without unnecessary expense or compromising investor protection.

However, this system of exemptions was recently replaced by the Northwest Exemption (see BC I 32-513), which could potentially afford MICs with a registration exemption if it were not for some restrictive conditions. These conditions include a requirement that the MIC not hold or have access to client assets and not provide any other financial services to the investor. Most MICs have therefore been relying on the temporary registration exemption afforded to them under BC I 32-517. The proposed elimination of both BC I 32-513 and BC I 32-517, will force MICs to register as EMDs, which will create insurmountable compliance challenges for MICs - **this is what will endanger the investing public.**

### The Exempt Marker Dealer Model

National Instrument 31-103 makes it a requirement of EMD's to comply with "know your client" rules and dispense suitability advice to investors prior to completing investment transactions. Requiring MICs to become EMD's would therefore necessitate MIC managers to investigate the financial needs and investment objectives of each potential MIC investor in order to advise him or her on each transaction about the most suitable or appropriate investment product, having regard to all investment and financial products. According to CSA Staff Notice 33-315, the product review process involves the following:

Registrants should consider factors such as product features and structure, including risks, costs, management and financial strength of the issuer. They should also determine whether expected returns are realistic. Registrants will also need to re-evaluate an existing product if a change to a key feature causes significant changes to the risk and return profile of the product.

Listed below are some factors that registrants should consider when assessing investment products.

#### ***General features and structure***

- basis of security's return (e.g. minimum return, dividends, interest rate)
- use of leverage
- conflicts of interest arising from the compensation structure or other factors
- overall complexity, transparency and uniqueness of features of the product's structure

#### ***Risks***

- the possibility that a client may lose some or all of the principal amount invested
- risks relating to the product, such as liquidity risk (including redemption rights and any

features that lock in the principal and/or returns for a specified period), price volatility, default risk, and exposure to counterparty risk

- risks related to assets underlying derivatives or structured products

### **Costs**

- fees paid to registrants or other parties, such as commissions, sales charges, trailer fees, management fees, incentive fees, referral fees and early redemption fees
- embedded costs, such as bid-ask spreads or other expenses

### **Parties involved**

- the issuer's financial position and history
- qualifications, reputation and track record of the parties involved in key aspects of the product, for example, the fund manager, portfolio manager, product manufacturer or sponsor, any guarantors and significant counterparties

### **Legal and regulatory framework**

- any laws or rules of self-regulatory organizations that apply to the registrant
- if distributed under an exemption, whether the product meets the requirements of that exemption
- legal characteristics of derivatives and structured products (e.g. jurisdiction of special purpose vehicles, bankruptcy protection and RSP eligibility)
- frequency, completeness and quality of the issuer's disclosure

MIC managers, acting in their EMD role, would then have to act as an investment advisor and financial intermediary for each MIC investor – this requires that they educate themselves about a host of investment products and become experts in those products, knowing all of the details identified above. For investors who have invested in the MIC manager's MIC on previous occasions or even in other MICs, this may oblige a MIC manager to recommend that the investor diversify his or her portfolio by investing in another MIC or even in some other kind of product. In other words, the suitability requirements of the EMD model is likely to require that investors wishing to invest in the MIC be turned away from the MIC and be sold a different financial product by none other than the MIC manager. The problem here is that MIC managers are busy managing their own MIC by building up a portfolio of mortgages for their pool, administering that mortgage pool and dealing with mortgage borrowers. Typically there is not an army of financial advisors selling MIC investments – MICs are a one stop shop providing mortgages to borrowers and pooled mortgage investments to shareholders. They are the quintessential direct to consumer investment dealer and not the middle man retailer who can readily discuss an array of different financial products from mutual funds, derivatives, stocks, bonds and the like. MIC managers are simply not equipped to explain how these other investment products work or even for that matter, provide other specific investment options with other MICs. MIC managers are intimately familiar with their own MIC fund and that is all they may be equipped to fully explain to investing consumers.

