PUBLICATION

Captive Dealers and Mortgage Investment Entities

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Captive Dealers and Mortgage Investment Entities: Concerns and Safeguards

On November 19, 2015, the Canadian Securities Administrators (CSA) published CSA Staff Notice 31-343, Conflicts of Interest in Distributing Securities of Related or Connected Issuers (the CSA Notice). The CSA Notice introduces a definition for a subset of registered dealer, the "Captive Dealer" (a Captive Dealer), which is characterized by firms registered as exempt market dealers that distribute securities of related or connected issuers with common mind and management. This Captive Dealer model of registered dealer is one heavily relied on by mortgage investment entities (MIEs), which for the purposes of this article refers to an entity whose purpose is to invest substantially all of its assets in debts secured by mortgages. While this article will focus on captive dealing as it relates to MIEs, the themes are applicable to Captive Dealers in other industry segments as well.

The CSA Notice sets out the main concerns with the Captive Dealer business model, suggests ways Captive Dealers can respond to conflicts inherent in this business model and goes on to suggest acceptable and unacceptable practices for responding to conflicts of interest. The CSA Notice also summarizes the CSA's expectations for firms proposing to become registered as Captive Dealers and what existing Captive Dealers can expect in terms of future CSA compliance reviews. To be clear, the CSA Notice is meant to provide guidance only; however, regulatory compliance reviews will often focus on a participant's adherence to the best practices raised in such notices. The CSA Notice explicitly states that the CSA will conduct compliance reviews where a Captive Dealer's adherence to the recommendations will be scrutinized. This has alarmed some MIEs since following each and every "best practice" contained in the CSA Notice could prove to be impractical and difficult to achieve, given the structure of their business model. Some see a discord since, on the one hand, the Captive Dealer business model for registered dealers is not prohibited by securities legislation but, on the other hand, many MIEs may well have to abandon their Captive Dealer business model if they followed certain suggested "acceptable practices" contained in the CSA Notice.

It is fairly obvious that the CSA sees compliance issues with the Captive Dealer business model. In the Ontario Securities Commission (the OSC) Staff Notice 33-745, Annual Report for Dealers, Advisors and Investment Fund Managers, dated September 25, 2014 (the OSC Notice), the OSC noted that dealers who trade solely in related issuer products generated a material conflict of interest "in large part due to the lack of separation between the mind and management of the EMD and the issuer." The OSC has had to reprimand Captive Dealers who have misappropriated investor funds, concealed the poor financial condition of the related/connected issuer and have sold unsuitable investment products to investors which were beyond the investor's risk tolerance or capacity to

absorb loss (OSC Notice at p. 51).

While these are legitimate concerns in terms of investors and investor protection, there are already existing regulatory requirements and features of the offering memorandum capital raising exemption (the OM Exemption), which mitigate these concerns.

In addition to the OM Exemption, there are other requirements under securities and corporate law applicable to MIEs which can address disclosure issues pertaining to conflict of interest. This includes requirements contained in National Instrument 31-103 Registration Requirements and Exemptions (NI 31-103), National Instrument 33-105 Underwriter Conflicts (NI 33-105) and provincial business corporation legislation regulating the use of annual financial statements.

While trying to manage some serious investor protection concerns, such as misappropriation of investor funds and the concealment of poor financial conditions of the related/connected issuer, the CSA Notice has likely overshot the mark, if there are already existing mechanisms prescribed by securities regulations and corporate law which can address these concerns.

Two “Acceptable Practices” in the CSA Notice that raise concerns

Among the recommended “Acceptable Practices” in the CSA Notice are two that raise practical concerns for MIE’s and they include:

1. Having unrelated dealers distribute the securities of the related or connected issuers, demonstrating to CSA staff that a third party has reviewed the products and found them suitable for distribution
2. Having the Captive Dealer sell products other than those of related or connected issuers as product diversification is seen as factor in helping reduce financial dependence of the dealer on an issuer.

In regards to #1 above, while it may be useful for a non-MIE type of Captive Dealer to conduct a third party review on an MIE issuer’s product and market the investment on its product shelf, the incentive for an MIE Captive Dealer to conduct a third party review on another unrelated MIE issuer’s product would be minimal. In the off chance that such a review was conducted, it would likely result in a very practical business conflict with a competitor.

The second practices noted by the CSA in #2 above is of even greater concern and would no doubt create a hardship for many MIEs if it was enforced by the regulators. For example, imagine there are two entities, an MIE issuer (Issuer Co.) and its manager (Manager Co.). Manager Co. is registered as an exempt market dealer (EMD), a restricted portfolio manager (RPM) and investment fund manager (IFM) and provides registrable services solely to Issuer Co. The Issuer Co. and Manager Co. have similar mind and management, they share the same office space, the same employees and for all intents and purposes, are the same entity. Issuer Co. pays management fees solely to Manager Co. for the provision of the EMD, RPM and IFM services. Investors who subscribe for securities of Issuer Co. through Manager Co. are only intending and expecting to subscribe for securities of Issuer Co.; they are not entering the offices of Issuer Co./Manager Co. to subscribe for securities of a third party. Since the business focus and expertise of most MIEs and their Captive Dealers is very narrow and limited, compelling Manager Co. to sell securities of a third party issuer would be tantamount to forcing Issuer Co. to sell a competing product of another MIE. If investors wanted to invest in another product besides the securities of Issuer Co. there is a very small chance they would be seeking advice from Manager Co. given the obvious connection between the two entities.

