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Commission des valeurs mobilières du Québec
Saskatchewan Financial Services Commission
The Manitoba Securities Commission

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Dear Sirs/Mesdames:

Re: Proposed National Instrument 41-201:
Income Trusts and Other Indirect Offerings

This is our firm's response to the request for comments regarding the proposed National Policy 41-201 — Income Trust and Other Indirect Offerings (the "Proposed Policy") published in the Ontario Securities Commission Bulletin on October 24, 2003.

PART A GENERAL COMMENTS

We support the Canadian Securities Administrators' view that guidance and clarification should be provided to market participants about income trusts and other indirect offerings. It is desirable to move from the current ad hoc approach to a clear and predictable regime based on principles that are consistent with the regulatory approach in other areas. For the reasons expressed below, we are concerned that the Proposed Policy may not meet this objective.

Scope of the Policy

The stated scope of the Proposed Policy is, we believe, too broad because it may lead to significant uncertainty by market participants over whether or not the Proposed Policy applies to a particular transaction. In particular, although its focus is income trusts in the context of public offerings, the Proposed Policy is stated to also apply to indirect offerings and to "structures in other contexts..."; the Proposed Policy further states that "many of the principles that we describe apply equally to direct offering structures." We believe this introduces a significant amount of uncertainty about whether the Proposed Policy applies to any particular transaction.

In addition, the Proposed Policy could be interpreted to apply to issuers or to transactions in circumstances which it should not apply. For example, the definition of "operating entity" is broad enough that it would apply to most special purpose issuers of asset backed securities, even though those issuers distribute debt and not equity. We recommend that specific examples of what is meant by other indirect offering "structures" be included and that there be an exemption for issuers of asset backed securities with an "approved rating", as such terms are defined in the National Instrument 44-101.

Policy Versus Rule

The stated purpose of the Proposed Policy is to provide guidance and clarification to market participants about income trusts and other indirect offering structures. In many respects, however, the Proposed Policy may be beyond the legally permitted and proper scope of a policy, because it (i) purports to establish mandatory requirements that are essentially rules or purport to improperly modify an existing statutory provision or rule; or (ii) it contains staff interpretations or guidance that are inconsistent or broader than an existing statutory provision, thereby arguably constituting an improper attempt at amending or changing legislation or rules.

(a) Mandatory Requirements

Here are some examples of mandatory requirements in the Proposed Policy that are properly the subject of a rule:

- Section 3.1
  - The requirement of the operating entity to comply with Ontario Securities Commission Rule 61-501 ("Rule 61-501");

- the requirement to provide an undertaking with respect to continuous disclosure and Rule 61-501; and
- the requirement to annually certify compliance with the undertaking described above.

- Section 3.4
  - The requirement to provide an undertaking with respect to insider reporting and the related certification requirement.
- Section 4.3.1
  - The change in the definition of "promoter".
- Section 5.3
  - The requirement for income trust issuers to file copies of green sheets and other marketing materials used in connection with an offering.

The requirement for the issuer to certify annually that the issuer has complied with its obligations is also the proper subject matter of a rule because it imposes a new mandatory requirement for income trusts: there is no requirement for a non-income trust issuer to certify annually that it has complied with Rule 61-501 or that it has been taking all reasonable steps to require insiders to properly file insider reports. We do not see why this more onerous obligation should be imposed on income trust issuers, but if it is, it should be done through a rule.

As a short-cut to amending a statutory provision or rule, the proposed undertaking regime introduces uncertainty: it is not always clear what obligations are being agreed to in the undertakings. For example, it is not clear to us how Rule 61-501 is intended to apply to income trusts and therefore what undertakings given in respect of Rule 61-501 actually require. If it is believed that that Rule 61-501 does not properly deal with entities that have their main operations conducted through subsidiary entities, then Rule 61-501 should be amended (as is being done). A formal amendment, with the appropriate consultation and review, will permit a proper consideration of the gaps in the Rule and the proper way to address these gaps, and should result in a coherent regime of application to all issuers at the same time. The resulting improved rule would, hopefully, be clear and all issuers would have the benefit of the fairness of a transparent regulatory regime.