It is simply wrong to impose a requirement on MIC managers that they cannot comply with and more importantly, it is dangerous for the public, if consumers expect to receive general comprehensive and competent financial advice regarding a variety of investment products from their MIC manager when that is likely not possible or even probable. This is why the EMD model is not the right regulatory model for MICs.

I have one other comment here. There does not appear to be any demonstrated harm which would justify a shift in the manner in which MICs are regulated. The BCSC proposal states that there has been significant non-compliance with the current registration exemptions, and concludes that this creates significant risk to the public. However, we also understand that the BCSC is not aware of any single grievance or allegation of harm from the public in relation to this particular compliance problem. While we understand the concept of risk and that there is theoretically a greater risk of public harm if compliance rules are not complied with, it cannot simply be concluded that investors are at risk from MICs who operate under registration exemptions. Perhaps the compliance rules have been misunderstood by the industry members who have complied with them in spirit.

In a recent MBABC survey, compliance with BCSC rules was achieved as follows:

- 11% report that they are currently registered as EMDs;
- 6 % report that they utilize the services of an EMD; and
- 86 % report that they rely on the temporary exemption.

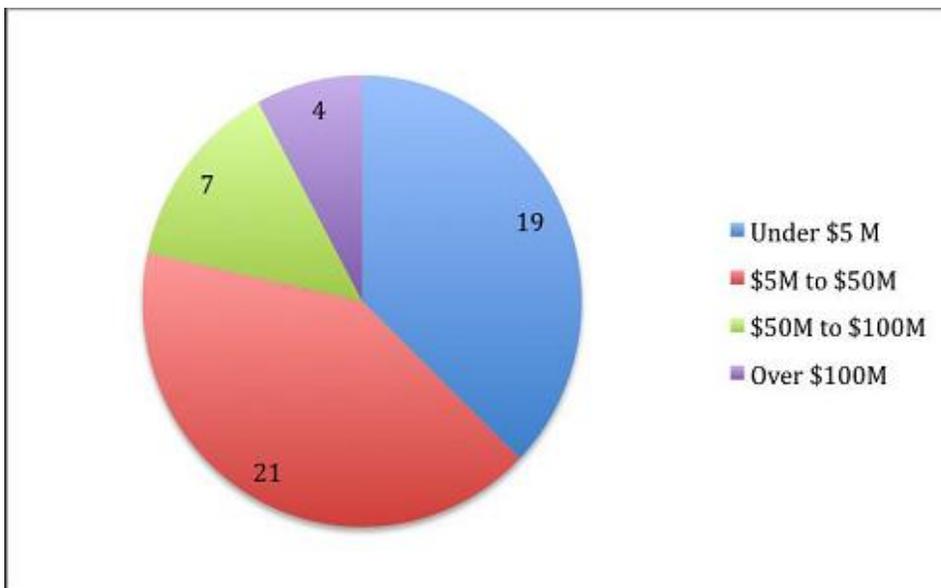
All respondents were of the view that they were in compliance with the requirements of BCSC. It is our observation that the MIC industry takes pride in its customer service, professionalism and respect for rules and regulations.

#### Economic Cost of Imposing EMD Registration on MICs without a Corresponding Benefit

The BCSC Memorandum, dated October 11, 2012 which analyzes the impact of capital raising requirements on the mortgage investment industry concluded that only \$1.8 million dollars would be taken out the available pool of available mortgage funds in the overall British Columbia economy. We believe that this estimate was based on some erroneous assumptions and grossly under values the level of mortgage capital which would be affected by the proposed new regulation.