Since there is no prohibition in securities law on the Captive Dealer business model being utilized in the example above, there shouldn’t be an expectation by securities regulators that MIEs who have adopted this business model suddenly implement guidelines and practices which would effectively run them out of business.

Existing Safeguard - the Offering Memorandum Exemption

One concern expressed in the CSA Notice is that Captive Dealers often fail to disclose or provide inadequate disclosure to investors about related issuers in cases where there is negative information (for example, where the issuer is experiencing financial difficulty), resulting in investors taking on more risk than they could or wish to bear.

Many Captive Dealers are agents for related MIE issuers who rely on the OM Exemption, which is now available for use in Ontario. Offering memorandums (OMs) have been subject to greater scrutiny over the last few years, particularly by the Alberta Securities Commission. OMs are required to have detailed, non-boilerplate risk factors which often address the issuer's cash deficiency as at the date of the OM. Under the new amendments to the OM Exemption which came into effect in Ontario on January 13, 2016 and which are effective in Alberta, Saskatchewan, Quebec, New Brunswick and Nova Scotia on April 30, 2016, issuers using the OM Exemption are required to file, on an annual basis, audited financial statements along with a statement of how funds raised were utilized, with investors and with applicable securities regulators.

Another concern expressed in the CSA Notice is that some Captive Dealers do not adequately disclose significant fees and charges paid to related or connected issuers, resulting in investors not understanding the costs associated with their investment. The OM requires disclosure in several areas, of commissions and fees payable in connection with the offering of an issuer. For example, fees paid to related parties are required to be disclosed in multiple areas in Form 45-102F2, the form of OM for non-qualifying issuers: (1) in the "use of available funds" table at the beginning of the OM, (2) in Item 7, "compensation paid to sellers and finders" and (3) in Item 2.7, the "material contracts" section of the OM where an issuer is required to disclose any fees being paid to Captive Dealers pursuant to a management agreement or dealer agreement. Also, Form 45-106F4 (Risk Acknowledgement Form) required in connection with the OM Exemption requires an investor to specifically acknowledge the amount of commissions being paid to a Captive Dealer.

Both the CSA Notice and the OSC Notice raise the concern that issuers related to Captive Dealers are using the proceeds raised from their distributions for purposes other than those stated in their offering or marketing materials. This type of activity is mitigated to the extent that issuers using the OM exemption are now required, as mentioned above, to file annual reports to investors and the regulators detailing exactly how proceeds raised by issuer were actually used by the issuer. Furthermore, issuers using the OM exemption are now subject to civil liability for any misrepresentation in their marketing materials, copies of which (along with any amendments) are to be filed with securities regulators.

Existing Safeguards - present securities legislation and policies

In the event an MIE is not relying on the OM exemption to raise funds, there is no reason why it cannot identify and respond to conflicts of interest in its subscription documents. An MIE can educate an investor in a sufficiently detailed manner about the nature and extent of the conflict of interest arising from the Captive Dealer business model in a subscription agreement, before the investor purchases the securities. This type of disclosure in a subscription agreement would likely satisfy the restriction on recommending related or connected securities contained in section 13.6 of NI 31-103.

Arguably, in the absence of the use of an OM, the Captive Dealer business model already requires that an issuer's subscription agreement satisfy the requirements of NI 31-105; the nature and extent of the relationship between the Captive Dealer and connected issuer must be explicitly referred to on the cover page of the subscription agreement (among other areas) where it is in plain sight of an investor.

If the MIE is a corporation, the business corporations' legislation of the jurisdiction of that MIE likely requires it to prepare annual financial statements. For example, in Alberta, the Business Corporations Act requires a

corporation to prepare annual financial statements (along with the report of the auditor, if any) and deliver the statements to each shareholder at least 21 days prior to each annual shareholders meeting.

While there is an inherent conflict of interest with the Captive Dealer business model utilized heavily by MIEs, it is unrealistic to expect these Captive Dealers to sell product of a competing MIE or to have a competing MIE's Captive Dealer sell its product. In the past, some Captive Dealers and related issuers have engaged in questionable business practices including the misappropriation of investor funds and have concealed their poor financial condition in an effort to sell product. Through existing safeguards built into the OM exemption, existing securities and corporate legislation, and disclosure in subscription documents that is compliant with NI 31-103 and NI 33-105, many of the concerns of the CSA and OSC have already been addressed.

For more information contact a lawyer in our Securities & Capital Markets group.

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