RE: Proposed Supervision Approach for High-Risk Syndicated Mortgage Investments - ID 2019-002

On behalf of the Ontario Securities Commission’s Investor Advisory Panel (IAP), I wish to thank you for this opportunity to comment on your recent Consultation 2019-002: Proposed Supervision Approach for High-Risk Syndicated Mortgage Investments, including proposed Form 3.2.1 – Supplementary Disclosure for Retail Investors in a High-Risk Syndicated Mortgage. The IAP is an initiative by the OSC to enable investor concerns and voices to be represented in its rule development and policymaking process. Our mandate is to solicit and represent the views of investors on securities-related policy and rulemaking initiatives.

It is admirable that FSRA recognizes a need for immediate action to protect retail investors from the dangers inherent in high-risk syndicated mortgages. However, the need is for effective investor protection, and we do not believe the measures being proposed will be effective. At the consumer end, those measures essentially amount to providing investors with a new disclosure document (Form 3.2.1 – Supplementary Disclosure for Retail Investors in a High-Risk Syndicated Mortgage). We do not think this will accomplish anything, for the reasons that follow; but as noted below, we believe elements of the proposal would be helpful as part of a better-targeted approach.

1. Disclosure does not work as a measure to protect unsophisticated investors

Disclosure is important for transparency, but it is useful only to a small segment of investors – those who are sophisticated enough to understand the significance and implications of the information disclosed. Unsophisticated individuals, by the very fact that they lack financial knowledge and understanding, are not well positioned to benefit from disclosure; and most Canadians have very low levels of financial knowledge and understanding.

Studies continually show this to be true. They also reveal that enhanced disclosure initiatives, such as CRM2, have done little to improve investors’ understanding and have not significantly empowered them.

Superficially, these unsatisfactory results can be explained by poor disclosure practices such as failure to use plain language in the disclosure, burying key information at the back end of a document, or failing to convey why the information is important (i.e., flunking the so-called “flip” test). But in our view these explanations miss the point.
The reality is that disclosure documents, even if better drafted to be more understandable and compelling, are nonetheless unlikely to be read – especially where the investor is presented with a risk disclosure document as part of a large mass of information and a blizzard of papers to sign during the investment subscription, as is typical with syndicated mortgages. In these circumstances the information quickly overwhelms the investor and they are unable to process it. The paperwork gets signed simply because doing so is necessary to gain access to the investment. It does not function as a true exercise in informing the investor.

In short, it has become abundantly clear that disclosure is not an effective tool for protecting unsophisticated investors, and regulators should cease turning to disclosure as the “go to” solution where protection is needed.

2. The disclosure proposed is flawed

We observe that Form 3.2.1 contains some very well-written, easy to understand text in some parts, but unfortunately it also contains a number of confusing, contradictory and unclear statements as well as some legalese that likely will diminish readership and inhibit understanding.

The Consumer Warning highlighted at the top of the first page – which sets the context and tone for the whole document – is framed as an equivocal statement that a syndicated mortgage “could be” a risky investment. We believe this warning is inadequate for two reasons:

• First, since it is proposed that Form 3.2.1 will be provided to investors only where the mortgage in question displays one or more of three high-risk indicia, the Consumer Warning should state plainly that: “This is a high-risk investment.”

• Secondly, since the vast majority of syndicated mortgages relate to commercial developments that likely will be precarious until the projects are completed, we believe it is inappropriate to state only that the investment “could be” risky, thereby implying a high degree of risk is merely a possibility rather than a likelihood.

The document also should be purged of unclear, undefined terms and legalistic language that appear in the first few paragraphs. Specifically:

• “A standard non-qualified syndicated mortgage funds property development where the mortgage has a loan-to-value of significantly less than 100%, considering all possible subordinations and prior ranking debt, and where the mortgage administrator does not have a conflict of interest.”

• “… that is an indicator of a high-risk non-qualified syndicated mortgage and not a standard one.”

• “… , after all subordinations and draws on senior debt, …”

This is not language that retail investors are apt to understand; and for any who do attempt to read the document, impenetrable text like this will only serve to dissuade them from reading it through to the end. In effect, this language serves as a barrier to informing investors about the risks they're facing.
Additionally, in the section referencing the absence of an investor protection fund, we are mystified by the document’s admonition that “you need to protect yourself.” We do not know what investors can do to protect themselves once they venture into a syndicated mortgage – to the best of our knowledge, investors have no means or opportunity to mitigate the risks inherent in these investments. Accordingly, the admonition seems to be misguided and undoubtedly will confuse any consumers who read it.

3. The proposal perpetuates a dubious concept of investment sophistication

Under this proposal, Form 3.2.1 will not be provided to designated classes of investors who “are generally knowledgeable and experienced with complex investments,” but this will include individuals who, like accredited investors, are deemed to possess sufficient financial sophistication simply because they have certain levels of income or assets.

Wealth has never been a valid indicator of investment knowledge or sophistication, and it is regrettably to see this fiction being perpetuated in an era where regulatory policy is meant to be evidence based. It is even more disconcerting where the required wealth threshold is below the average selling price of a detached home in many communities – meaning that a person with effectively no investment experience and a low level of general financial literacy could easily qualify as a "designated" investor for purposes of a syndicated mortgage investment after selling what may well be their core, and perhaps only, substantial asset. Under this proposal, they would not receive even the flawed disclosure contained in Form 3.2.1.

4. The real source of danger is not being addressed

Syndicated mortgages are complex and thus easily misunderstood, especially where the project being financed is a substantial commercial project. As recent events have witnessed, it appears some who promote these investments count on them being mistakenly viewed as safe and secure. They are aggressively marketed on the basis that investors' money will be “secured” by a mortgage, and it is this factual but often misleading statement that places prospective investors in danger.

We believe this hazard can be eliminated only by prohibiting any representation or statement, even if strictly factual, that implies or reasonably could be interpreted as implying a high-risk syndicated mortgage is a safe or secure investment. Thus, for example, marketing materials and presentations should be prohibited from containing statements that investors’ funds are “mortgage-backed” or “secured by a mortgage registered on title” unless the materials and presentations also state, at the same point and with equal prominence, that:

• the mortgage will not make the investment secure or guarantee repayment because other lenders will be entitled to be repaid before the syndicated mortgage lenders, and the value of the land may be insufficient to cover all those debts, and

• the syndicated mortgage therefore is a high-risk investment in which investors may lose some or all of the money they invest.

This prohibition should be combined with your innovative initiative requiring everyone marketing syndicated mortgages to identify and report to FSRA any indicia that the mortgage is a high-risk one. However, the requirement should be to report the indicia before any (or any further) marketing takes place – not at or after the investment’s point of sale, as currently proposed.
As stated above, we do not believe the balance of your proposed approach will be effective. While we commend your desire to take action quickly, we respectfully suggest it is not beneficial to the public interest for ineffective action to be taken, and therefore we urge you to reconsider the design of this initiative. Also, having regard to the expected transfer of regulatory responsibility over syndicated mortgages to the province’s securities regulator, we would encourage you to partner with OSC staff in developing this revised concept.

Thank you again for this opportunity to express our views on your proposal. If you require clarification of any of our comments, or wish to discuss them further, please let me know.

Sincerely,

[Signature]

Neil Gross
Chair, Investor Advisory Panel