April 10, 2013

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

Financial and Corporate Sector Policy Branch
Ministry of Finance
PO Box 9418 Stn Prov Govt
Victoria, BC V8W 9V1

Re: Supplemental Submissions for BC Notice 2013/01- An Analyses of BC Syndicated Mortgage Lending Under American Jurisprudence

I have reviewed some American jurisprudence on the subject of whether a syndicated mortgage[1] is legally considered to be a security or a commercial contract. This American legal analysis may be of some assistance to you in the context of your deliberations concerning how syndicated mortgages in British Columbia should be regulated. I therefore ask that you consider this as an addendum to my previous submission of February 21, 2013, and consider it in your determination of whether to implement the proposal contained in BC Notice 2013/01 in relation to syndicated mortgages.

As you know, exempt market dealers trade in securities and not commercial products or services. A crucial factor in selecting the appropriate regulatory regime for persons arranging syndicated mortgages would therefore be whether they are a security OR a loan secured against title. Leading American cases determine that syndicated mortgages are not securities

[1] As an aside, the reference above to "syndicated lending" is meant to refer to customary syndicated lending – which we define as a mortgage loan actually advanced by a syndicate of lenders against the security of an ascertainable real estate asset as opposed to another possible definition of the expression "syndicated mortgage" which might be defined as a mortgage security that itself has been syndicated to investors. The latter definition (which for example, might involve the syndication of perhaps a portfolio of existing mortgages amongst investors) would likely (being in the nature of a passive investment that would not pass the Banco Espanol tests referenced below) fall into the category of a security while the former (active lending involving the taking of a security against a real estate asset), would not. In this letter any reference to syndicated mortgage is a reference to the former definition only. This distinction was made by one of our members, Lanyard Financial Corporation, in their submission to you of January 25, 2013. This point is also well articulated by the U.S. Second Circuit Court in Gary Plastic Packaging Corp.v. Merrill Llynch, et al, 756 F.2d 230 (2d Cir. 1985) which stands for the proposition that a transaction may be subject to the securities laws even if the underlying instrument would not be a security if sold in other contexts.

but, rather, are mortgage loans which fall outside of the ambit of the securities regulators. The tests employed by the courts in analyzing mortgage syndications are similar to those used to determine whether notes and stocks are securities.

The "investment contract" test was originated by the United States Supreme Court in the precedent setting case of ***SEC v. W J Howey Co.*, 328 US 293 (1946)**. In this case, the Defendant, Howey Co. owned Florida land used for growing citrus fruits, which it then sold in parcels of one acre or less in conjunction with optional long term service contracts. While no purchaser was required to enter into a service contract, they were strongly encouraged to do so. The contracts provided for a lease of the land from the purchaser back to Howey Co. which would then tend to the land, grow the fruit and market the fruit for sale. Under the service contract, Howey Co. had complete possession of the land leaving the purchaser with no right of access to the land or fruit. The citrus fruit investment was marketed to business and professional persons throughout the United States, who were promised sizeable profits in various sales pitches. Howey Co. had not complied with any securities requirements, such as by filing registration statements, and the Securities and Exchange Commission sought an injunction to prevent Howey Co. from continuing to sell the investments.

The investments were, in essence, "leasebacks" and the central issue was whether the leaseback agreements constituted an investment contract within the meaning of the governing securities legislation. **The court opined that in examining an investment scheme, the substance of the investment ought to be examined over its form. This would enable a flexible approach that was capable of being applied to potentially any investment scheme "devised by those who seek the use of the money of others on the promise of profits." (at 299). <u>The test is whether the scheme involves: an investment of money (or money's worth) in a common enterprise, with the expectation of profit to be made through the management and control of others</u>.** Thus there is a distinction between a **consumer contract**, which is essentially an agreement for the sale of a commodity or service and a **security**, which is an investment in a common enterprise wherein the investors expect to earn a profit from the management and control of others in a business enterprise. The Court found that the fruit leaseback involved: (i) a common enterprise, which was the growing and selling citrus fruits; (ii) with a reasonable expectation of profits; and (iii) with profits to be derived from the entrepreneurial or managerial effort of others. The investment contract test was satisfied and the land sale, lease back and service contract was a security.

In the 1990 decision of ***Reves v. Ernst & Young*, 494 US 56(1990)**, the US Supreme Court devised an even more detailed test to assist in determining whether an instrument is a consumer contract or a security. The Court found that in circumstances where the investment in question does not bear a strong "family resemblance" to judicially recognized exceptions to the definition of a security, the following four factors can assist in making an evaluation of the subject investment instrument:

1. **Motivations of the Buyer and Seller:** The court concludes (at 351): "If the seller's purpose is <u>to raise money for the general use of a business enterprise or to finance substantial investments</u> and the <u>buyer is interested primarily in the profit the note is expected to generate</u>, the instrument is likely to be a security. If [on the other hand] the

note is exchanged …..to advance some other commercial or consumer purpose… the note is less sensibly described as a "security"."

2. **Plan of Distribution:** If the investment plan is to distribute the opportunity to investors representing the broader common public, then the instrument is more likely to be a security. However, an investment opportunity distributed to a narrowly defined pool of persons will more likely be viewed as a consumer contract.

