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Ontario Securities Commission
Alberta Securities Commission
British Columbia Securities Commission
Commission des valeurs mobilières du Québec
Saskatchewan Financial Services Commission
The Manitoba Securities Commission

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Dear Sirs/Mesdames:

Re: National Instrument 41-201

We are writing in connection with the October 24, 2003 request for comments on proposed NI 41-201 (Income Trusts and Other Indirect Offerings).

This letter is issued on behalf of the Canadian Association of Income Funds (“CAIF”), a national association of Canadian public income funds, publicly-listed partnerships, income trusts and royalty trusts (collectively, “Income Funds”). We do not represent the interests of fund-of-funds or other investment/mutual funds. Our web site is located at www.caif.ca

Before we begin, CAIF would like to thank each of you for taking the time to look specifically at our sector, and for recommending a set of changes that should encourage the long-term development of Income Funds by enhancing the quality and the nature of prospectus and continuous disclosures of Income Funds.

Our comments are directed at providing additional insight into your proposals and in responding to certain of the questions raised by you in your request for comments. We have chosen not to comment on Part 4 (Prospectus Liability), as we believe that the legal community and investment banks are in a better position than we are to comment on this area.

Fundamentally, CAIF’s desire is for Income Funds to operate on a level playing field with regular share corporations. We hope the high standards that you are advocating for Income Funds in your proposed policy will also apply to regular share corporations, as we do not wish to be at a competitive disadvantage to other issuers, or to be unfairly targeted.

We respond to the proposed national instrument below by way of referring to the Part numbers and titles set out in the proposed instrument.

(a) **Part 2.2 (Does an income trust’s distributable cash provide an investor with a consistent rate of return?):** We support your view that investing in an Income Fund is more like an investment in an equity security. Some market participants refer to Income Funds as “high-yielding equities.” However, within Part 2.2, you make several references to *“non-taxable”* returns of capital and these references may be misleading. We would prefer that you change such references throughout the instrument (see also Parts 2.4 and 5.2) to “tax deferred” returns of capital. The portion of distributions that are allocated to “return of capital” merely mean that the adjusted cost base of the investor’s ownership is reduced, thereby leading to an increase in the investor’s taxable gain on sale of the securities; that is, a deferral of tax until the date of sale, rather than during the investor’s holding period. We think you should consider extending the last sentence of Part 2.2, and the second last sentence of Part 2.4, to make this clear. You may also wish to point out that, under current tax law, the effective tax rate on capital gains is more favourable than is applicable to ordinary income and that the general consequence of distributions that include returns of capital will be to “convert” taxable income into taxable capital gains.

(b) **<u>Part 2.4 (What cover page disclosure do we expect about distributable cash?)</u>**: Under the proposed instrument, issuers will be required to set out the following on the face of the prospectus: *"The estimated portion of your investment that will be taxed as a return on capital is **-** and the estimated portion that will be taxed as a return of capital is **-**."* We do not believe it is appropriate to assume that this information will be available consistently for every issuer. We are concerned that in order to estimate and insert the amounts expected to be applicable to each category of taxable portions, issuers will effectively need to develop detailed forecasts of their expected financial information which would need to be supported by a formal forecast included in the prospectus. If so, this will add significantly to the cost of the prospectus filing and increase the length of time needed for the offering process. We ask that you delete the requirement of providing the actual expected dollar amounts under each category of tax. Issuers that are in a position to provide this information can still do so without it being a requirement.

(c) **<u>Part 2.7 (What disclosure do we expect about short-term debt?)</u>:** We would like to point out that Income Funds generally operate with modest financial leverage. In addition, their management teams are typically more risk adverse and thus often make greater use of interest-rate hedging and/or refinancing-risk mitigating strategies.

(d) **<u>Part 2.8 (Are agreements relating to the operating entity's short term debt material contracts of the income trust?)</u>:** We agree that the debt arrangements are significant items that require proper disclosure. However, designating such credit agreements as a "material contract" (thus requiring issuers to file the full agreements on SEDAR) is not appropriate, as such agreements often contain sensitive commercial information vis-a-vis the borrower's operations and financial covenants. Moreover, such requirements would put Income Funds at a competitive disadvantage versus regular share corporations. However, to be clear, we do not support the concept of any issuer (whether a regular share corporation or an Income Fund) having to file its credit agreements on SEDAR. The emphasis should be on ensuring adequate disclosure of the risks to investors as you have proposed within Part 2.9. If these requirements are not sufficient to address your concerns, you should expand the disclosure requirements rather than insist that the credit agreements be filed on SEDAR.

