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**Overview of Mortgage Investment Corporations,
Registration Issues and Capital Raising Exemptions**
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What is a Mortgage Investment Corporation (MIC)?

- A MIC is a company that is entitled to special tax treatment under Section 130.1 of the *Income Tax Act* (Canada) (the “Tax Act”) that allows investors to pool their funds to be loaned out as mortgages.
- The rules under Section 130.1 of the Tax Act were introduced to attract more money to the Canadian mortgage market for residential financing, which is a multi-billion dollar industry in Canada.
- The Tax Act requires that 100% of the MIC’s net income be distributed to its shareholders by way of a dividend, which is taxed as interest income.

Objectives of a MIC

- To preserve capital.
- To generate a stable stream of income for investors, primarily by making loans secured by mortgages.
- To provide investors with an opportunity to participate indirectly in a portfolio of mortgages.
- To provide an attractive return to allow the MIC to pay distributions to its shareholders in the form of dividends.

Rules under Section 130.1 of the Income Tax Act Rules

- A MIC must be a Canadian corporation.
- Must have at least 20 shareholders.
- No shareholder may own more than 25% of the issued shares of any class of the MIC.
- No more 25% of the assets of the MIC may be invested in real property, except property acquired by foreclosure or otherwise after mortgage default.
- A MIC cannot manage or develop real property.
- A MIC cannot own shares of non-resident corporations.
- A MIC cannot hold real property located outside of Canada.

Rules under Section 130.1 of the Income Tax Act Rules

- A MIC cannot loan funds where the security is property located outside of Canada.
- At least 50% (computed based on the cost amount to the MIC of all its assets) of the assets of the MIC must be invested in mortgages over residential properties and/or cash and deposits held in the Canadian Deposit Insurance Corporation insured institutions or credit unions.

Rules under Section 130.1 of the Income Tax Act Rules

- A MIC must not exceed certain debt-to-equity ratios depending on the percentage of assets invested in residential mortgages and/or cash and deposits in qualifying financial institutions:
 - If less than 2/3rds of the MIC's assets are invested in this manner, the debt-to-equity ratio may not exceed three to one
 - If 2/3rds or more of the MIC's assets are invested in this manner, the debt-to-equity ratio may not exceed five to one.

First taxation year

- In the first taxation year of the MIC, the requirements of at least 20 shareholders and no shareholder owning more than 25% of the issued shares of any class will be considered to be met throughout the year to the extent they are met on the last day of that taxation year.

“Prohibited Investment” concern when structuring a MIC

- Shares of a MIC will generally be “qualified investments” for deferred income plans, including but not limited to, RRSPs, RRIFs and TFSAs, provided that, the MIC does not hold any indebtedness of a “connected person” (generally the annuitant or any person that does not deal at arm’s length with the annuitant). However, an investment in a MIC through a TFSA, RRSP or RRIF will be a “prohibited investment” if:
 - The annuitant of the RRSP or RRIF or the holder of the TFSA has a “significant interest” in the MIC; or
 - The MIC does not deal at arm’s length with such annuitant.

“Prohibited Investment” concern when structuring a MIC

- An annuitant has a “significant interest” in a corporation if he or she owns directly or indirectly, 10% or more of the issued shares of any class of the corporation.
- This definition includes all shares owned by the annuitant as well as shares owned by any person that does not deal at arm’s length with the annuitant, which includes “related” persons.
- “Related” persons is defined broadly in the Tax Act and includes, but is not limited to:
 - (i) A person who is a descendant of another person is related to that person;
 - (ii) A person is related to his or her brothers and sisters;

“Prohibited Investment” concern when structuring a MIC

(iii) Spouses are related to each other; and

(iv) Spouses of persons in (i) or (ii) are related to the other persons referred to therein.

- For example an annuitant’s grandson’s wife is a “related” person.
- Therefore, be careful when initially structuring the share capital of a MIC so that the initial founders and shareholders and their “related” persons are not prohibited from investing through TFSAs, RRSPs and RRIFs if that was their intention.

