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To: Financial Services Regulatory Authority of Ontario (FSRA)
huston.loke@fsrao.ca

To: Ontario Securities Commission (OSC)
comments@osc.gov.on.ca

To: Ministry of Finance (MoF)
Gina.Stephens@ontario.ca

Re: Comments on Proposed Regime for Non-Qualified Syndicated Mortgages (NQSMs)

The comments below are being delivered to each of you in one letter due to the collaborative approach being taken among the OSC, FSRA and MoF to address all aspects of the implementation of the new NQSM regime.

The comments below are based on discussions I have had with some of AUM Law's clients and team members, as well as from discussions that took place during FSRA Stakeholder Advisory Committee for Mortgage Brokering meetings and the recent roundtable that was hosted by FSRA with several industry participants, including the OSC and MoF. The comments below do not necessarily represent the views of other members of AUM Law, the firm as a whole, or any particular clients of AUM Law.

AUM Law represents market participants who are registered with:

- the OSC only;
- FSRA only (as a mortgage broker and/or mortgage administrator); or
- Both FSRA and the OSC.

AUM Law does not provide advice with respect to real estate transactions. AUM Law focuses on advising its client base with respect to the regulatory aspects of their businesses and investment fund formation and related matters.

My comments below include the following:

- Expand the definition of "permitted client" to include business associates and investors with at least $2 million in investable assets;
- Empower FSRA to have exemptive relief abilities;
- Introduce an alternative reporting system for Reports of Exempt Distribution (Form 45-106F1) relating to NQSMs;
- Permit non-registered entities to receive business income relating to sourcing NQSM opportunities and investors; and
- Permit principals of certain issuers of NQSMs to become dealing representatives on third-party platforms.

Expand the Definition of Permitted Client (FSRA)

I have heard from several industry participants that they were very pleased with the proposal to ensure that lending businesses which only deal with permitted clients will remain under the oversight of FSRA only. Please consider expanding the definition of permitted client to include: (1) business associates and (2) accredited investors with at least $2mm of net investible assets.

Business associates:
Extending the definition of "permitted client" to include "business associates" would encompass individuals who, because of association with the issuer, have a knowledge and understanding of the issuer well beyond that of a "retail investor". For example, a business associate may be a 25 year-old analyst employed by the manager of the issuer working 12 hours a day on an investment opportunity, who partly chose to work at the issuer (or manager of the issuer) because of the ability to participate in these types of deals. Or a business associate may be a 20-year industry veteran who spent most of their working hours on a particular deal and, as an independent contractor, is responsible for a particular aspect of a deal. Investor protection concerns relating to suitability and access to information would not be applicable for these individuals. If the current proposed definition of "permitted client" is adopted, however, these individuals may not be offered the ability to invest alongside the permitted clients as lenders may reasonably choose to avoid paying exempt market dealer (**EMD**) fees by refusing their subscriptions.

I expect that in the most common scenarios, permitted clients will make up the overwhelming majority of the committed capital and those permitted clients would welcome (and often insist) that those working on the investment have skin in the game. If "business associates" are able to satisfactorily answer a handful of questions (i.e. to show that they have not been required to invest in deals by the issuer and that they have a legitimate knowledge of the business and transaction that a retail investor would not have), and pertinent information is provided in quarterly reporting forms, it would have a significant positive impact for lenders and business activity in general.

Accredited investors with $2mm of net investible assets:
Investors with this level of investable assets have largely illustrated either a level of sophistication, or ability to have advisors as required, that warrants their inclusion in the quarterly reporting process rather than having to go through a formal EMD process. I understand that under either regime, dealers and issuers will need to be mindful of investor concentration issues. Through staff guidance and the quarterly reporting process, FSRA members will be able to document concentration matters similar to what the OSC would expect from an EMD during a regulatory audit of concentration among its client base.

Empower FSRA to grant Exemptive Relief

The MoF has invested considerably in a very senior and experienced staff for FSRA. Empowering that staff to assess whether and how regulatory objectives can be achieved through an exemptive relief order that applies to a business in specific circumstances reduces regulatory burdens, encourages businesses to engage pro-actively and frankly with FSRA instead of acting outside the regime, reduces business and litigation risks, and enhances transparency. Exemptive relief orders provide clarity to businesses and the public on how a business may operate in a specific circumstance, as most exemptive relief orders will have terms and conditions attached to them, after going through several layers of independent review. Exemptive relief uses similar principles to "sandboxes" which have become popular ways for various governments and regulators to work collaboratively with parties that may not exactly fit what was intended by a rule's drafters. If participants can engage with a regulator and then publicly expose why they have gone to great effort and expense to explain why a particular course of action should take place, that promotes business growth and investor protection. I understand that the MoF will not want staff of FSRA using exemptive relief to override

laws that are in force, but that is not what it would be intended for and with minimal safeguards this would not be a realistic occurrence.

