



**Signature Funds**  
**A Member of CI Mutual Funds Inc.**  
**151 Yonge St, Suite 1100**  
**Toronto Ontario, M5C 2W7**  
**Telephone: (800) 268-9374**

December 19, 2003.

Alberta Securities Commission  
Saskatchewan Securities Commission  
Manitoba Securities Commission  
Ontario Securities Commission  
Commission des valeurs mobilières du Québec  
Nova Scotia Securities Commission  
Securities Administration Branch, New Brunswick  
Office of the Attorney General, Prince Edward Island  
Securities Commission of Newfoundland and Labrador  
Registrar of Securities, Government of Yukon  
Registrar of Securities, Department of Justice, Government of the Northwest Territories  
Registrar of Securities, Legal Registries Division, Department of Justice, Government of Nunavut

In care of:

Mr. John Stevenson, Secretary  
Ontario Securities Commission  
20 Queen Street West Suite 1900, Box 55  
Toronto, Ontario M5H 3S8  
Fax: (416) 593-2318  
[E-mail: jstevenson@osc.gov.on.ca](mailto:jstevenson@osc.gov.on.ca)

And

Ms. Denise Brosseau, Secretary  
Commission des valeurs mobilières du Québec  
Stock Exchange Tower  
800 Victoria Square  
P.O. Box 246, 22<sup>nd</sup> Floor  
Montreal, Quebec H4Z 1G3  
Fax: (514) 864-6381  
[E-mail: consultation-en-cours@cvmq.com](mailto:consultation-en-cours@cvmq.com)

Dear Mr. Stevenson and Ms. Brosseau,

**Re: Request for Comments**  
**Notice of Proposed National Policy 41-201**  
**Income Trusts and Other Indirect Offerings**

We are submitting this response to your request for commentary on National Policy 41-201. We wish to comment on what we perceive as both the strengths and weaknesses of this proposal.

## **1. Summary and Discussion of the Policy:**

### **Specific Requests for Comment**

- Do you agree that the scope of the Policy is appropriate?

We agree with approach that National Policy 41-201 is taking by targeting the entire class of indirect offerings, including business income trusts, real estate investment trusts and royalty trusts and excluding investment trusts that fall under the definition of “investment fund” as contained in proposed National Instrument 81-106. This approach is broad and should deter attempts to circumvent legislation, as the majority of relevant distribution-oriented financial instruments should fall under the category of indirect offerings as targeted by the CSA.

The policy appears to be targeting the right areas: initial and continuous disclosure, risks, and accounting statement reconciliation to GAAP where Canadian indirect offerings are following a lower standard than publicly listed direct offerings. However the policy should be more specific on other areas of disclosure including certain details on management compensation for top executives and disclosure of related-party transactions.

- Do you think that the discussion about indirect offerings is clear? Do you agree with the distinctions that we make between direct and indirect offerings?

We agree that National Policy 41-201 outlines distinctions between direct and indirect offerings. The CSA has correctly identified that reporting standards have been lower for indirect offerings, a concern that we noted as well as investors. While distinctions are noted, more emphasis should thus be placed on the broad tenet that indirect offerings, regardless of differences due to legal structures, are not different from direct offerings when it comes to the obligation of reporting requirements for public investors. This tenet is central to the CSA’s position and provides the basis from which all subsequent recommendations originate.

- As currently drafted, the Policy is targeted to all market participants, including issuers, their advisors, and investors. Do you think that the format of the Policy is easy for market participants to follow?

National Policy 41-201 is clear to institutional investors. However, we believe that more work is required to make this document more accessible to retail investors and their advisors who are significant investors of indirect offerings. We are concerned that while the term “indirect offering” is useful in defining the class of targeted securities, it is not the terminology used in the income trust marketplace today. More emphasis needs to be made connecting the two terms. Further work could be done to simply and provide more utility to National Policy 41-201. More descriptive passages, extensive use of examples, and separation of points would help the goal of making this document more accessible for the average investor.

## **2. Prospectus Disclosure: Unique Attributes of Income Trusts**

### **Specific Requests for Comment**

- We are considering whether to give direction regarding the risk factors that issuers describe in relation to the operating entity. Do you agree that this guidance would be appropriate?

We believe that more disclosure of investment risks pertaining to indirect offerings is required. Given the wide variations in levels of disclosure from current indirect offerings, we believe that the CSA should give more direction to issuers.

We noted two problematic areas but more likely exist.

