December 23, 2003

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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:

Comment Letter in respect of Proposed National Policy 41-201 "Income Trusts and Other Indirect Offerings"

This letter is submitted in response to the Request for Comments in respect of proposed National Policy 41-201 "Income Trusts and Other Indirect Offerings" (the "Policy") published at (2003) 26 OSCB 6971. The numbering we use in this letter corresponds to the numbering used in the Policy.

Part 2 – A – Distributable Cash

It is our general experience that substantive risk factors in respect of both structural risks pertaining to trust structures and operating risks pertaining to the underlying business are adequately addressed by the general requirement for risk factor disclosure in the general prospectus form.

However, we are not troubled by the suggested language in paragraph one of Section 2.4. In our experience, a form of such risk factor language is often included on front page disclosure. The specific cross reference to the page on which forecast or pro forma distributable cash is disclosed is not unhelpful. Is it intended that this cross-reference be to such information in the summary or in the body of the prospectus?

In contrast, we disagree with the requirement in paragraph 2 of Section 2.4 to include language on the prospectus cover page concerning the tax character of distributable cash and disagree with respect to the use of the nomenclature “return on capital” and “return of capital”. A description of distributable cash and the character thereof is not disclosure which business trusts typically include on their face page (although it may be more common for REITs and royalty trusts). It is not information which will be determinative for investors making a decision about whether to invest in a business trust, primarily because in the business trust structure there is very little, if any, distribution of amounts that represent a “return of capital”. Further, even if it is expected that there will be any such distributions, the amounts thereof will change annually. Therefore, the estimate which the Policy contemplates can only be determined on a reasonable basis if there is a forecast prepared; however, many business trusts do not prepare such a forecast. We therefore suggest that this type of disclosure, if required at all, be required only in the summary, and then only if it is otherwise included elsewhere in the prospectus.

For those offerings where a discussion of distributable cash is nevertheless appropriate, we have strong concerns about the use of the phrase “return of capital”. It can be used too broadly and this in some circumstances represents an improper use of the term both from a trust law and an economic perspective. Every investment trust (including a business trust) is required to distribute to its unitholders annually an amount equal to the trust’s income for income tax purposes so that the unitholders and not the trust recognize this income for tax purposes. However, in the case of a business trust, often the annual cash flow generated by the trust exceeds the trust’s income as calculated for tax purposes. When this excess cash flow is distributed by the trust to unitholders, it is not treated as income for tax purposes in the hands of the unitholders (although it does reduce the unitholders’ adjusted cost base of their units for purposes of calculating any capital gain or loss on a future disposition of units). Because these distributions out of excess cash flow are not treated as distributions of income, they have sometimes been referred to as a “return of capital”. However, what is referred to as a “return of capital” in certain prospectuses (in other prospectuses it is referred to as a “tax deferred distribution”) is simply a distribution out of the excess of the distributable cash flow of the

business trust over the income of the business trust for tax purposes. In most circumstances, a distribution of such excess cash flow would not be a return of capital of the trust either in a trust law sense or in an economic sense.

To take a simple example, assume a REIT is formed with an aggregate subscription of $100MM and it uses such funds to purchase land and buildings where 20% of the purchase price is allocated to land and 80% of the purchase price is allocated to buildings. Also assume that the buildings earn $10MM in rents, the REIT has operating expenses of $2MM, and improvements of $1MM are undertaken to maintain the property in its current condition which latter amount is added to the cost of the property. In such circumstances,[1] the trust would have net cash flow of $7MM and taxable income of $4.8MM. Assuming the trust distributed its net cash flow of $7MM, the unitholders would have an aggregate income inclusion of $4.8MM and an aggregate adjusted cost base reduction of $2.2MM (i.e., equal to the excess of the distributed cash over the income of the trust). However, this $2.2MM excess is not a return of capital either as a matter of trust law or economically. Therefore, requiring issuers to refer to such excess as a "return of capital" rather than a "tax deferred distribution" would be misleading. If a mandatory description is to be required, we therefore strongly urge that any disclosure relating to distributable cash not be required to be expressed in language which includes the term "return of capital".

<u>Part 2 – B – Distributable Cash – Non-GAAP Measures</u>

As is observed in the Policy and the accompanying Request for Comments, estimates of distributable income are an important factor in measuring performance of income trusts, and thus the pricing of income trusts upon their initial offering. Such estimates could also influence the subsequent market trading prices. Estimates in the IPO context are either derived from a forecast or from pro forma adjustments to historical financial information. These two sources may derive from quite different processes.

A forecast, as forward looking information, is subject to an audit with the formal review that process entails. The assumptions must be set out in detail and such assumptions must represent the planned course of action given management's judgment as to the most probable set of economic conditions. It must be updated.

Historical information upon which the pro forma adjustment is based may or may not be audited and the pro forma adjustments are not subject to a formal audit or review process by an auditor. It is not subject to updating. It is not clear why, from a policy perspective, there should be

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[1] Ignoring for the sake of simplicity of calculation the impact of the half year rule contained in the *Income Tax Act* and assuming for the sake of simplicity that the trust has no deductions for purposes of the Tax Act other than its cash operating expenses and capital cost allowance on the buildings.

significant differentiation in treatment of such information in the context of an initial public securities offering.