(b) Staff Interpretations and Guidance

Certain statements in the policy (such as staff's view about application of the definition of "promoter") may also be an improper modification of legislation. The same may be true of the imposition (through a policy) on income trusts of rules that are different from those other issuers must comply with (such as the requirement to file "short term debt" credit agreements; annual certification of compliance with undertakings; required disclosure regarding stability ratings; requirement to file green sheets).

PART B SPECIFIC COMMENTS

Part 2(C): Short-Term Debt

The Proposed Policy draws a distinction between income trust issuers and other issuers by creating obligations to disclose short term debt that are unique to income trust issuers. The distinction appears to be made on the basis that income trusts are particularly sensitive to cash flows.

We do not think that it is appropriate or necessary to require income trusts to give debt obligation disclosure that is different from the debt obligation disclosure of other issuers. In particular, we do not think it is appropriate to state categorically that the agreements relating to short-term debt must be listed as material contracts and filed on SEDAR. Each issuer is required to consider which of its contracts are material, and that judgment is audited by the underwriters and their counsel. Mandated public filing puts income trust issuers at a disadvantage compared to other issuers who are not required to file their contracts, because, although credit agreements have standard covenant patterns, there is sensitive commercial information in credit agreements. In addition, the content of the agreement is of no relevance to the issuer's ability to refinance the debt on advantageous terms — it is only relevant to the covenants and the consequence of a default. We submit that it is not necessary to provide more than a summary of the principal covenants that could result in a default and impair distributions.

We are aware that it has been market practice for income trust issuers to describe their credit facilities and to include a risk factor with respect to the impact that the credit facility may have on the issuer's ability to pay distributions or take other actions. We do not object to this disclosure but do not believe it is of special relevance to income trusts. In our view, any issuer with a credit facility whose terms would be material to an investor, whether because of its impact on the issuer's ability to pay distributions or otherwise, is already required to disclose that material fact in a prospectus and to include a risk factor identifying the risks raised by that facility.

We note that the Proposed Policy also includes a definition of "short term debt" that is not consistent with the accounting definition, and we are concerned that this will lead to confusion. In addition, we note that it is not always the operating entity that borrows the third party debt, but the policy is written only to apply to an operating entity.

Part 2(D): Stability Ratings

The Proposed Policy states that "...in many ways, investing in an income trust is more like an investment in an equity security rather than in a debt security". We agree. In our view, an income trust unit has the investment risk characteristics of high yield debt and equity, combined with the legal rights of an equity security, and should be viewed by investors as such. Holders of income trust units are susceptible to risk of loss and fluctuations in distributions, and they do not have the remedies of debt holders.

In our view, the requirement to state whether or not a trust has obtained a stability rating, and to require those that do not to state the reasons for not obtaining one, is to mandate

for an equity prospectus disclosure more appropriate for debt. We note that even for debt prospectuses disclosure regarding credit ratings is not mandated.

Some income fund issues do obtain stability ratings, presumably where their stability is a particularly attractive factor in marketing their units. For other income trusts, potential growth, and corresponding distribution variations, will be a more material attribute for disclosure purposes. In those cases, the issuer and the underwriters make the judgment that the resources required to obtain a rating, and to deal on a going-forward basis with the ratings agency, are not merited in the context of that issuer's circumstances. Mandated disclosure as to why the trust did not obtain a stability rating taints such issuers by implying that their disclosure is deficient or that there is some deficiency or undue risk associated with the particular income fund. In our view this is not an appropriate approach, nor is it necessary. The market is well able to assess quality and risk differences between income funds, and those differences are reflected in the expected levels of distributable cash that underpin each offering.

Part 2(E): Determination of Offering Price

We do not understand that rationale for requiring disclosure of third party valuations and related disclosure regarding the determination of value through negotiation between security holders and the underwriters. It is our understanding that the valuation exercise you are referring to is undertaken in order to prepare the issuer's financial statements (e.g. purchase price accounting). In our experience, underwriters are not involved in this assessment; rather it is prepared by the staff of the operating entity in conjunction with its auditors.