The first pertains to the disclosure of all risks at time of the issuance of the indirect offering. Several key documents are filed after the indirect offering issuance window has closed. These include documents such as the trust indentures, shareholders agreements and key debt covenants. We too are concerned that

issuers may not be disclosing all of the risks during the investment roadshow and that poor continuous disclosure could compound the situation eventually surprising unsuspecting investors. For example, restrictive debt covenants not fully disclosed during the investment roadshow could become problematic if the issuer borrows too much thus inevitably putting the current distribution at risk. While debt concerns were discussed in National Policy 41-201<sup>1</sup>, our concerns encompass the disclosure of risks broader than this example. We agree that with the CSA that all relevant risks contained in material documents filed after a deal closes should be disclosed on a best efforts basis in the prospectus during the investment roadshow process.

The second area that requires direction is the need to bridge and harmonize disclosure practices between direct and indirect issues. National Policy 41-201 addresses many of these differences, however some less obvious points were overlooked. One such example risk is subordination under voting structures that favour issuers over public investors. Direct issuers must clearly disclose voting subordination in their public filings. Income trusts sponsors often put in place a notion of effective subordination by insisting that while they hold an economic interest above a certain threshold (e.g. 30%) that they receive the right to vote for a higher disproportional amount of directors to the Board. This may be described as a risk in some form but may not be specifically noted as subordination. Subordination can be a significant risk to investors and better disclosure is required within the prospectus, especially given the popular trend towards the issuance of income trusts as a means to monetize private equity holdings. These private equity investors have different investment timeframes and goals that could conflict with long-term public trust unitholders.

We believe that it is extremely difficult to provide directions on the exact disclosures required for every risk specific to each income trust. Rather than placing the obligation on the CSA to provide direction for each difference between direct and indirect offerings, issuers should familiarize themselves with practices used in the more developed direct offering market and take more of a proactive role in communicating such risks based on the higher standard of disclosure. This should be a tenet of National Policy 41-201 especially as the indirect issuance market continues to rapidly evolve.

## **A. Distributable Cash**

### **Specific Request for Comment**

- We recommend that issuers include in their cover page disclosure a breakdown of the anticipated distributable cash figure that sets out its estimated “return on” versus “return of” capital. We believe this breakdown would provide investors with important information regarding their investment. Do you agree with this recommendation?

We agree that more information on the specific breakdown of distributable cash figures is required and should be highly visible e.g. appear on the cover page.

Disclosure of distributions and their origins should be clear and simple to understand. This should apply to any pro forma projections of distributions in the prospectus. Cash flow derived from operations and any temporary shortfalls compensated from cash reserves, working capital borrowing or any increase in debt or bank lines should be especially clear given the growing use of debt in income trust structures. Straightforward graphics or any other aids could be recommended with the goal of providing a way for investors to quickly comprehend quarterly, annual and seasonal cash flow trends.

## **D. Stability Ratings**

### **Specific Requests for Comment**

- Do stability ratings play a valuable role in an investor’s decision?

We do *not* think that stability ratings play a valuable role in an investor’s decision-making process for reasons cited below.

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<sup>1</sup> Discussed in Section 2.8 of (2003) 26 OSCB p.6980

- We are concerned that investors may have difficulty comparing income trusts. Do stability ratings offer an appropriate and effective means of comparison? Is there a more appropriate or effective method?

We have serious concerns regarding the use of stability ratings to rate income trusts, principally that stability ratings may imply fixed income characteristics to income trust offerings that are more equity-like in risk as they do not guarantee distributions. Secondly, we believe that stability ratings suffer from the same problems as other credit ratings: 1) Agencies have historically been more reactive than proactive with regard to describing risk due to infrequent updates. 2) A stability rating is not a guarantee but rather a subjective opinion and in the most recent credit downcycle several bankruptcies occurred under the watch of the credit rating agencies with little advance warning for investors. 3) Conflicts of interest can arise since issuers must pay the rating agencies to provide a stability rating.

### 3. Continuous Disclosure about the Operating Entity

#### Specific Request for Comment

- We are considering asking that issuers who disclosed expected distributable cash to provide, on an annual basis, an updated comparison of distributed and distributable cash to the expected distributable cash figure. We are also considering recommending that issuers include in this annual update a breakdown of distributed and distributable cash between the “return on” versus “return of” capital to allow investors to analyze the tax attributes of their return. What do you think of these recommendations?

We agree that more information on the specific breakdown of distributable cash figures is required and should be highly visible e.g. appear on the cover page.

