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Ontario Securities Commission  
C/o John Stevenson, Secretary to the Commission  
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**Re- *Proposed National Policy 41-201***  
**Income Trusts and Other Indirect Offerings**

I applaud the Ontario Securities Commission for publication of ***Proposed National Policy 41-201***, a paper on the highly relevant subject of income trusts. In this context, this letter is a response to your request for comments. Overall, I personally support the objective of the Ontario Securities Commission in its desire to enhance investor understanding and protection where appropriate on income trusts, a relatively new form of security which has met with significant market acceptance over recent years. ***Working Paper 2003-25 published by the Bank of Canada***, similarly signals an interest by Canada's central bank in maintaining efficiently operating capital markets through recognition of income trusts as a topic on which a broader level of investor understanding should be prompted by market regulators. I have attached Table 8 from Working Paper 2003-25 to this letter as it represents a comprehensive examination of the macro issues ranging over ***legal and regulatory; corporate governance; operations; and market related*** issues. The Bank of Canada Working Paper is essentially a synthesis of various securities research papers published by the Research Departments at Canadian underwriting securities dealers and leading law firms who has published comment letters on the subject- the latter, albeit mainly on liability and other legal issues.

This letter examines and responds the macro issues in ***Proposed National Policy 41-201***. ***It does not*** provide answers to the many specific questions postulated. The reader can only surmise that where available, the answers to the technical questions raised in ***Proposed National Policy 41-201*** will eventually be used to guide various aspects of securities regulations. Nevertheless, the creation of a complex regulatory regime for servicing this new investment class will do little to assist in the development of an informed investment constituency. In any event, it should be noted that a strong

productive economy is a condition precedent or premise on which most securities are valued and on which capital and goods & services markets efficiently operate.

My comments are advanced in the following paragraphs.

An appropriate *definition of Funds from Operations (FFO) and/or Distributable Cash* represent critically important information trains to investors, particularly as these data points are being used as primary information for unit valuations, through the discounting process. Consequently, the OSC should carefully scrutinize the quality of issuer representations made by reporting issuers in various securities filings. Since “cash related” concepts could easily be misleading or distorted and at least are often subject to soft judgments, issuer care and regulatory scrutiny is particularly appropriate. Moreover, it is important to note that these data points are not recognized in the Handbook of generally accepted accounting principle in Canada. The basic issue with these measures is their tendency to minimize the significance of the “going concern concept,” a fundamental tenet of financial accounting. It is important for income trust reporting issuers to clearly portray in their financial accounting and other communications tools, the differences between *return of capital* and *return on capital*. Cash related terms such as *Funds From Operations, Distributable Cash and Earnings Before Interest, Taxes, Depreciation and amortization* often fail to discern between capital and income. Also, there is a particular need by reporting issuers, regulators and statutory auditors to recognize operations and financial asset impairments and to appropriately amortize intangible assets.

The *operating entity* supporting an income trust is often concentrated in a narrow line of commercial activities. Consequently, income trusts can be said to contain a significant exposure to specific risks, many of which are beyond the comprehension level and suitability for the average investor. It is the responsibility of the reporting issuer to maintain and regulators to ensure that reporting documents provide a suitable portrayal of the *possible risks and potential adverse consequences*, which could arise through ownership of a narrowly focused business. In particular, it is important that Risks section of the prospectus and Management Discussion and Analysis section of ongoing financial reports be thorough, yet subject to comprehension by the average retail investor.

*Stability ratings*, while useful to some investors, could be said to create a false sense that an income trust security is a proxy for a fixed income security. In reality, income trust units are equity investments with a high payout of cash from operations and with only modest amounts of capital being redeployed in the business. The high cash payouts by income trusts make them somewhat dependent on equity market financing conditions, a variable window of availability, to raise capital for required fixed capital investments and/or acquisition financing needs. The stability rating process for this type of security is relatively new and can be said to be unseasoned in the capital marketplace, in contrast with general acceptance of bond ratings. It should also be noted that stability ratings contain nominal, if any, predictive significance, as rating changes are likely to be made after an adverse event impacts unit trust prices, rather than precede it. Moreover, stability ratings do not fully portray general or market risks, such as interest rate risk and the impact of inflation on interest rates.

The promoters and *vendors of operating* assets should be required to specify the purpose for which the offering is being made. A simple attempt to take advantage of investor enthusiasm through an initial public offering of a security issue, which is expected to meet with short-term acceptance and enthusiasm, is not an acceptable reason for transferring un-diversified risks to a broad array of public investors, even through the income trust distribution process is supported by the marketing divisions of underwriting securities dealers.