(e) **<u>Parts 2.10 to 2.13 (stability ratings et al)</u>:** Many of our members believe that stability ratings merely perpetuate a myth that Income Funds are similar to bonds and further confuse retail investors. After all, stability ratings are issued by bond rating agencies. Another argument is that when

Loblaws, Northern Telecom and Celestica are required to obtain and publish stability ratings, then so too should Income Funds. Further, issuers of debt are not generally required to obtain ratings by securities regulators. Given the foregoing, many of our members are of the view that the management time and operating expense associated with obtaining a rating is not helpful for their investors or in the investors' best economic interests. In our view, while the proposed policy does not force Income Funds to obtain a stability rating, the disclosure requirements for Income Funds that do obtain a rating, or for describing why an Income Fund does not have one, appears to provide indirect support and endorsement by you for such ratings. This may have unintended consequences of investors believing that they are investing in a fixed income security. The direct answer to your question (within Part 2D of your request for comments), is that the most effective method of comparing income trusts is via rigorous, fundamental equity research, just as it is for comparing regular share corporations. The danger with your proposals is that investors might come to rely blindly on stability ratings and thus believe, incorrectly, that they have no need for performing fundamental equity analysis on Income Funds before investing in such issuers. Stability ratings focus on a very narrow aspect of a particular Income Fund. We recognize that stability ratings may be helpful for certain sub-sectors within the Income Fund sector, but suggest that your proposed requirements be withdrawn.

(f) **Part 3.1 (What continuous disclosure do we expect about the operating entity?):** Firstly, perhaps the requirement to annually certify compliance with the spirit of 3.1 could be dropped as long as the issuer's annual management information circular and annual report adequately deals with the requested disclosure. Alternatively, the requested certification could be an added requirement within circulars, rather than as a unique SEDAR filing. Secondly, our members would like greater clarity as to what is meant by "a significant asset" of the Income Fund. Finally, the proposed requirements for disclosing operating entity financial statements should apply equally to regular share corporations that operate with holding companies as the issuer (potentially representing a large percentage of all issuers).

(g) **Part 3.2 (Comparative financial information):** This section of the proposed instrument deals primarily with instances where there has not been a change of control at the IPO and thus, the original carrying values of the assets are continued to be reported subsequent to the IPO. We note that preparing comparative information for periods prior to the IPO date can be problematic and perhaps not entirely helpful when presented together with information from the post IPO period(s). Often it is not simply a matter of the operating business (in which the Income Fund acquires interests) having operated in a different form (the proposed policy cites the

"corporate" form as an example); for example, the operating business may have been operated as a division of a larger enterprise, or perhaps the operating business itself consisted of assets and businesses previously owned and conducted in whole or in part by a variety of legal entities. The pre-IPO period will likely differ as it relates to many items including arms length interest expense, public company expenses, debt levels, capital taxes as well as income tax expense and other balance sheet tax accounts. To provide a full set of financial statements of the prior period will add to the complexity of information presented and render some financial statements almost incomprehensible. To make such financial statements more comparable would often require several, material pro-forma entries. We recommend that the requirement to provide comparable information be limited to the line items from "revenue" down to and including "EBITDA," with adequate disclosure, to the effect, that the prior period excludes public company expenses and capital taxes that the entity will be required to absorb subsequent to the IPO. We also believe that the proposed required disclosures should only be made within the MD&A, rather than on the face of the financial statements. This will avoid confusion for the readers.

(h) **Part 5.1 (What are our concerns about sales and marketing materials?):** Your definition of "Yield" states that it includes *"the return (other than a return of capital)."* We do not understand what this means. In our experience, the term "return" is usually used to mean the total amount to be distributed by an issuer divided by the market price of the particular share or unit, expressed as a percent. It is not at all clear to us why returns on capital should be excluded from Yield, or for that matter why any distinction need be made between the streams of distributed cash paid to unitholders.

(i) **Part 5.2 (What information do we expect the green sheets to contain?):** In reference to disclosure of tax efficiencies, you request that the disclosure relate to *"the foreseeable period."* We are uncertain about what these words mean. Since the tax results can change depending upon the Income Fund's future action (e.g. acquisitions, dispositions or capital expenditures), which is not usually foreseeable, disclosure relating to tax usually only relates to a one-year period. Please confirm that this is what you expect.

(j) **Part 5.3 (Do we expect income trusts to provide us with copies of their green sheets?):** Currently, other issuers are not required to file green sheets when filing a preliminary prospectus. We do not believe that it is appropriate for these additional requirements to be imposed on Income Funds.

In summary, we are supportive of your efforts to improve disclosures for investors in Income Funds. Our view is that Income Funds should be treated the same as regular share corporations and held to the same high standard required so that fundamental, equity analysis can be performed by investors.

We are available anytime to discuss or assist with the ongoing development of this instrument. For example, we could organize a small roundtable of experts if this would be of assistance to you, particularly as it relates to parts 4 and 5 of the proposed national instrument. Please contact the undersigned should you require further assistance, or require clarification on any of the above, at 416-696-7702, extension 5278. Alternatively, you can write to us at CAIF's above noted address.

Yours very truly,
CANADIAN ASSOCIATION OF INCOME FUNDS

"signed"

by: Stephen D. Rotz, CA, CFA
Vice President, Ontario