

## 6.1.2 Proposed National Policy 41-201 Income Trusts and Other Indirect Offerings

### PROPOSED NATIONAL POLICY 41-201 INCOME TRUSTS AND OTHER INDIRECT OFFERINGS

#### Part 1 - Introduction

##### 1.1 What is the purpose of the policy?

It is a fundamental principle that everyone investing in securities should have access to sufficient information to make an informed investment decision. The Canadian Securities Administrators (the CSA or we) believe that there are distinct attributes of an investment in income trust units that should be clearly disclosed.

Within our securities regulatory framework, raising capital in the public markets results in certain rights and obligations attaching to issuers and investors. We believe that it would be beneficial to express our view about how the existing regulatory framework applies to non-corporate issuers (such as income trusts) and to indirect offerings, in order to minimize inconsistent interpretations and to better ensure that the intent of the requirements is preserved. Our concerns relate to the quality and nature of prospectus disclosure and continuous disclosure records, accountability for prospectus disclosure and liability for insider trading.

This policy provides guidance and clarification by all jurisdictions represented by the CSA. Although the primary focus of this policy is on income trusts, we believe that much of the guidance and clarification that we provide is useful for other indirect offering structures. As well, the principles can apply more generally to issuers that offer securities which entitle holders of those securities to the net cash flow generated by the issuer's business or its properties. We provide guidance about prospectus disclosure and prospectus liability to minimize situations where staff might recommend against issuance of a receipt for a final prospectus where it would appear that the offering may be contrary to the public interest due to insufficient disclosure, structure of the offering, or a combination of the two. Many of the principles that we describe apply equally to direct offering structures.

Although the main focus of this policy is on the income trust structure in the context of public offerings, these principles also apply to income trust structures in other contexts, such as the reorganization of a corporate entity into a trust. Although an offering document is not prepared in a reorganization, we expect that the resulting prospectus-level disclosure provided to relevant security holders will follow the principles set out in this policy. The principles that we describe also apply to income trusts in the fulfillment of their ongoing continuous disclosure obligations. In addition, when we are determining whether to grant exemptive relief to an income trust issuer in connection with a reorganization or other similar transaction, we will consider the principles described in Part 3 of this policy.

##### 1.2 What do we mean when we refer to an income trust in this policy?

When we refer to an income trust or issuer in this policy, we are referring to a trust or other entity (including corporate and non-corporate entities) that issues securities which entitle the holder to substantially all of the net cash flows generated by: (i) an underlying business owned by the trust or other entity, or (ii) the income-producing properties owned by the trust or other entity. This includes business income trusts, real estate investment trusts and royalty trusts. In our view, this does not include an entity that falls within the definition of "investment fund" contained in proposed National Instrument 81-106 *Investment Fund Continuous Disclosure*.

##### 1.3 What is an operating entity?

In the most basic income trust structure, the operating entity is: (i) a subsidiary of the income trust with an underlying business, or (ii) income-producing properties owned directly by the income trust. In more complex structures, there may be a number of intervening entities above the operating entity. Generally, the operating entity is the first entity in the structure that has an underlying business which generates cash flows. There may be more than one operating entity in the income trust structure.

In addition to identifying the operating entity, it is also important to understand the operating entity's business. In some cases, its business is to own, operate and produce revenues from its assets. In other cases, its business is to own an interest in a joint venture or to derive a revenue stream from holding a portfolio of investments or financial instruments.

##### 1.4 How is an income trust structured?

Typically, an income trust holds a combination of debt and equity or royalty interests in an entity owning or operating a business (the operating entity). Substantially all of the net cash flows that are generated by the operating entity's business are distributed to the income trust. The income trust then distributes that cash flow to its investors (unitholders or investors).

An income trust focuses on the ownership and management of assets of the operating entity. The principal purpose of the income trust is to distribute cash generated by the operating entity to its unitholders.