From our survey results, 54 respondents reported raising 1.5 billion dollars annually. If you extrapolate this dollar volume to the estimated number of MICs in BC, which is 225 (our estimate), there would be an estimate of 6.25 billion dollars raised in BC annually by MICs. 71% of MICs reported that they may be forced to cease MIC activity if they were required to either become an EMD or utilize the services of an EMD to raise capital. This could potentially result in the loss of 4.43 billion dollars of mortgage funds from the capital pool in BC. This is a significant amount, which would have the impact of:

- removing mortgage lenders from the marketplace, which will make it more challenging for borrowers to find available mortgage capital;
- preventing some borrowers from completing mortgage transactions without the support of an added second or third private MIC mortgage;
- loss of employment from mortgage industry members and support staff who would no longer be arranging and administrating mortgages – also the loss of construction related employment from developers and builders who would not be able to finance developments;
- loss of investment opportunities for lenders who may find other places to put their funds; and
- higher borrowing costs and less access to mortgage capital will lead to an increase in foreclosure rates and borrower defaults.



I note that the February 12, 2013 Speech From the Throne, by the Honourable Judith Guichon, OBC Lieutenant-Governor, stated the following in relation to government regulation:

### **Growing business**

These networks help create the conditions for job creation. But it is businesses small, medium and large, not government, that create jobs.

Competitive tax rates also help make this possible. British Columbia has one of the lowest general income tax rates in Canada.

**Business also needs regulation that works, while not adding a huge burden. British Columbia has reduced regulatory requirements by 42 per cent, and is the only province to have a regulatory reform law. [emphasis added]**

But there is more we can do.

In the coming weeks your government will renew its commitment to small business owners, to keep our province the most small business-friendly jurisdiction in Canada.

Small business owners have identified their priorities: access to qualified workers, greater mentorship to help business grow, and better collaboration between different levels of government.

Your government will act on these and other priorities.

**In keeping with the government's commitment to reduce red tape and the regulatory burden on business, the BCSC has no choice but to provide a regulatory model for MICs which does not require EMD registration - because to require EMD registration will not only place a significant regulatory and financial burden on MICs which will fail to provide any corresponding benefit, but it will also significantly harm the public through the provision of ineffective investment and financial advice and the elimination of billions of dollars of mortgage capital from the economy.**

#### The Right Regulatory Model for MICs

Consumers do need regulatory oversight over the professionals who provide them with financial services. Registration under the *Securities Act* and its accompanying know your client rules and suitability requirements are certainly essential for financial intermediaries. However, these requirements should not be imposed on MICs as MIC managers are not capable of fulfilling the role of financial advisor to the investor. In addition, some investors are people with considerable wealth who may dislike intrusions into their financial status and investing habits. We believe that consumers should ultimately be responsible for looking after their own interests and take responsibility for their own choices. The goal of government should be to ensure that consumers **are empowered to make informed, careful investment decisions**. Providing consumers with relevant knowledge is actually a much more powerful consumer protection tool than imposing a system of paternalistic "advisor knows best" regulation over them. I also note that the financial intermediary model has its own set of ethical and public protection challenges. The BCSC may wish to better understand the motivation that fees play in the actual advice dispensed by advisors. Distribution fees may include entry loads, exit loads and trail commissions. Compensation issues interfere with any fiduciary role and create conflicts of interest.

We ask that the BCSC consider other options for regulating MICs. Recognising that MICs are fundamentally different from any other investment vehicle regulated by BCSC by virtue of their extensive current regulation by the Canada Revenue Agency and the Registrar of Mortgage Brokers, we believe that it may be appropriate to bring back the OM exemption for MICs. The OM could be improved, drafted in plain English with better disclosure of the risks and previous returns of mortgage pools, details of mortgage investments and rigorous disclosure of MIC compensation, fees and operating expenses. In addition, there could be conditions attached to the use of the OM exemption which could curb predatory practices against vulnerable sectors of society, such as a condition that the investor have a certain dollar value net worth or that some investors not be permitted to use leverage to acquire shares.

Recommendations:

For the reasons stated above, the MBABC urges that the BCSC not implement the proposal contained in BC Notice 2013/01 in relation to MICs, and that it explore other regulatory solutions to regulating MICs such as an improved OM exemption.

If you wish to discuss any of these matters further, please feel free to contact me.

Yours truly,  
MBABC

A handwritten signature in black ink, appearing to read 'S. Gale', written in a cursive style.

Samantha Gale, CEO  
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