Classes of Shares

- MICs typically have two classes of shares – common shares and preferred shares.
- Common Share Attributes
 - Usually the only voting class of shares
 - Typically issued to the founders, directors and officers of a MIC
 - Usually not entitled to dividends
 - No redemption provisions

Classes of Shares

- Common Share Attributes (cont'd)
 - Participate equally in distribution of assets after the holders of preferred shares have received the par value together with all dividends declared and unpaid and after a distribution of the par value of each common share to such holders
 - Be careful about the “prohibited investment rule”
 - Consider having 11 or more common shareholders

Classes of Shares

- Preferred Share Attributes
 - Usually no voting rights
 - Entitled to dividends paid either in cash or preferred shares
 - May be subject to rights of redemption by the MIC
 - Rights of redemption by the holder
 - Usually mandatory redemption on death of a holder where no spouse survives
 - On a winding up or liquidation entitled to receive the par value of each share together with all dividends declared and unpaid in priority to any distribution to holders of any other class of shares

Classes of Shares

- Preferred Share Attributes (cont'd)
 - On a winding up or liquidation, once such prior distribution is made to the holders of preferred shares, and after a distribution of the par value of each common share to such holders, the holder of the preferred shares are entitled to participate equally with holders of common shares in any further distributions of the assets on a pro rata basis

Restrictions on Redemptions

- A MIC is not able to proceed with a redemption if:
 - The MIC is insolvent at the time of redemption;
 - The redemption would render the MIC insolvent;
or
 - The redemption would cause the MIC to become disqualified as a MIC under the Tax Act.

Constraints on Transferability

- Shares cannot be transferred without the consent of the directors of the MIC, which directors may decline to provide such consent.
- Directors of a MIC cannot consent to a transfer unless immediately following such transfer no one shareholder would hold more than 25% of the shares in any class and the number of shareholders would not be reduced to less than 20.

Registration with FICOM under the Mortgage Brokers Act

- Each MIC is required to register with FICOM as a mortgage broker under the Mortgage Brokers Act.
- Each MIC is required to have at least one submortgage broker registered under the Mortgage Brokers Act.

Securities Registration Issues – Investment Fund Manager Registration

- Canadian Securities Administrators Staff Notice 31-323, effective February 25, 2011 provides guidance on whether a MIC (a pooled Mortgage Investment Entity) is required to be registered as an Investment Fund Manager.
- A MIC will be considered to be an investment fund if its primary activity is managing an investment portfolio that include mortgages. Relevant factors are:
 - The MIC does not take an active role in originating the mortgages that become part of the investment portfolio; and
 - The MIC buys and sells mortgages in accordance with a stated portfolio investment strategy.

Securities Registration Issues – Investment Fund Manager Registration

- A MIC will not be considered to be an investment fund if its primary activity is mortgage lending, that is, by operating a business that creates and manages mortgages. Relevant factors are:
 - The MIC originates the mortgages in the name of the MIC directly or through its agent (i.e. management company);
 - The MIC funds the mortgages;
 - The MIC enters into the mortgage agreements as the mortgagee; and
 - The MIC administers the mortgages, either directly or through its agent.

Securities Registration Issues – Investment Fund Manager Registration

- If the MIC is considered to be an investment fund, then the MIC or its management company, if any, must register as an investment fund manager under National Instrument 31-103 (“NI 31-103”).

Securities Registration Issues – Adviser Registration

- Definition of “adviser” under the *Securities Act* (British Columbia) means a person engaging in, or holding himself, herself or itself out as engaging in, the business of advising another with respect to investment in or the purchase or sale of securities or exchange contracts.
- A person or company that advises a MIC that is an investment fund about investing in or buying or selling mortgages will be subject to the adviser registration requirement if it is in the business of advising in securities.