3. **Reasonable Expectations of Investors:** The Court, in making its determination, may consider how the investment in question is perceived of by the ultimate investors. That is, do they view their subject investment as the making of a loan or, alternatively, as the investment in a business enterprise? If the latter, then this would dictate in favour of finding the instrument was a security.

4. **Existence of Another Regulatory Scheme:** If a transaction involving an instrument is governed by a regulator other than a securities regulator, then there is less of a need for the transaction to be protected by securities laws, and the instrument is less likely to be considered a security.

These four factors were applied to a syndicated mortgage transaction to determine whether it was a consumer contract or a security in ***Banco Espanol de Credito v. Security Pacific National Bank*, 973 F2d 51 (2nd Cir 1992)**, which is a leading case on this issue. The court found that the syndicated lenders participated in the mortgage for commercial and not investment purposes. The solicitation for participation in the syndicated mortgage was offered to a limited group of entities and not to members of the public at large. In addition, contractual documents signed by the syndicated lenders confirmed for them that the transaction was a syndicated loan and not an investment in a business enterprise, which guided their expectations of the transaction. And lastly, there was regulatory oversight over the syndicated loan by the Office of the Comptroller of Currency. All of these factors lead to the determination that the syndicated mortgage was a consumer contract.

Application of both the "investment contract test" set out in ***W.J. Howey*** and the "four pronged test" set out in ***Reves*** to standard syndicated mortgage transactions in British Columbia leads to the same conclusion as that arrived at by Second Circuit Court in ***Banco Espanol***. It is submitted that substantially the same legal reasoning (and common sense business/commercial considerations) utilized by the U.S. Courts in all three cases cited above should be applied by our Provincial regulators when considering the most appropriate regulatory regime to govern syndicated lending within the Province:

1. **An investment of money (or money's worth) in a common enterprise, with the expectation of profit to be made through the management and control of others:** Clearly a group of lenders who are first supplied with specific underwriting materials (including FICOM mandated materials) and who thereafter elect to advance a single mortgage loan against title to an identifiable real estate property have no common enterprise with either the borrower or the mortgage broker (other than their relationship as a lender to the borrower) and clearly their expectation of

profit is wholly dependent upon the specific contractual terms of the mortgage loan documentation and not on the management skill and control of others.

2. **Motivations of the buyer and seller:** Mortgage brokers involved in conventional syndicated mortgage lending act as mere intermediaries who match borrowers with lenders. Their business is arranging mortgage loans. They cannot be considered "sellers" of securities in any fair analyses. Syndicated mortgage lenders are not buyers of securities who pay a price to acquire an investment or business interest. Rather, they are plain and simple mortgage lenders and the "commercial or consumer purpose" being advanced is the simple and ordinary making of a mortgage loan. The motivation of syndicated mortgage lenders to participate in the loan transaction will be to earn contractually agreed upon interest and fees to be paid by the borrower.

3. **Plan of distribution:** While mortgage brokers may advertise their general brokerage services to the general public, it would be extremely rare for them to advertise specific mortgage opportunities to the world at large. Funding mortgage loans with specific funding deadlines and the need to distribute comprehensive underwriting materials to prospective lenders would be near impossible if mortgage brokers accomplished this by scraping up small sums from a multitude of people. Almost all (if not all) syndicated mortgage loans are funded from a pre-existing, select group of corporations or individuals who are well known to the mortgage broker in question and who, if they become a member of a lending syndicate for a particular mortgage loan, are required to make a sizeable contribution to the funding of the loan. This narrow plan of distribution also leads to the conclusion that syndicated mortgages are consumer contracts.

4. **Reasonable expectations of syndicated mortgage lenders:** There are plenty of documents required in all syndicated mortgage transactions taking place in B.C. which, assuming any clarification was needed in the first place, make it abundantly clear to any prospective syndicated lenders that: (i) they are lenders of a loan; and (ii) the loan has specific repayment terms and entitlements to compensation (in the form of contractual interest payments and fees). These documents include a Form 9 Lender Disclosure Form or an Offering Memorandum, a Form B Mortgage Instrument, a Lender Risk Acknowledgment and the mortgage loan agreement or commitment letter. There can be no doubt that syndicated mortgage lenders in British Columbia fully understand that they are lending money to a borrower against the security of a mortgage charge and are well aware of the specific terms of that loan and also of any conflicts of interest that might involve the relevant mortgage broker. The foregoing is assured by reason of the existing requirements of the present oversight agency, FICOM.

5. **Regulatory oversight by another regulator:** The Registrar of Mortgage Brokers regulates the mortgage administration and lending activities of all mortgage syndicators, in addition to the capital raising activities of qualified mortgage syndicators. Accordingly, all syndicated lending activity in B.C. is currently subject to oversight by an existing regulatory agency.

The “investment contract test” and the “four pronged test” when applied to the conventional syndicated mortgage business results in the unmistakable conclusion that syndicated mortgages in British Columbia are commercial contracts and loans secured by land - NOT securities. It follows that the proper place for their regulation would be under the *Mortgage Brokers Act* and not with the BC Securities Commission under the BC *Securities Act*. Accordingly, the MBABC urges that the BCSC not implement the proposal contained in BC Notice 2013/01 in relation to syndicated mortgages.

Yours truly,

Samantha Gale
CEO, MBABC