What is a Syndicated Mortgage and is it a Safe Investment? (Lessons from Recent Public Mortgage Syndicate Failures)

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What is a Syndicated Mortgage?

A syndicated mortgage investment (SMI) is an arrangement in which more than one investor (i.e. lender) is involved in a loan or debt obligation secured by a mortgage. Syndicated mortgages range in complexity, from simple three party loan transactions to large-scale commercial real estate development projects funded by a group of investors. The latter is the focus of this presentation. Syndicated mortgages are marketed as an attractive investment opportunity as they permit small investors to pool resources together for large scale development projects, allowing these investors greater access to the real estate market. Investors also get the opportunity to choose which projects they would like to be involved in. Ordinarily, investment funds derived from syndicated mortgages are used to fund the 'soft costs' of a development project, with the promise of a healthy interest payment on the loan.[1] However, as described below, SMIs can be extremely risky.

Though governed by the Financial Services Commission of Ontario (FSCO), syndicated mortgages are considered a security instrument in Ontario. However, as they are currently sold by licensed mortgage brokers, SMIs have to date been exempted from the normal registration and filing provisions related to the sale and distribution of a security. This may change in the near future.

Concerns about Investor Protection in the Syndicated Mortgage Market

According to FSCO, the syndicated mortgage market nearly doubled from $3.7 billion in 2014 to $6.6 billion in 2016.[2] This sharp increase is one of the causes for concern that investors may participate in syndicated mortgage transactions without being fully aware of their risks. SMIs are often marketed as 'low risk, high reward', which belies the actual and oft-not appreciated dangers of relying on loans offered by issuers with payment dependent on future financing and development. Not unexpectedly, FSCO has seen an increase in complaints about syndicated mortgages over the last five years. In fact, the regulator has received more than 183 complaints about syndicated mortgages since 2013.[3]

Some of these complaints have also received media attention. In a particularly well-publicized case, Fortress Real Developments Inc. (which was/is one of the largest companies in the syndicated mortgage industry) was named in four proposed class-action lawsuits in 2016 along with FSCO. The suits claimed $27.5 million in damages as well as a return of any profits for a condominium development project in Barrie, Ontario. The lawsuits alleged that Fortress, its principals and its related entities mislead investors by representing to them that the development project was 'safe' and 'secure'. In particular, the investors also alleged that they were kept in the dark with regards to how their money was spent as well as the true value of the land.

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[1] Financial Services Commission of Ontario (FSCO), *Annual Report 2016-2017* (Toronto: Financial Services of Ontario, 2017), available online at: http://www.fsco.gov.on.ca/en/about/annual_reports/Pages/ar2016-mortgage.aspx

[2] Financial Services Commission of Ontario (FSCO), *2016 Annual Information Return Results* (Toronto: Financial Services of Ontario, 2016), available online at: https://www.fsco.gov.on.ca/en/mortgage/air/Pages/2016-AIR-results-rpt-ma-mb.aspx#syndicated

[3] *Supra* note 1

To date, Fortress has denied any wrongdoing and the class action proceedings were dismissed by the Ontario Superior Court of Justice.[4] However, by 2018 it came to light that Building & Development Mortgages Canada (BDMC), which was Fortress's affiliated mortgage brokerage company, had raised over $700-million from 11,000 investors since 2013 and that 35% of that money had gone into paying commissions and consulting fees instead of towards the actual developments. FSCO announced orders against eight of the parties involved in these transactions, as well as $1.1 million in administrative penalties against the mortgage brokerages involved in the developments.[5] In addition, a replacement administrator was appointed to administer the BDMC mortgage portfolio. Many of the Fortress developments are now subject to enforcement proceedings.

With a story similar to Fortress, the "Textbook" entities, which were developers of student residences, accommodations for people suffering from various forms of cognitive impairment and low-rise condominiums, raised approximately $120 million, including approximately $95 million in SMIs. Despite raising such a significant sum of money, when the Textbook entities became subject to receivership proceedings, they had not completed any material development activities and had virtually no remaining funds. The authors are currently acting as the Receiver and Receiver's counsel in the Textbook entities' receivership proceeding, and have commenced litigation in connection with the SMI scheme.