Securities Registration Issues – Adviser Registration

- A person or company that advises a MIC that is not an investment fund needs to consider whether it is in the business of advising based on guidance under Section 1.3 of NI 31-103 companion policy and required to register.

Business Trigger for Advising (Section 1.3 of NI 31-103CP)

- Engaging in activities similar to a registrant.
- Carrying on the activity with repetition, regularity or continuity.
- Being, or expecting to be, remunerated or compensated.
- Directly or indirectly soliciting.

Adviser Registration Categories

- Categories for registration of firms
 - Portfolio Manager
 - Restricted Portfolio Manager
- The regulators will consider discretionary exemption applications from advisers of MICs from the portfolio manager proficiency requirements. If allowed the adviser will be registered as a restricted portfolio manager with terms and conditions limiting its advising to MIC activities.

Securities Registration Issues – Dealer Registration

- A MIC or any other person or company trading a MIC's securities will be subject to the dealer registration requirement if it is in the business of trading in securities.
- Business trigger for trading - same as advising and includes *intermediating trades or acting as a market maker*.
- Common trading triggers for MICs:
 - Frequently trade in securities (continuous offering through an offering memorandum);
 - Solicit investors actively; or
 - Employ or contract individuals or a company to perform activities similar to a registrant.

Dealer Registration Exemption under BC Instrument 32-517

- The BCSC has implemented an exemption from the dealer registration requirements for trades in securities of MICs – *BC Instrument 32-517*.
- This exemption is not available in any other Province or Territory of Canada.
- The exemption is scheduled to expire on June 30, 2015, but may be extended again as it has in the past since June 30, 2011.

Dealer Registration Exemption under BC Instrument 32-517

- Key requirements for the exemption under 32-517 to apply:
 - The person is not registered under provincial or territorial securities legislation.
 - The person is not registered under the securities legislation of a foreign jurisdiction.
 - The person does not advise, recommend or otherwise represent to the investor that the securities are suitable to the investor's:
 - Investment needs and objectives;
 - Financial circumstances; or
 - Risk tolerance.

Dealer Registration Exemption under BC Instrument 32-517

- In addition, 32-517 requires:
 - The person to obtain from the investor a signed Risk Acknowledgement – Appendix A to 32-517 (must be kept for 8 years); and
 - The person to electronically file with the BCSC a current information report, Appendix B to 32-517, or an update of a previously filed Appendix B within 10 days after the issuance of the securities.

Dealer Registration Exemption under BC Instrument 32-517

- If the MIC is required to register as an investment fund manager or the MIC's management company, if any, is required to register as an investment fund manager and/or an adviser, then the exemption under 32-517 is not available and the MIC or management company, as applicable, will be required to register as an Exempt Market Dealer in order to sell securities of the MIC.

Registration Exemption for Trades in Connection with Certain Prospectus-Exempt Distributions – BC Instrument 32-513

- BC Instrument 32-513 which is also known as the *NorthWestern Exemption* is a commonly misused exemption for unregistered selling agents of MICs.
- The NorthWestern Exemption is typically for third-party finder's that are not in the business of trading in securities (i.e. one-off transactions).
- MICs typically continuously offer its securities for sale and the MIC or the person or company trading the MIC's securities will be considered to be in the business of trading requiring registration or another exemption.

BC Instrument 32-513

- Key requirements for the exemption under 32-513 to apply:
 - The distribution is made in reliance on one of the following prospectus exemptions of NI 45-106:
 - Accredited investor (section 2.3);
 - Family, friends and business associates (section 2.5);
 - Offering memorandum (section 2.9); or
 - Minimum investment amount (section 2.10).
 - The person is not registered or formerly registered under securities legislation in any jurisdiction, including a foreign jurisdiction.

BC Instrument 32-513

- The person does not advise, recommend or otherwise represent to the investor that the securities are suitable to the investor's:
 - Investment needs and objectives;
 - Financial circumstances; or
 - Risk tolerance.
- The person does not hold or have access to the investor's assets.
- The person has not provided financial services to the investor other than in connection with a prospectus-exempt distribution.
 - Financial services includes, but is not limited to (i) mortgage broker services, (ii) insurance or related services, and (iii) financial planning services.

