

PUBLICATION

Offering Memoranda and Mortgage Investment Entities: Select Disclosure Issues

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Before discussing some 'best practices' in preparing mortgage investment entity issuing documents we should review the key regulatory elements. National Instrument 45-106 Prospectus Exemptions (NI 45-106) provides for the offering memorandum exemption in section 2.9 of NI 45-106 (the OM exemption). NI 45-106 also provides a prescribed form for offering memorandums (OMs) for all non-qualifying issuers found in Form 45-106F2 (the F2). The F2 is to be used by all non-qualifying issuers (typically those who are not reporting issuers). This includes many 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 owing to it that are secured by mortgages.

MIEs are unique when compared to other exempt market issuers as their assets consist primarily of investments in a portfolio of mortgages which may include mortgages that are in default or impaired. As a result, drafting an OM for an MIE requires special attention. The Canadian Securities Administrators (CSA) have given MIEs some guidance on OM disclosure which can be found in CSA Staff Notice 45-309, "Guidance for Preparing and Filing an Offering Memorandum under NI 45-106" (CSA Notice 45-309). In our experience, there are a number of areas in MIE OMs which require specific attention. In order to increase the disclosure quality found in MIE OMs we offer the following comments and recommendations.

Disclosure of an MIE Mortgage Portfolio and Impaired Loans

Item 2.2 of the F2 requires that an MIE disclose their business in a manner sufficient to enable a prospective purchaser to make an informed investment decision. One of the primary elements under this section is the mortgage portfolio disclosure. It is not sufficient for MIEs to merely list information about the number of mortgages in their loan portfolio, the loan to value and the priority of mortgages and the number of mortgages impaired or in default. The CSA Notice 45-309 provides a 'best practices' approach which includes disclosing: (1) repayment terms and interest rate; (2) basis for determining the value of the underlying property on which the loan to value is calculated and (3) location of the properties underlying the mortgages. One of the challenges is to provide this comprehensive information on each mortgage within a portfolio that consists of hundreds of mortgages that turn over regularly. To stay consistent with a 'best practices' approach, we recommend that MIE issuer's group its mortgages into specific segments and provide the recommended

disclosure for each segment within the mortgage portfolio. Issuers should strive to have smaller segments with narrow ranges of disclosure instead of large groups with broad ranges of disclosure. For example, 20% of the mortgages have one year terms and bear interest at rates between 13 and 15%.

It is also crucial that the audited financial statements included in an OM reconcile with the mortgage information set out under Item 2.2 of the OM. In particular, MIE issuers must set out the mortgages in good standing, mortgages in default, impaired mortgages and foreclosed mortgages where the lands are now held by the MIE. We consider it important to also distinguish, where applicable, between mortgages which are in default and mortgages which are impaired. Many MIEs classify impaired mortgages as loans that are in default, that are not fully secured and where full repayment of the loan is not anticipated. Defaulted mortgages would not be considered impaired if they are fully secured and full repayment is anticipated.

Lastly, if an MIE is investing in first, second and third mortgages, the OM disclosure should set out a percentage range of the overall mortgage portfolio that is held in the second and third subordinated mortgages.

Lines of Credit and Third Party Mortgages

It is common for MIEs to borrow funds or become obliged under third party mortgages in a foreclosure. Generally, credit lines are secured through a general security agreement charging the assets of the MIE. The nature and scope of the MIE's assets charged and the method by which it is registered should be carefully considered; for example, where the lender's security consists of a specific assignment of mortgage loans or otherwise adversely affects the MIE's mortgage assets.

In circumstances where the MIE has foreclosed and taken title of the property but it remains subject to a first mortgage held by a third party, the MIE will remain obligated to service these mortgage payments placing additional pressure on the MIE's cash resources.

In both of these examples, the OM will require additional disclosure. Specifically, the impact and risk of security taken and the effect it may have on the priority of payment of funds to the investors, either through the payment of interest or the return of capital upon redemption or wind up. Obligations under third party mortgages will also warrant additional disclosure in the mortgage portfolio and risk factor disclosure sections of the OM and in the financial statements included in the OM.

Risk Factor Disclosure

An area that always seems to draw regulatory scrutiny in OM's is the risk factor disclosure. MIEs must be extremely thorough in their consideration of the risks specific to an investment in the MIE's securities. MIE issuers should avoid boilerplate, generic risk factors and should identify the MIE's specific circumstances. For example, the increased risk due to non-performing mortgages is a common risk related to the mortgage investment industry. A 'best practices' approach when addressing this risk factor would be to list the number of mortgages in the MIE's portfolio which are impaired or in default as of the date of the OM and the total amount of any loss provisions taken by the MIE. It would also be prudent to address what effect the loss provisions may have on the payment of dividends.

Another common risk factor for MIEs is the risk related to foreclosure. Such risk factors should not only address the expenses incurred in the foreclosure process but also set out the ongoing costs to the MIE of owning the property until it is sold, including: property taxes, capital repair and replacement costs, maintenance costs, insurance costs and third party mortgage payments. The negative impact on the MIE's ability to invest in new mortgages and meet redemptions should also be addressed.

Finally, MIE issuers should take care to specify in its risk factors, the potential risks associated with the subordinated mortgages it may hold in its portfolio, particularly if the portfolio is heavily weighted with second

or third mortgages. This risk factor may also identify that a MIE's priority under its mortgage security may be altered by a court under certain insolvency/bankruptcy proceedings.

Development of Business

Item 2.3 of the F2 requires that issuers disclose the general development of their business over at least the two most recently completed financial years. Although the F2 states that this disclosure can be made in one or two paragraphs, this is the absolute minimum and in practice, much more disclosure is typically required. For example, although a two year period is specified, if a MIE is being impacted by events that occurred prior to the two most recent years, then such disclosure should go back and describe such prior events and how such events continue to impact the MIE.

A 'best practices' approach when disclosing significant events for the most recent fiscal year should address changes in the MIE's financial circumstances (both positive or negative) as disclosed in the financial statements included in the OM. This disclosure should not only discuss the factors leading up to those changes but also the impact of such changes and how the MIE will address any adverse financial circumstances.

There are a number of unique disclosure concerns related to MIEs which must be considered when drafting OMs, including the items discussed above. An MIE cannot simply follow the F2 or another MIE's OM precedent. It is imperative that attention is paid to the specific circumstances of each MIE for compliant OM disclosure. MIE issuers should strive to achieve 'best practices' disclosure in OMs so as to provide a comprehensive and accurate description of the MIE's business and risk factors for the benefit of investors.

The information provided in this article is not meant as legal advice. Viewers are cautioned not to act on information provided in this article without seeking specific legal advice with respect to their specific circumstances.

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