Disclosure of distributions and their origins should be clear and simple to understand. This should apply to any continuous disclosure with investors. Cash flow derived from operations and any temporary shortfalls compensated from cash reserves, working capital borrowing or any increase in debt or bank lines should be especially clear given the growing use of debt in income trust structures. Straightforward graphics or any other aids could be recommended with the goal of providing a way for investors to quickly comprehend quarterly, annual and seasonal cash flow trends. A requirement to disclose if a trust was a net borrower or net retainer of cash during a reporting period could achieve the goal of clarifying cash sources of distributions in a basic and simple manner.

#### Additional Comments

*The following is commentary on several disclosure issues that may or may not have been addressed in National Policy 41-201.*

#### ***Complete "Look Through" of Financial Statements Within the Trust Structure<sup>2</sup>***

We **strongly** suggest the implementation of a complete "look through" of financial statements within the trust structure, namely that all material entities within the trust structure act as reporting issuers. This is currently not the case. Based on certain ownership levels, use of external management, legal and accounting standards, it is possible for a trust to use equity accounting methods. Thus the trust does not have an obligation to provide full disclosure of the operating entity that is the source of cash distributions. For example, an operating unit could report as a one-line item in a filed annual report. We are aware of a few royalty trusts<sup>3</sup> that report this way and others likely exist. This lack of disclosure of the operating entity makes it extremely difficult to analyze cash flow trends within the most important unit of the trust structure. We strongly believe that regardless of ownership levels or legal structures, the

<sup>2</sup> Discussed in Section 3.1 of (2003) 26 OSCB p.6982

<sup>3</sup> Details can be provided upon request

operating entity of the indirect offerings and the trust itself should be considered as reporting issuers with the requirement of full and complete disclosure on an ongoing basis.

#### ***Disclosure of Third-Party and Related-Party Transactions***

There should be clear declaration of any transactions between the trust and any third-party or related parties that directly or indirectly benefit one or more employees of the trust. Direct offerings are currently required to disclose this information. The goal of this is to deter any preferential self-dealing within the larger trust structure.

#### ***Management Compensation***

Compensation agreements between the employees of the trust and any outside parties should be disclosed including any retainers, finder fees etc. This is to ensure that the fees are reasonable for the services rendered and do not bias management to the detriment of the public trust unitholders. This disclosure is incremental to the information proposed in Section 2.15 of (2003) 26 OSCB p.6981 that we also agree with.

#### ***Insider Trading<sup>4</sup>***

We believe that any insider possessing material information should be prohibited from transacting and profiting from that information if not fully disclosed to the public. This should apply to all levels of the trust structure including the publicly traded trust, private trusts, limited partnerships, operating entities and any other notable structures.

#### ***Use of External Versus Internal Management Contracts***

A reference to the entire management structure of an indirect offering should appear prominently on the cover of the prospectus of the trust followed by detailed disclosure inside the prospectus. If management has agreed to use an external party (over the preferred route of internal management), the justification and benefits of using external management should be clearly disclosed. Furthermore, any formula used to compensate external management should be laid out in clear terms for investors to analyze.

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<sup>4</sup> Discussed in Section 3.4 of (2003) 26 OSCB p.6983

## **Additional Commentary Related to Proposed National Policy 41-201**

As active investors in the income trust market, we have a vested interest in improving the initial and continuous disclosure requirements and thus the quality of indirect offerings. We strongly believe that a great deal of work is required to bring standards in the indirect offerings market up to the current standards of direct offerings. We commend the effort of the CSA in recognizing these deficiencies and opening a public forum to solicit commentary with the intent of creating an action plan to address outstanding problems.

While proposed National Policy 41-201 tackles key issues that should improve the quality of the indirect offerings market, one area that also requires attention is governance standards, albeit that this area is outside of the scope of the National Policy. We wish to bring to the attention of the CSA the current efforts of the Canadian Coalition for Good Governance, where we and others institutional investors sit as members. We are currently working towards the goal of converting our governance framework for corporations for use in the income trust market. We see this as a compliment to the CSA's efforts on proposed National Policy 41-201. Governance directives will deal with the expected role of trustees, board size and composition and other subjects. Here we are following the lead of the CSA by looking through the legal differences of indirect offerings and applying the same principles of governance that the CCGG has already provided for the benefit of corporate issuers. Details of current corporate guidelines and initiatives can be found on the CCGG Web Site: [www.ccg.ca](http://www.ccg.ca). We shall keep the CSA apprised of our future recommendations.

Sincerely,

Ben Cheng  
Vice President, Portfolio Management  
Signature Funds  
416-681-3129  
[bcheng@cifunds.com](mailto:bcheng@cifunds.com)