BC Instrument 32-513

- In addition, 32-513 requires:
 - The person to obtain from the investor a signed Risk Acknowledgement – Appendix A to 32-513 (must be kept for 8 years); and
 - The person to electronically file with the BCSC a current information report, Appendix B to 32-513, or an update of a previously filed Appendix B within 10 days after the issuance of the securities.

BC Instrument 32-513

- Another concern for use of the exemption under 32-513 by unregistered selling agents of MICs is the requirement to “**not hold or have access to investor’s assets**”. It is common for MICs that have management companies, which sell the MIC’s securities, to have the same officers. In this situation the BCSC takes the position that the management company holds or has access to the investor’s assets, and therefore, the exemption under 32-513 would not be available.

Capital Raising Exemptions

- The following are the common prospectus exemptions contained in National Instrument 45-106 used by MICs:
 - Private issuer (section 2.4);
 - Family, friends and business associates (section 2.5);
 - Accredited investor (section 2.3);
 - Offering memorandum (section 2.9); and
 - Minimum investment amount (section 2.10).

Capital Raising Exemptions

- **Private Issuer exemption:**

- Used for initial structuring of the MIC and available for up to the first 50 investors not including employees or former employees if requirements are met.
- Not available after another exemption has been used or have reached the 50 person limit.
- Available for an investor who purchases as principal and is:
 - (a) A director, officer, employee, founder or control person of the issuer;
 - (b) A director, officer or employee of an affiliate of the issuer;

Capital Raising Exemptions

- (c) a spouse, parent, grandparent, brother, sister, child or grandchild of a director, executive officer, founder or control person of the issuer;
- (d) a parent, grandparent, brother, sister, child or grandchild of the spouse of a director, executive officer, founder or control person of the issuer;
- (e) a close personal friend of a director, executive officer, founder or control person of the issuer;
- (f) a close business associate of a director, executive officer, founder or control person of the issuer;
- (g) a spouse, parent, grandparent, brother, sister, child or grandchild of the selling security holder or of the selling security holder's spouse;
- (h) a security holder of the issuer;

Capital Raising Exemptions

- (i) an accredited investor;
- (j) a person of which a majority of the voting securities are beneficially owned by, or a majority of the directors are, persons described in paragraphs (a) to (i);
- (k) a trust or estate of which all of the beneficiaries or a majority of the trustees or executors are persons described in paragraphs (a) to (i); or
- (l) a person that is not the public.

Except for an issuance to an accredited investor, no commission or finder's fee may be paid to any director, officer, founder or control person of the MIC.

Capital Raising Exemptions

- **Family, Friends and Business Associates exemption:**
 - Available for an investor who purchases as principal and is:
 - (a) a director, executive officer or control person of the issuer, or of an affiliate of the issuer;
 - (b) spouse, parent, grandparent, brother, sister, child or grandchild of a director, executive officer or control person of the issuer, or of an affiliate of the issuer;
 - (c) a parent, grandparent, brother, sister, child or grandchild of the spouse of a director, executive officer or control person of the issuer or of an affiliate of the issuer;
 - (d) a close personal friend of a director, executive officer or control person of the issuer, or of an affiliate of the issuer;

Capital Raising Exemptions

- (e) a close business associate of a director, executive officer or control person of the issuer, or of an affiliate of the issuer;
- (f) a founder of the issuer or a spouse, parent, grandparent, brother, sister, child, grandchild, close personal friend or close business associate of a founder of the issuer;
- (g) a parent, grandparent, brother, sister, child or grandchild of a spouse of a founder of the issuer;
- (h) a person of which a majority of the voting securities are beneficially owned by, or a majority of the directors are, persons described in paragraphs (a) to (g); or
- (i) a trust or estate of which all of the beneficiaries or a majority of the trustees or executors are persons described in paragraphs (a) to (g).