Moreover, we question the degree of relevance of this valuation information to investors. To the extent values have been ascertained, they are reflected in the income fund's financial statements. The valuation of the IPO is not based on this accounting valuation. That determination is made after the marketing exercise is completed and an assessment is made of the level of cash distributions (on a standard issue of price of $10.00) per unit that will be required to complete the offering. Once that determination is made, the market value of the income fund is a function of the aggregate level of distributable cash divided by the expected percentage distribution per unit.

Part 2(F): Management Contracts

We agree that income trusts have an obligation to disclose the executive compensation paid by the operating business on an ongoing basis. We also agree that the past compensation is relevant, though possibly less relevant than the plans for the period following the public offering. In particular, we believe that the Proposed Policy should clearly state that disclosure of previous compensation programs that are being terminated or substantially revised as part of the income fund offering do not need to be disclosed. In many offerings, management's pre-offering compensation package includes equity growth based incentives which are not appropriate for a cash flow based income fund. Providing full disclosure of historical compensation plans that are not continuing is not only unnecessary, it is also potentially confusing to investors.

We assume that when the Proposed Policy refers to management contracts it means contracts with a third-party manager of the business, rather than contracts with particular executives or employees. We agree that management contracts may be material and should in such case be disclosed in the prospectus and filed on SEDAR. Similarly, if management incentive plans refer to arrangements with a third-party manager which could be material, we agree with the principles stated in the policy. However, if management arrangements will result in cash payments, then they will always have an impact on distributable cash and we do not think it is appropriate to use this fact to distinguish between different types of issuers or to impose unique disclosure obligations on income trusts in respect of their management contracts or management incentive plans. Indeed, it can be argued that the need for disclosure is less pressing in the case of an income trust issuer if the plans provide an incentive to management to meet the distribution targets which have been publicly identified.

We note that issuers have been required to file their long term incentive plans relating to the senior executives of the operating business on SEDAR. We do not think it is appropriate for income trust issuers to be required to file their employment contracts or executive incentive arrangements to any greater extent than is required of other issuers. It would unfairly put income trust issuers in a disadvantage compared to other issuers. The fact that income trust issuers distribute more of their cash flow than other issuers does not mean that employment arrangements are more or less relevant or that changes in them are more or less material than for other issuers. On the contrary, one might argue that the regular distribution of cash flow restrains any urge of an income trust to pay exorbitant executive compensation and is therefore a positive feature of an income trust rather than a potential risk.

Section 3.4: Insiders

As noted above, we submit that if the definition of insider in the context of an income trust does not properly apply to insiders of the operating subsidiary then the definition should be changed through legislative amendment rather than through requiring undertakings. In addition, all issuers are obligated to take appropriate steps to ensure compliance with insiders with reporting obligations. We submit that there is no principled basis to require income trusts to annually certify compliance with its obligations and not to impose a similar requirement on all issuers.

Part 4: Prospectus Liability

As noted above, we believe the Proposed Policy is not the correct method to effectively expand the statutory definition and past practice in applying promoter liability. We recognize the importance of the issue the Proposed Policy seeks to address in Part 4. We suggest that a market-based solution has already developed, as underwriters and investors have become increasingly sophisticated regarding the extent of responsibility assumed by vendors for prospectus disclosure. We suggest that a market-based solution, together with strict disclosure requirements, much of which is described in section 4.4 of the Proposed Policy, will be the most consistent and predictable approach in this area.

(a) Discussion

In section 4.3.1, the Proposed Policy states that a vendor that receives, directly or indirectly, a "significant portion" of the offering proceeds is a promoter and should sign the prospectus in that capacity. We believe that this new definition of promoter is overly broad and uncertain in its application, would impose liability on many parties that they would not bear in a traditional IPO, and is inconsistent with past market practice in Canada.