We are not qualified to assess the appropriate starting basis of comparison between distributable cash and a GAAP measure, but do agree that the assumptions and rationale for any adjustments should be as clear in a pro forma historical narrative as they are in a forecast. A requirement in the MD&A to comment on the actual performance in light of the adjustments used in calculating pro forma historical distributable cash may provide useful information to investors (akin to commenting on forecast performance) and serve as a useful discipline in the prospectus process.

In the context of continuous disclosure information, estimates of distributable income are analogous to other earnings estimates. It is not evident to us that income trusts make any more use of continuous disclosure estimates or guidance than corporations. It is also not clear to us that a policy differentiation that would result from the Policy between the treatment of distributable cash estimates and the treatment of earning guidance by corporations is warranted in the context of continuous disclosure.

Part 2 - C - Short-term Debt

The Policy identifies a number of concerns relating to short term debt, which it defines broadly as any debt due in the next five years. These concerns relate to the impact that debt obligations may have on trust distributions. It is suggested that all short term instruments be described and be disclosed in accordance with a number of detailed parameters. This would potentially include a wide variety of debts including revolving operating lines, letters of credit, derivatives, short long term loans (and even mortgages) that happen to be maturing in the period. However, apart from refinancing risk, the risks identified in the Policy are equally applicable to both short or long term debt.

Debt in a trust structure at any level is typically superior to distributions and debt in an operating entity is structurally superior to distributions to unitholders by virtue of structure and contract. Based on the prospectuses in which we have been involved, we would be very surprised if any reader could reasonably claim that they did not understand that distributions were subordinated to debts of the operating entity.

REITs typically provide an aggregated mortgage chart indicating principal by maturity, by average interest rate and by percentage floating rate versus fixed rate exposure. We believe this type of consolidated disclosure is sufficient in that context. We are not aware of investor requests for disclosure of the type suggested in the Policy and we do not believe that type of disclosure is material to REITs that have multiple mortgages. At the very least, some form of materiality concept needs to be considered in the Policy, both by virtue of the percentage that debt is of equity and percentage that a particular debt is of all debts.

We agree that exposure to debt risks such as interest rate fluctuation or refinancing risk may merit disclosure if the borrowing is material; however, we do not see particular value to investors in filing every debt instrument due in the next 5 years, particularly for mortgages in the REIT contexts or in respect of undrawn or revolving operating facilities.

Part 2 - D - Stability Ratings

The Policy raises a concern about comparability across trusts. In our view, a trust is an equity investment. Equity investments are generally not rated and yet comparability has not been raised as an issue. However, it is possible to obtain a so-called 'stability' rating for income trusts. Although we do not believe debt offerings to be analogous to income trusts; from a regulatory view point, stability ratings for income trusts are somewhat analogous to credit ratings for debt securities.

In our view, the disclosure of stability ratings should be regulated in a similar manner to the disclosure of credit ratings. Section 10.8 of Form 41-501F1 and Section 8.7 of Form 44-101F3 each mandate the type of disclosure that must be provided in a long-form or short-form prospectus, respectively, if a credit rating for the securities has been received from one or more approved rating organizations. These sections do not mandate the specific wording of the disclosure, they do not require any disclosure if no rating is received, nor do they mandate disclosure of the reasons for not obtaining a rating. The sections also do not mandate cover-page disclosure of the rating, although we acknowledge that credit ratings are typically disclosed on the cover page. We recommend that the precise form and location of the disclosure concerning stability ratings not be specifically mandated but rather that the Policy indicate the type of information that the Canadian Securities Administrators recommend be disclosed if a stability rating is obtained. Further, we submit that disclosure of the fact that a stability rating has not been obtained is not warranted and disclosure of the reasons for not obtaining a rating is not meaningful and should be deleted as a requirement from the Policy.

Part 2 – F – Executive Compensation

We agree that executive compensation information may generally be important information. However, whether it is planned compensation or historical compensation that is the important information may vary. The importance of historical information is also affected by the manner in which estimated distributable income is communicated, by forecast or pro forma adjustment. There may be circumstances in which historical executive information is not available or relevant. For example, historical information may not be relevant if the operating entity is acquiring assets from multiple different entities, if the roles of the executives will be materially changed or if compensation arrangements are materially changing (as is often the case as incentive compensation is restructured in the conversion to a trust). In such cases, the planned compensation is much more germane than historical information.

The final sentence of section 2.17, which states "We also remind issuers of their statutory obligation to make timely disclosure of any material change in their affairs, which would include any material change to prospectus disclosure about executive compensation", could be interpreted as a revision of the statutory definition of material change. We recommend that the words "which would include any material change to prospectus disclosure about executive compensation" be deleted. Alternatively, we recommend that this phrase be rewritten as follows: "which would include any change in executive compensation that constitutes a material change".