Another recent case concerns Black Bear Homes Ltd., where over $9 million was raised through a syndicated mortgage of 120 investors for a residential development near Lake Erie. The syndicated mortgage was promoted to investors with a 12 percent annual interest return on a short term loan. However, the funds were ultimately misappropriated and the development project was found to be a sham. The investors were also unaware that a prior ranking mortgage was registered on the property. The license of the primary broker in the transaction was revoked as a result.[6]

As the above cases illustrate, the regulation of the SMI industry is intimately tied to the regulation of the mortgage broker regulations and financial services industry as well. The province is now tasked with figuring out the best way to regulate all the actors involved in these types of transactions to best protect investors.

Role of FSCO in Regulation

One of the most contentious topics in the conversation around regulating the syndicated mortgage industry is the role of FSCO. The agency has been criticized by the public for delays in its responsiveness to complaints about the industry, and has been characterized as 'reactive' instead of 'proactive' in its protection of investors.[7] A 2014 Auditor General's report highlighted that the regulator had several problems with management and enforcement. The report found that the regulatory body was slow in handling complaints[8], even though 95% of the complaints pertained

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[4] *Madryga v Fortress Real Capital Inc*., 2017 ONSC 4792; *McDowell v Fortress Real Capital Inc*., 2017 ONSC 4789; *McDowell and Aversa v Fortress Real Capital Inc.*, 2017 ONSC 4791; *Martino v Fortress Real Capital Inc*., 2017 ONSC 4790

[5] Barbara Shecter, "FSCO reaches $1.1 million settlement over syndicated mortgages", *Financial Post* (February 2, 2018), found online at: https://business.financialpost.com/investing/fsco-reaches-1-1-million-settlement-over-syndicated-mortgages

[6] Nicole Brockbank and Michelle Cheung, "120 investors likely lost $9M in syndicated mortgages tied to convicted fraudster", *CBC News* (April 24, 2017), found online at: https://www.cbc.ca/news/canada/toronto/syndicated-mortages-1.4078124

[7] Auditor General of Ontario, *Annual Report 2014: Chapter 3 - Financial Services Commission of Ontario— Pension Plan and Financial Service Regulatory Oversight* (Toronto: Auditor General of Ontario, 2014), found online at: http://www.auditor.on.ca/en/content/annualreports/arreports/en14/303en14.pdf at 148

[8] *Ibid* at 147

specifically to the insurance and mortgage brokerage sectors. Moreover, the auditor general noted that "several complaints with high risks to consumers takes several years to address".[9]

The growth and diversification of the syndicated mortgage industry has deepened FSCO's regulatory gaps. Under the Ministry of Finance, a three member panel released a report that reviewed the mandate of FSCO, the Financial Services Tribunal and the Deposit Insurance Corporation of Canada.[10] The panel members found that "all companies involved in raising money for property development through the sale of syndicated mortgages to small investors should be actively monitored to ensure compliance with relevant legislation and regulations in a manner that is consistent with the level of oversight and scrutiny applied by securities regulators".[11] The Report also found that as SMIs were considered a security, they should be overseen through a securities regulator rather than FSCO, or at least be governed in a similar regime[12]. The report highlighted that "there has been an observable increase in non-standard services, such as syndicated mortgage promoters and non-bank lenders…Regulators will have to become increasingly nimble and responsive to emerging gaps in monitoring and enforcement".[13]

Categorizing SMIs and Addressing the Associated Risks

To address mounting concerns in the syndicated mortgage market, recent legislative efforts have introduced various changes.