An example of when exemptive relief may have been appropriate relates to the requirement in Reg 188/08 that requires lenders to obtain audited financial statements from borrowers. Industry practice appears to be that lenders only obtain audited financial statements in a small minority of circumstances. This is because prudent commercial mortgage underwriters first and foremost consider the quality of the underlying mortgaged property through the various due diligence tools and information sources that they have at their disposal, rather than relying upon financial statements provided by the borrowing entity. Such tools and sources may include agreements related to the specific security to be provided to support the mortgage (e.g. cost sharing agreements, pre-sales and deposit agreements, etc.), independent third party cost consultant-prepared budgets and cashflows, appraisals, purchase and sale agreements, cost consultant-approved budgets and reports, security opinions, legal advice, environmental and geotechnical reports, commitment letters with explicit funding conditions, project milestones and records of borrower execution history and qualifications, etc. Where the property is a completed property, other materials such as tenant rent rolls, operating statements for the property, and tenant estoppel certificates may be useful in evaluating its quality.

FSRA understands the disconnect between the rule and reasonable business practices that are occurring and appears to be addressing this through the MBLAA review. To mitigate litigation and regulatory audit exposure, some lenders have co-lenders sign a short waiver acknowledging the issue and waiving liability regarding the failure to comply with Reg 188/08. Even in these circumstances, these FSRA members will routinely sign agreements that provide a representation that the FSRA members is not acting in contravention of any laws. If the investment does not go according to plan, are they explosed to an investor claiming that they wrongly represented in an agreement that they were acting in accordance with all applicable laws? If senior FSRA staff could have issued individual or limited blanket relief to address the issue when it first became evident quite some time ago, it could give comfort to industry participants that they are not acting in breach of any laws while the multi-year MBLAA review process plays out.

Modify the Form 45-106F1 Filing and Fee Payment Regime For NQSMs (OSC)

Under the current proposals, an important subset of the market that provides construction lending which banks do not generally make available, will experience a material increase in fees relating to filing form 45-106F1s if they do not restrict their business to “permitted clients” only. These important market participants may have multiple construction loans with multiple (typically three to five) draws. The loans are structured with these draws, which take place at important construction milestones, to protect investors. If each draw triggers a requirement to file a Form 45-106F1 and pay related fees, a lender that is funding a number of projects could easily end up having to file 25-50 reports each year with an estimated cost of $12,500-$25,000 in filing fees. In addition to incurring fees (tied to the amount of the draw), the lender also will incur costs in preparing and filing these reports in rapid succession, which it might or might not be able to pass on to investors or borrowers.

Some investment fund managers are able to file their reports of exempt distribution annually under an alternative reporting system. Would the OSC consider implementing an alternative reporting system to address the unique nature of these types of businesses? One reason I believe this is warranted relates to the change in regime whereby these types of transactions will now be processed through an EMD with securities laws obligations regarding know your product, know your client, suitability and relationship disclosure. The need to have almost real time filings and oversight of these transactions has been greatly reduced since the inception of National Instrument 31-103 Registration Requirements, Exemptions and Ongoing Registrant

Obligations (NI 31-103). If the OSC decides to maintain the current timing requirements, I suggest that after an initial 45-106F1 is filed for a NQSM, no fees should be collected for further distributions relating to the same project with respect to additional 45-106F1s that are filed.

Business structure – Business Income (OSC)

Prior to March 1, 2021, an individual who participates in sourcing both the opportunity and investors for an NQSM as part of their business activities can receive income relating to all such efforts into a corporation that they own. Similar to many other businesses and industries, this allows these small businesses to grow by spending pre-tax dollars on activities such as marketing, hiring administrative personnel, and purchasing equipment and supplies. As of March 1, 2021, however, unless very expensive and difficult to receive exemptive relief/tailored terms and conditions are obtained by a registrant from the OSC, any individual who previously earned business income from NQSMs will need to be paid as an individual if they are a dealing representative on a third party platform, which is the only viable option for many small businesses. This potential regulatory change would result in these industry participants immediately having to pay income tax on any amounts that the OSC deems they should declare as income associated with registerable activities, so that they will have to use after-tax dollars to invest in, sustain and grow that same part of their business. By contrast, if an individual engaged in the same activities through a standalone registrant, which is not a realistic option for some market participants, they would be able to operate in a more tax-efficient manner. This potential regulatory change could cause the loss of the smaller businesses that have long served this market, or could result in some market participants acting outside of the regime at the risk of being caught.