Capital Raising Exemptions

- No commission or finder's fee may be paid to any director, officer, founder or control person of the MIC or an affiliate of the MIC.
- "Close personal friend" is an individual who knows the director, executive officer, founder or control person well enough and has known them for a sufficient period of time to be in a position to assess their capabilities and trustworthiness.
- The "close personal friend" relationship must be direct (i.e. not a close personal friend of a close personal friend of a director).
- Same requirements applicable to "close personal friend" apply to "close business associate".

Capital Raising Exemptions

- **Accredited Investor exemption:**

- The categories of “accredited investor” are set forth in the definition in Section 1.1 of NI 45-106.
- The most commonly used categories of “accredited investor” are:
 - (i) an individual who, either alone or with a spouse, beneficially owns financial assets having an aggregate realizable value that before taxes, but net of any related liabilities, exceeds \$1 000 000; and
 - (ii) an individual whose net income before taxes exceeded \$200 000 in each of the 2 most recent calendar years or whose net income before taxes combined with that of a spouse exceeded \$300 000 in each of the 2 most recent calendar years and who, in either case, reasonably expects to exceed that net income level in the current calendar year.

Capital Raising Exemptions

- “Financial assets” means cash, securities, or a contract of insurance, a deposit or an evidence of a deposit that is not a security for the purposes of securities litigation.
- Such “financial assets” are generally liquid or relatively easy to liquidate.
- The value of an investor’s personal residence would not be included in a calculation of “financial assets”.

Capital Raising Exemptions

- For purposes of the net income category, if the combined net income of both spouses does not exceed \$300,000, but the net income of one of the spouses exceeds \$200,000, only the spouse whose net income exceeds \$200,000 qualifies as an accredited investor.

Capital Raising Exemptions

- **Offering Memorandum (“OM”) exemption:**

- Most commonly used capital raising exemption by MICs after the initial structuring and investments by any family, friends and business associates.
- Most MICs are not reporting issuers which requires use of Form 45-106F2 (OM for non-qualifying issuers).
- The MIC must ensure that the information provided to the investor is current and does not contain a misrepresentation.

Capital Raising Exemptions

- If a material change occurs in the business of the MIC after delivery of an OM to a potential investor, the MIC must give the potential investor an update to the OM before the MIC accepts the subscription agreement.
- Under the OM exemption, the investor has the right to cancel the agreement to purchase shares until midnight on the 2nd business day after signing the subscription agreement.
- During this period, the MIC must arrange for the funds to be held in trust on behalf of the investor (i.e. keeping the cheque, without cashing or depositing it, until the period expires).

Capital Raising Exemptions

- The MIC must file the OM with the BCSC on or before the 10th day after the first distribution under the OM – no need to file again after subsequent closings unless the OM has been updated.
- The investor has rights of action if the OM contains a misrepresentation.
 - Investor may claim damages or ask to cancel the agreement.
 - If cancellation is sought, investor must commence action within 180 days after signing the subscription agreement.
 - If damages are sought, investor must commence action within the earlier of 180 days after learning of the misrepresentation and 3 years after signing the subscription agreement.

Capital Raising Exemptions

- An investor has a right of action for damages against:
 - The MIC;
 - Every director at the date of the OM; and
 - Every person who signed the OM.
- The MIC, its directors and the signatories to the OM have a defence if the investor knew of the misrepresentation at the time of purchase.
- Various other defences are available under Section 132.1 of the Securities Act.

Capital Raising Exemptions

- **Minimum Amount exemption:**
 - Available for an investor who purchases as principal and the shares have a cost of not less than \$150,000.
 - The minimum amount exemption is not available to distribute securities to a company that has no pre-existing purpose and was created or used solely to qualify for the \$150,000 threshold.

Overview of Mortgage Investment Corporations, Registration Issues and Capital Raising Exemptions

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