As of July 1, 2018, Ontario now divides syndicated mortgages into two main types: qualified syndicated mortgages and non-qualified syndicated mortgages.[14]

Qualified syndicated mortgages are those that meet the following criteria:

1. They are negotiated or arranged through a mortgage brokerage.

2. The SMI secures a debt obligation on property that
   (a) is used primarily for residential purposes
   (b) includes no more than a total of four units and
   (c) if used for both commercial and residential purposes, includes no more than one unit that is used for commercial purposes

3. At the time the syndicated mortgage is arranged, the amount of the debt it secures, together with all other debt secured by mortgages on the property that have priority over, or the same priority as, the syndicated mortgage, does not exceed 90% of the fair market value of the property relating to the mortgage, excluding any value that may be attributed to proposed or pending development of the property.

4. It is limited to one debt obligation whose term is the same as the term of the syndicated mortgage.

[9] *Ibid*
[10] George Cooke, James Daw and Lawrence Ritchie, *Review of the Mandates of the Financial Services Commission of Ontario, Financial Services Tribunal, and the Deposit Insurance Corporation of Ontario* (Ontario, March 31 2018), found online at: http://www.mortgagebrokernews.ca/files/file/mandate-review-final-report.pdf
[11] *Ibid* at 27
[12] *Ibid*.
[13] *Ibid* at 79
[14] Financial Services Commission of Ontario (FSCO), *Changes to syndicated mortgage transactions take effect July 1, 2018*,(Toronto: Financial Services of Ontario, 2018), available online: https://www.fsco.gov.on.ca/en/mortgage/Pages/smi-amendments.aspx

5. The rate of interest payable under it is equal to the rate of interest payable under the debt obligation.

By contrast, non-qualified syndicated mortgages are a "more complex, higher risk product that may not be suitable for the average investor"[15]. These syndicated mortgages are a catch all term that encompass all syndicated mortgages that do not meet the regulatory definition of a qualified syndicated mortgage.

Generally, non-qualified syndicated mortgages deal with what is known in the industry as "mezzanine" type financing.[16] In these financings, instead of paying for the costs of construction, investments are used to fund "soft costs" such as consultant fees, zoning permits, architecture costs, or marketing and sales expenses, with the result that the money raised during the investment period is used up for administrative costs before it can be utilized to develop the property. Moreover, these mortgages are often sold to investors based on the projected values of a completed development without disclosure of the inherent risks of real estate.[17] The most notable risk is that these types of mortgages are typically not paid back first, or at all, if the construction project is not completed, as they typically rank below the project's main (usually institutional) investors. As a result, if a project goes wrong – which is not uncommon in long-term and complex real estate projects- investors may lose their entire investment.

The first major thrust of the regulatory changes are the amendments to O Reg 188/08: Mortgage Brokerages: Standard of Practice under the *Mortgage Brokerages, Lenders and Administrators Act*, 2006, SO 2006, c 29. Since July 1, 2018 mortgage brokerages that deal with non-qualified syndicated mortgage transactions are required to[18]:

- Observe a $60,000 limit on non-qualified syndicated mortgage investments over a 12-month period for investors or lenders who are not part of a 'designated' class of investors and lenders. The regulation defines the designated classes of investors and lenders as those that have already met higher income and asset tests.

- Collect and document specific information related to a potential investor's or lender's financial circumstances, needs, objectives, risk tolerance and level of financial and investment experience using a new FSCO form.

- Undertake and document a suitability assessment, using specific criteria, for each potential investor or lender using a new FSCO form. This creates an individualized approach to investment brokering wherein brokers and brokerages have a heightened duty to promote suitable products to their customers.

- Collect and document expanded disclosure information using a new FSCO form. This includes information regarding the property appraisal and, in the case where the borrower is not an individual, the borrower's financial statements.

[15] *Ibid*
[16] *Supra* note 1
[17] Ontario Services Commission Bulletin, *"Request for Comments"*, (Toronto: Ontario Services Commission, 2018), 41 OSCB 1873, available online at: http://www.osc.gov.on.ca/en/SecuritiesLaw_ni_20180308_45-106_syndicated-mortgages.htm
[18] *Supra* note 7

- Report written complaints received by the brokerage related to non-qualified syndicated mortgages to FSCO's Superintendent of Financial Services within 10 business days of receiving the complaint.