Selling Shareholder Liability

In our experience, where an existing shareholder realizes some liquidity by participating as a portion of a public offering, it is usual that transactions are effected to protect the shareholder from prospectus liability as a selling shareholder (e.g. placing the securities to be sold in a separate subsidiary or creating a class of redeemable securities that are redeemed with proceeds from the offering; these are arrangements that have been permitted by regulators in the past). Whether or not these arrangements are effective to remove those parties from the liability consequences of being a "selling shareholder" is untested and will remain uncertain until determined through a definitive judicial process.

We believe that the prospectus liability requirement for "selling shareholders" is so lacking in clarity and specificity of application, and the consequences, from a civil liability perspective, are so dramatic, that it should be narrowly interpreted. To suggest otherwise is to invite a long, and ultimately unresolvable, debate regarding tracing of proceeds, debt versus equity investors and regulatory fairness. Moreover, to hold otherwise will be to invite similar debates on traditional common share IPOs, or secondary offerings, where, in an effort to avoid issuer level liability, an existing investor will undertake a variety of pre-offering corporate steps that either side step the issue or leave the impression of selling security holder liability without any substance (e.g. transferring the securities to be sold to a wholly-owned subsidiary with no other assets and winding up that subsidiary after the offering has been completed).

Promoter Liability

We understand the history of the promoter requirement contained in the securities legislation is rooted in the junior mining financings that were prevalent several decades ago. In those transactions, it was typical for a "real promoter" to invest time, energy and out-of-pocket expenses to establish a number of mining claims that would be transferred to a corporation that was subsequently taken public. It would be usual in those transactions for the promoter to receive shares of the corporation as compensation for its services and for property transferred to the corporation; and it would also be usual for the corporation to effect a public offering in short order thereafter. In these circumstances a real promoter would have created a business and an issuer that could be offered to the public at a valuation that would only be justified if the assets contributed to the business performed as expected, or hoped, over time.

The definition of "promoter" works in tandem with the requirement in securities legislation that permits the Director, *in his or her discretion*, to require any promoter of the issuer *within the two preceding years* to sign a prospectus certificate. The intent of these provisions is to require a "real promoter" who is, in effect, selling to the public services and property without

an established market value, to stand behind the public offering, or to wait a reasonable period of time (i.e. two years) in order to better establish the value of the assets that are being sold to the offering corporation.

Although the application of the promoter definition has been expanded over time, it is our view that a proper interpretation of the definition would not result in a conclusion that the phrase "services or property" includes an investment of cash in an issuer. Drawing a distinction between a cash investment (which has a clear value), and a contribution of services or property, not only makes sense in the historical context of this definition, but is consistent with a similar distinction made in the *Business Corporations Act* (Ontario) ("OBCA") with respect to consideration paid for shares of a corporation (see subsection 23(3) of the OBCA which speaks to consideration for shares being "fully paid in money or in property or past service").

We believe that the definition of promoter, and the circumstances under which it is appropriate to require a promoter to sign a prospectus, is what it is. That is to say, securities legislation stands on its own and, properly interpreted, provides for the appropriate circumstances where a party should be viewed as a promoter and should sign the prospectus. We would suggest leaving this requirement as it is, to be applied in appropriate circumstances. In particular, we believe that in the context of income fund offerings, the application of the promoter definition should be applied at the level of the operating entity and not the trust.

(b) Policy Concerns

The application of prospectus liability as the discipline to address the policy concern underlying Part 4 is problematic because, except in the narrow circumstance of a vendor's securities comprising 100% of the amount offered to the public, the prospectus liability regime for selling shareholders and promoters is a blunt instrument with an uncertain policy rationale. If the Proposed Policy's new definition of promoter – which contains no reference to control over the issuer or operating entity or knowledge of its affairs – is applied uniformly to all prospectus offerings of securities, there will be many situations where vendors with relatively small holdings or without detailed knowledge of the business of the issuer, will be required to accept prospectus disclosure liability.