Where *external debt is employed in the capital structure* of an income trust or in the various operating entities supporting the trust, it must be fully disclosed. Disclose in the prospectus and in the Management Discussion and Analysis section of ongoing reporting documents should include an impact or sensitivity statement pertaining to the impact of an increment (say a 1%) change in the general level of interest rates on floating and/or short term debt. A similar disclosure should be required on significant components of gross revenue and net revenue. Examples include mineral and petroleum & natural gas prices for these types of income trust. Significant cost factors should also be required disclosure in a business trust, for example the impact of an increment of change in the price of sugar, cocoa, energy and/or electricity. Management Discussion and Analysis reporting of sensitivity data is often provided by common share based reporting issuers, is relevant to uninformed investors and hence, should not be the private domain of knowledgeable investors and often senior managements and should be similarly required or portrayed by income trust reporting issuers. As a general principle, the standards of disclosure for income trusts should be consistent and hence, no less onerous than those entities which have common shares listed on leading stock exchanges.

On the concept of continuous disclosure, it is important to prompt *continuous relevant disclosure, instead of more disclosure*. It is the responsibility of auditors, securities exchanges and securities regulators to ensure the information disclosed is relevant and not misleading.

*Operating entity disclosure requirements* should generally be similar to those for reporting issuers with equity securities. As to vendors of operating assets, liability for undisclosed operations risks in a prospectus should be present, unless the ownership of the business has been held independently for a reasonable period – say one year. Income trusts should not become a vehicle for corporations to divest marginal assets to an unsuspecting and/or growing public of income trust investors. Liability for original vendors should only be for misrepresentations on fact and/or failure to adequately disclose foreseeable risks and should not cover systemic or market risks. *Vendor liability*, that of original asset owners and that pertaining to trust promoters, should be similar to tort law liability for a consumer products manufacturers and/or pharmaceutical companies. Essentially, the vendor of the original business or operating entity assets, which becomes the core of a new income trust owes a duty to the public for a reasonable, but short period.

*Governance procedures* are important to income trust investors, as with common stock based reporting issuers. . Where *conflicts of interest* are present, disclosure should be required and non-arms length transfers of assets must be supported by fairness opinions. Related party management contracts and other non arms length arrangements also require disclosure. Independent management is generally preferred to promoter and/or related party management by the operating asset vendor. A majority of

independent trustees is preferred in trusts managed by promoters and/or operating asset vendors.

*Insiders* are generally deemed to be those who are in possession of material inside information, which is frequently defined as that which could be deemed to have an impact on a share or income trust unit price, if known and acted upon by a member of the general the public. Hence, the definition of an insider should not exclude those persons who are not part of the management of the operating entity. Insiders include joint venture partners and contracted third parties such as bankers, underwriters, public accountants, legal counsel and others who are in possession of material inside information. Insiders have a duty to maintain and not disclose or act upon material inside information.

In conclusion, I personally welcome the opportunity to comment on ***Proposed National Policy 41-201, and note a conceptual framework is hollow without a commitment by the relevant securities commission administrators, supported by their respective commissions, to administer betterments to current disclosure obligations and enforcement standards.*** I am open to a continuing dialog on this subject and many other financial reporting topics and business issues. I have personally benefited from and have appreciated dialogs with David Brown, Q.C., Chairman and John Carchrae, Chief Accountant at the Ontario Securities Commission and through attendance at public forums such as 2003 Dialog With The OSC – November 12,2003.

Sincerely

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# Income Trusts – Understanding the Issues

## Bank of Canada Working Paper 2003-25

### Summary of Issues in Income Trusts – Table 8

Category	Issues
<ul style="list-style-type: none"><li>• Legal and regulatory</li></ul>	<ul style="list-style-type: none"><li>• Personal liability of unit holders</li><li>• Tax treatment</li><li>• Bankruptcy</li></ul>
<ul style="list-style-type: none"><li>• Corporate governance</li></ul>	<ul style="list-style-type: none"><li>• Related to trustees</li><li>• Related to management</li><li>• Rights of unit holders</li></ul>
<ul style="list-style-type: none"><li>• Operational issues</li></ul>	<ul style="list-style-type: none"><li>• Subordination of claims by unit holders</li><li>• Cash-flow sustainability</li><li>• Financial leverage</li></ul>
<ul style="list-style-type: none"><li>• Market issues</li></ul>	<ul style="list-style-type: none"><li>• Level of interest rates</li><li>• Risk premiums</li><li>• Future access to financing</li><li>• Secondary market liquidity</li></ul>

**Source:** *Bank of Canada Working Paper 2003-25 by Michael R. King  
– September, 2003.*