To address the issue and to give additional support to FSCO, the Province has also begun pushing for the Ontario Securities Commission to take over oversight of the syndicated mortgage industry and to strengthen protections for investors.[19] While the details of the transfer are not yet known, investors and industry watchdogs are eagerly awaiting a more transparent and effective regulatory regime.

In the interim, in March 2018, the Canadian Securities Administrators (CSA) released a proposal for changing the prospectus and offering memorandum exemptions for syndicated mortgages, thus adding an additional layer of documentary regulation, transparency and oversight to syndicated mortgages, not just in Ontario but nationally. As a result, SMIs would be treated more akin to securities, as opposed to mortgage instruments. Necessarily, these proposals include removing the private issuer prospectus exemption for syndicated mortgages and ensuring adequate disclosure of the market value of the real property (not the future value of the proposed development) to potential investors.[20]

Are Syndicated Mortgages a Good Investment?

Notwithstanding the regulatory changes and potential new oversight, the question remains whether syndicated mortgages can be considered a good or safe investment. FSCO warns potential investors that while there are "many legitimate SMI opportunities, FSCO warns consumers to be wary of SMIs with advertisements promoting a high return or 'fully secured' investment".

FSCO also has released a news bulletin outlining the potential risks from syndicated mortgages. The entity warns investors of: [21]

1. No guaranteed high returns
2. A lineup for repayment
3. "Secured" does not mean guaranteed
4. No investor protection fund

It also encourages investors to:

1. Check for a license
2. Ask where you are in line for payments
3. Ask about property value
4. Get independent advice
5. Consider investment limits
6. Read and understand all associated paperwork
7. Ensure full disclosure
8. Inspect the project

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[19] Ontario Ministry of Finance, *Budget 2017 Chapter 11: Helping You and your Family*, (Toronto: Ministry of Finance, 2017), available online at: https://www.fin.gov.on.ca/en/budget/ontariobudgets/2017/ch2.html#ch21

[20] *Supra* note 17

[21] Financial Services Commission of Ontario, Before Investing in a Syndicated Mortgage, (Toronto: Financial Services Commission of Ontario, 2018), available online at: https://www.fsco.gov.on.ca/en/mortgage/Pages/smi.aspx

This type of cautionary language has been expressed not only to the mortgage industry but to lawyers by the Law Society of Ontario (LSO). In an October 2017 publication, the LSO warned lawyers of "instances in the marketplace where individuals have sustained significant financial loss by investing their savings in SMIs in which Ontario lawyers have played a role". LSO went on to remind lawyers of their ethical and professional duties to their clients and included reference material for lawyers to best be able to protect and advise their clients. One of these reference material notes that the presence of more than one of the following factors, if present during an SMI transaction, may point to a high degree of risk.[22] Some of these factors are:

- The syndicated mortgage arrangement involves an entity that promotes and/or facilitates the syndicated mortgage loan (Syndicator) and a mortgage broker.
- The Syndicator or mortgage broker or agent makes the arrangements with the lawyer for the provision of independent legal advice to the investors.
- The stated purpose of the syndicated mortgage loan is to fund "soft costs" in the development project such as applying for zoning changes, advertising, interior design and architect's fees or to acquire the real property for development.
- The mortgage securing the loan does not rank in first priority or the priority of the mortgage changes over time pursuant to the terms of the loan agreement.
- Higher fees than usual are payable or paid to the Syndicator, mortgage broker and/or lawyer and these fees are paid from the loan advances of the mortgage.

[22] Law Society of Ontario, Notice to Lawyers Concerning Syndicated Mortgages, (Toronto: Law Society of Ontario, 2017), available online at: https://library.carleton.ca/sites/default/files/help/writing-citing/uniform_legal_style.pdf