The other difficulty with the Proposed Policy's approach is that, in order for it to be applied on a logical and even-handed basis, it will be necessary to trace the offering's proceeds into the hands of the ultimate beneficial owner of the existing securities. Many vendors with legal ownership are, in one form or another, asset managers who are acting on behalf of a large number of investors who are the parties that are "profiting from the offering" but who have no special knowledge of the issuer or its business and no ability to control its affairs. Lastly, we cannot find a principled distinction between an existing equity investor, which indirectly "profits from the offering", and an existing debt investor, which does so. If the new promoter definition is to be applied uniformly to all public offerings, this issue needs to be addressed as well.

(c) Suggested Approach

In considering the appropriate regulatory position on this issue, we believe that it is of fundamental importance that the regulatory approach adopted be capable of consistent

application to all comparable transactions. This standard will not be met by developing a regulatory posture that applies only to income fund or "indirect" offerings. In order to achieve a satisfactory outcome it is necessary to build a position based on principles that can be applied to the various sorts of public offerings that are in the market today, and those that might come forward in the future. To do otherwise, will be to accept uneven treatment across comparable transactions and invite market participants to adopt offering structures whose sole purpose is to achieve a more favourable outcome on this issue.

The best approach, from a process and regulatory policy development perspective, may be to introduce an amendment to the prospectus liability provisions of the securities acts, or issue a rule that would address the issue.

Absent a rigorous analysis resulting in a rule or legislative amendments, it seems to us that it is not possible or advisable to adopt a "one size fits all" solution. There are different issues at play in different types of offerings and we would suggest that the following approach would best achieve the appropriate regulatory policy objectives and permit transactions to be completed on an effective basis.

In offerings where an appropriate party signs the prospectus as a promoter, or there is an identified selling security holder that falls within the applicable legislative scheme, the regulatory concern underlying Part 4 of the Proposed Policy will be adequately addressed. In other situations, we believe that it is necessary to consider whether the vendor is holding the securities as principal (e.g. beneficial owner) or is acting as an asset manager on behalf of a number of investors.

In circumstances where the vendor is acting as principal and by virtue of the level of its holdings of securities of the issuer and/or representation on the board of directors, can fairly been seen as holding a control position and having access to a high degree of knowledge regarding the business, capital and affairs of the issuer, it would be appropriate to require those investors to take responsibility for the disclosure in the prospectus. The vendor would accept this liability by entering into contractual arrangements (e.g. a representation and warranty with an appropriate indemnity) with the issuer regarding the disclosure in the prospectus. The financial limit placed on the vendor's indemnity would be negotiated with the underwriters to properly reflect the circumstances of the offering and the risks of the underlying business. The vendor's liability would be subject to a due diligence defense.

In circumstances where the vendor is not acting as principal but, instead, is managing the investment on behalf of others (this is typically the case with private equity investors) the fund manager should only have liability for prospectus disclosure if it has acted in a manner analogous to a control person. For example, with private equity investors, it is typical for the asset management company to occupy one or more positions on the board and to have a fairly active involvement with senior management of the company. In these circumstances, it can fairly be concluded that the fund manager possesses a high degree of knowledge regarding the issuer and is in a position to accept liability for prospectus disclosure. The amount of this liability should be no greater than the proceeds realized by the fund manager as a result of the public offering. The existing investor would accept this liability by entering into contractual

arrangements with the issuer regarding the disclosure in the prospectus. The specific terms of these arrangements would be negotiated with the underwriters.

The suggested approach outlined above is a summary description of the arrangements that are commonly adopted in Canadian income fund offerings today. In effect, the parties to the transaction have addressed the concern underlying Part 4 through private contract. We agree with the provisions in section 4.4.3 of the Proposed Policy, which would require clear and detailed disclosure of these arrangements. We suggest the mandated disclosure also include, where material, a description of the assets available to support the vendor's representations, warranties and indemnities.

The market has reached its solution in this area; where existing investors do not take the appropriate responsibility for the disclosure, we suggest mandated disclosure is a preferable solution to a blunt and possibly inconsistent imposition of promoter liability.

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We appreciate the opportunity to comment on the Proposed Policy and would be pleased to discuss any aspect of this submission with you.

Yours truly,

"Karrin Powys-Lybbe" *"Kevin Morris"*

KMM/ca

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