It is not apparent to us that there is any policy basis to distinguish between the disclosure of income trust executive compensation plans and those of corporations in terms of the requirement, if any, to file actual copies of plans on SEDAR. We believe that the current prospectus disclosure requirements are sufficient. Accordingly, we disagree with the requirement that internal management incentive plans be filed on SEDAR, as this represents a departure from current statutory requirements. We agree, however, that management contracts with third party managers for management of the entire trust would ordinarily constitute material contracts.

Part 3 – Continuous Disclosure

The concerns raised about the absence of disclosure of operating entity financial information appear to apply to investments by trusts that are not consolidated for financial reporting purposes. The Policy should specify that separate reporting of the operating entity's financial results is only applicable where those results are not consolidated into the trust's financial reporting; otherwise there will be unnecessary and confusing duplication. If undertakings are necessary in a subsidiary situation because securities legislation as currently drafted does not treat wholly-owned entities of trusts as subsidiaries for the relevant purpose, it would be preferable to properly amend the legislation, as it is likely deficient in other areas such as insider trading reporting.

The Policy suggests that historic comparative information should always be presented in the initial year after the trust becomes a reporting issuer. This issue is one to be primarily addressed by accounting experts, but we observe that the policy appears to address a scenario where an entire business was previously carried on by one entity. There may be circumstances where comparative information is not available on a basis that is relevant or not available at all, particularly if assets have been purchased from multiple parties.

We agree that insiders of the operating entity employee should be caught by the ambit of insider trading reporting rules as if the operating entity was the report issuer. We suggest that a similar policy concern should apply to third party managers. If the law is deficient, it should be amended and not approached through contractual undertakings, except for a short interim period, as enforcement rights should be against the relevant individuals, not the trust.

Part 4 – Prospectus Liability

We generally agree with the policy analysis in Section 4.1, 4.2, 4.31 and 4.32 seeking to ensure that non arm's length parties receiving a substantial portion of prospectus proceeds should bear liability in respect of the prospectus.

However, it is not clear to us whether the receipt of proceeds *per se* is contemplated defining those who should be within the statutory definition of 'promoter' in all jurisdictions. However, in most instances we expect that the regulators could require vendors who receive substantial proceeds to execute a certificate as a promoter on the basis that they have had sufficient involvement in the founding, organizing or reorganizing of the trust.

If the concept that receipt of proceeds is evidence of the existence of a promoter remains part of the Policy, we believe the Policy should offer guidance as to what constitutes a "significant portion of the offering proceeds". We also suggest it should be possible to ultimately receive some amount of the proceeds from an offering without being considered to be a promoter.

Section 4.4.3

We agree that it may be germane to investors to identify that they have no direct rights under securities legislation against a vendor of assets (where material) to the trust or its subsidiaries, if such vendors are not promoters.

We disagree with the requirement to provide "a detailed description of the vendors' representations, warranties and indemnities contained in the acquisition agreement". We are skeptical that such disclosure could ever be written in a "clear and readable manner to ensure that investors understand the nature" of the representations, warranties and indemnities, without reproducing the entire list of representations in total. It becomes particularly cumbersome in the circumstances of multiple vendors or even with one vendor, if required to be placed in the summary section of the prospectus.

We believe that the more relevant disclosure is whether or not an agreement has been negotiated at arm's length and, if not, that its terms and conditions therefore may not reflect commercial practice between arm's length parties. We believe this is sufficient disclosure to alert investors to the concern the Policy articulates. An investor who wishes to review the detailed representations obtained can review the purchase document, which we expect would normally be a material agreement filed on SEDAR. It may be that the timing of the filing of such document could be considered so that, for example, it must be filed within two weeks of filing the preliminary prospectus. It is also may be germane to identify whether a promoter or vendor has material assets other than the proceeds from the sale to the trust (which may not remain available for recourse by the trust in any case), and to identify other limitations on contractual recourse by the trust.

We note that the purchase agreement and its representations are negotiated between, and are the responsibility of, the trust and the vendor(s) and their counsel. We generally think it is not the role of securities regulators to impose contractual conditions on such parties. The value of representations and, as noted above, availability of substantive recourse can vary greatly. For example, a representation as to the absence of misrepresentations in the prospectus may be of use to the trust in a third party action against a vendor if the trust is sued; however, it is not a substitute for appropriate application of the 'promoter' certification requirements.

Part 5 - Sales and Marketing Materials

It is unclear that there is any policy basis or need to recommence the review of greensheets, and to distinguish between income trusts and corporations in this regard. As we understand the concern which Part 5 is attempting to address, the concern is as to the use of the term "yield" and how it is understood in the context of income trusts. This concern could otherwise be addressed directly if there are specific concerns about the use of such term, and identifying disclaimers which must accompany its use in a prospectus and in marketing or other documents.

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We are pleased to have this opportunity to provide you with our comments on National Policy 41-201. If you have any questions or comments please contact Chris Murray at 416.862.6701.

Yours very truly,

OSLER, HOSKIN & HARCOURT LLP
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