In light of the compliance and industry protection developments that have occurred since NI 31-103 came into force in 2009, it appears that Staff has recognized that there may be circumstances where terms and conditions may appropriately facilitate payment to a business entity that is not itself registered. Hopefully Staff, prior to March 1, 2021, will broaden the scope and provide comfort to the industry that if the right safeguards are in place, non-registered entities can receive payments that will be reported as business income. It is appropriate for individual market participants to be able to treat the income as business income if:

- The individual is raising capital from investors in their network, be it for a syndicated mortgage investment (SMI), or another exempt market security similar to an SMI (now that they are being clearly treated as an exempt market security);
- There is full transparency to investors,
- There is a registrant ensuring that all registerable activity is being done by and through the registrant; and
- Relevant information can be produced to the OSC on request regarding any entities that are possibly receiving fees relating to registerable activity.

The OSC will have insight through their ability to audit a registrant firm at any time. If employees or independent contractors to registrants provide appropriate reporting (notice to reader financial statements which can be provided to the OSC on demand or request), training, and attestation, and if there are significant consequences regarding any deviation from a compliant plan, it is not warranted to bar an individual from receiving business-related income as such.

OSC Restrictions on Dealing Representatives

Staff has imposed terms and conditions on third party EMDs so that some individuals originating NQSMs cannot become registered as dealing representatives on a third party platform. These terms and conditions

will require these individuals/small businesses either to: (1) pay additional fees to a third-party EMD to perform additional functions, or (2) dedicate or hire an additional resource internally to take this on this responsibility. In my view, largely as a result of industry experience since the implementation of NI 31-103, engagement with regulators through outreach, audits and industry events, and the need for businesses to have good business processes to protect themselves from litigation risk, the need to have such an absolute term and condition no longer appears to be warranted.

In *Re Waverley Corporate Financial Services Ltd*., the Panel stated that Section 28 of the Securities Act (Ontario) provides that the Director may impose terms and conditions of registration at any time during the period of registration of a company if it appears to the Director that (a) the person or company "is not suitable for registration"; (b) the person or company "has failed to comply with Ontario securities law"; or (c) "the registration is otherwise objectionable." The Panel stated that given their findings regarding the first two tests, they found find it unnecessary to engage in an analysis of the third test. However, in my experience, OSC staff have concluded that certain of the terms and conditions imposed in *Waverly* should apply generally to the business model. One of those terms is an absolute prohibition against registration of primary principals of an issuer as dealing representatives for firms that distribute that issuer's securities. I appreciate Staff's original insistence and intentions with respect to imposing such a broad term. The conflict of the main principal of an issuer also conducting a know your client and suitability assessment should be avoided in almost every case. But in a principles-based regime there also should be instances where it is appropriate, with appropriate oversight and controls, to permit the operation of these SMI businesses without subjecting them to these terms and conditions.

The cornerstone of a relationship with a third-party EMD would involve detailed and tailored policies and procedures and meaningful third-party oversight (addressing one of the main conflicts of interest of the captive dealer model, as set out at pages 40-41 of OSC *Staff Notice 33-751 – Summary Report for Dealers, Advisers and Investment Fund Managers* dated September 14, 2020 (OSC SN 33-751). Staff allows registration of primary principals as dealing representatives (and even CCO) under the captive dealer model, but disallows it under the third party oversight model. The principles of NI 31-103 should apply to both relationships, and it should not be banned under either. To mitigate litigation risk, and avoid the conflict entirely, most principals of an issuer will strongly prefer not to be involved in investor onboarding and qualification related matters. But for some small businesses, it may be warranted. The only way a registrant can oppose such a term is to pursue a costly and lengthy opportunity to be heard process.

Is Staff about to provide comfort in advance of March 1, 2021 that, in addition to allowing a principal of a NQSM to be a dealing representative on a third party platform if a proper compliance regime is in place (including clear insight into the flow of all funds associated with a transaction), all revenue associated with such a transaction can be paid to a business entity not registered with the OSC and be treated as business income? The reduced costs and tax efficient payments may make the difference in justifying a small business's decision to stay in the industry.

Conclusion

Thank you for you and your branches' continued active engagement with industry participants, which has been extensive since the proposals were first announced. Please do not hesitate to contact me if you have any questions or would like further information.

Sincerely,

Kevin Cohen