

1.1.3 OSC Staff Notice 81-722 – Mortgage Investment Entities and Investment Funds

OSC STAFF NOTICE 81-722 MORTGAGE INVESTMENT ENTITIES AND INVESTMENT FUNDS

Purpose

This notice sets out guidance from staff of the Ontario Securities Commission (Staff) on the factors that Staff will consider in determining whether an issuer which proposes to invest all or substantially all of its assets in a pool of mortgages (a mortgage investment entity or MIE) is an investment fund.¹ For the purposes of this notice, an MIE is an issuer that invests in mortgages in the manner described below.

For a discussion of the registration requirements applicable to entities that invest their assets in mortgages, please see CSA Staff Notice 31-323 *Guidance Relating to the Registration Obligations of Mortgage Investment Entities* (CSA Staff Notice 31-323).²

Background

Recently, Staff have seen an increase in the number of prospectus filings by MIEs. Often, these MIEs describe themselves as non-redeemable investment funds and file a prospectus in the form of a completed Form 41-101F2 *Information Required in an Investment Fund Prospectus* (Form 41-101F2).

Generally, the mortgages³ purchased by these MIEs are originated and serviced by one or more mortgage originators (each, an Originator), who may or may not act as the MIE's manager. Regardless of whether the Originator is the MIE's manager, the Originator may nonetheless use the MIE as a source of funding for the Originator's mortgage lending business.

Staff are generally of the view that MIEs with the attributes described above are not investment funds for the reasons provided below.

MIEs and Investment Funds

Consistent with the definition of "non-redeemable investment fund" in subsection 1(1) of the *Securities Act* (Ontario) and the discussion in section 1.2 of Companion Policy 81-106CP to National Instrument 81-106 *Investment Fund Continuous Disclosure*, an investment fund does not invest for the purpose of exercising or seeking to exercise control, or being actively involved in the management, of any issuer.⁴

In Staff's view, structuring an offering of an issuer that describes itself as a non-redeemable investment fund, where the issuer is, or is an extension of, an operating business is contrary to the spirit and intent of the definition of a non-redeemable investment fund.

In our reviews of MIE prospectuses, Staff have been carefully examining the role played by the Originator in the public offering, and its relationship to the MIE. Based on our reviews, it appears that MIEs are often an extension of the Originator's business. Essentially, the Originator sources mortgages, which are then funded through the money raised by the MIE in its public offering. The MIE thereby becomes the lender to the mortgagor, which results in the MIE engaging in, or being the source of funding for, a lending business on behalf of the Originator. In Staff's view, this is inconsistent with the nature of an investment fund and is, in essence, an operating business.

Staff are of the view that the Originator plays a vital role for the MIE, such that the performance of the MIE is largely dependent on the Originator's business expertise in originating and servicing mortgages. In fact, this expertise is what the MIE is indirectly offering to the public through its securities. Even though the MIE has been established as a separate legal entity, in our prospectus reviews, Staff are examining the relationship of the MIE and Originator comprehensively, and may regard the MIE as part of the Originator's business.

¹ This notice focuses on those MIEs that describe themselves as non-redeemable investment funds and propose to become reporting issuers. Therefore, the discussion in this notice does not address mutual funds subject to National Policy 29 *Mutual Funds Investing in Mortgages*, which are a particular type of mutual fund established prior to the coming into force of National Instrument 81-102 *Mutual Funds* (NI 81-102).

² While the discussion in CSA Staff Notice 31-323 focuses on applicable registration requirements, the current notice focuses on the nature of an MIE and why Staff generally do not consider MIEs to be investment funds.

³ The mortgages purchased by MIEs are generally not "guaranteed mortgages", as defined in NI 81-102.

⁴ For a further discussion of these issues, please see *The Investment Funds Practitioner – November 2012*, (2012) 35 OSCB 9997 at 10000 and 10001.

While MIEs may appear similar to investment funds that invest in debt or equity securities, unlike such funds, which purchase the securities on the secondary market or through primary distributions, MIEs indirectly lend money to individual mortgagors in respect of mortgages that are tailor-made by the Originator for the mortgagor. Accordingly, in Staff's view, an MIE is more akin to a lending business than an investment fund, which generally invests in a portfolio of securities.

Prospectus and Continuous Disclosure Requirements

Staff believe that information regarding the Originator's business and how it decides what mortgages to originate and how to service them is material information for securityholders of the MIE. The MIE's success depends on the Originator and its expertise, which, as stated above, is indirectly what is being offered to the public through the MIE's securities.

As, in Staff's view, they are not investment funds, the MIEs described in this notice are required to file an initial prospectus in the form of a completed Form 41-101F1 *Information Required in a Prospectus* (Form 41-101F1), not Form 41-101F2. Staff believe that the use of Form 41-101F1 enhances investor protection, as Form 41-101F2 is designed to provide disclosure regarding a passively held portfolio and would not, in Staff's view, provide investors with meaningful disclosure about the MIE's operating business.

This investor protection concern also extends to the continuous disclosure (CD) regime. Consistent with Staff's view outlined above, MIEs are expected to comply with the CD regime applicable to reporting issuers that are not investment funds (National Instrument 51-102 *Continuous Disclosure Obligations*). This will generally provide investors with more meaningful disclosure regarding the MIE and the Originator's role vis-à-vis the MIE than the CD regime applicable to investment funds.⁵

Further Information

The determination of whether an entity is an investment fund is fact-specific. If issuers and their counsel are uncertain regarding whether an MIE is an investment fund, we encourage them to use the pre-filing procedures under Part 8 of National Policy 11-202 *Process for Prospectus Reviews in Multiple Jurisdictions*.

Questions

If you have any questions, please refer them to:

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⁵ In addition to other differences between the CD regime for investment funds and for non-investment fund issuers, a reporting issuer that is not an investment fund is currently required to prepare its financial statements in accordance with the International Financial Reporting Standards (IFRS). Investment funds are not required to prepare their financial statements in accordance with IFRS until financial years beginning on or after January 1, 2014.