Often the pre-offering owners (referred to as owners or vendors) of the operating entity (or its predecessors) sell less than their entire interest in the operating entity to the income trust. Through their retained ownership interest, the vendors participate in distributions of the operating entity's net income.

### **1.5 What is an income trust offering?**

In a typical income trust offering, an income trust is created to distribute units to the public. The proceeds that the income trust raises are used to acquire debt and equity or royalty interests in the operating entity, or interests in income producing properties. We view the income trust offering as a form of indirect offering. Instead of offering their securities directly to the public, the vendors sell their interests in the operating entity to the income trust. The income trust purchases those interests with proceeds that it raises through its offering of units to the public. The interests in the operating entity that the income trust acquires are thus indirectly offered to the public. Through their direct investment in units of the income trust, unitholders hold an indirect interest in the operating entity.

By issuing units under a prospectus, the income trust becomes a reporting issuer (or equivalent) under applicable securities laws. The operating entity typically remains a non-reporting issuer.

### **1.6 How does an indirect offering differ from a direct offering?**

In a conventional direct offering, interests in the operating entity are offered to the public through a public distribution of the operating entity's securities. By contrast, in an indirect offering, interests in the operating entity are not offered directly to the public but are instead acquired by a separate entity (for example, an income trust or its subsidiary). The securities of this separate entity, such as units of a trust, are offered to the public under a prospectus. The issuer applies the proceeds of the offering to satisfy the purchase price of the interests in the operating entity.

In a direct initial public offering (IPO), an issuer may choose to finance the acquisition of another business with proceeds raised under the offering. In that scenario, the issuer and the vendors of the business are generally arm's-length parties. This differs from the structure of an indirect offering, such as the initial public offering by most income trusts, where the income trust and the vendors of the business are not arm's-length parties.

In an indirect offering, the vendors negotiate the terms of the purchase of the business by the income trust, and are also involved in the negotiation of the terms of the public offering with the underwriter(s).

If vendors initiate or are involved in the public offering process, we believe that they are effectively accessing the capital markets themselves. This fact gives rise to the concerns that we describe in Part 4. Vendors that are involved in a non-IPO offering process are also effectively accessing the capital markets through an indirect offering, and the concerns that we describe in Part 4 are equally applicable.

## **Part 2 - Prospectus disclosure**

We describe below certain unique attributes of income trusts that we expect to be included in prospectus disclosure. We would like these attributes, and the offering generally, to be described in a simple, clear and readable manner to ensure that investors understand the nature of their investment.

### **A. Distributable cash**

#### **2.1 What is distributable cash?**

Distributable cash generally refers to the net cash generated by the income trust's businesses or assets that is available for distribution, at the discretion of the income trust, to the income trust's unitholders. The cash that is available to an income trust for distribution per unit varies with the operating performance of the income trust's business or assets, its capital requirements, and the number of units outstanding.

#### **2.2 Does an income trust's distributable cash provide an investor with a consistent rate of return?**

No. In many ways, investing in an income trust is more like an investment in an equity security rather than in a debt security. A fundamental characteristic that distinguishes income trust units from traditional fixed-income securities is that the income trust does not have a fixed obligation to make payments to investors. In other words, it has the ability to reduce or suspend distributions if circumstances warrant (see section 2.3 below for further details). The trust's ability to consistently make

distributions to unitholders will fluctuate depending on the operations of the operating entity or the performance of the income trust's assets (such as income-producing real estate properties or oil- and gas-producing properties).

Unlike an issuer of a fixed-income security, an income trust does not promise to return the initial purchase price of the unit bought by the investor on a certain date in the future. Investors who choose to liquidate their holdings would generally do so by selling their unit(s) in the market.

In addition, unlike interest payments on an interest-bearing debt security, income trust cash distributions are, for Canadian tax purposes, composed of different types of payments (portions of which may be fully or partially taxable or may constitute non-taxable returns of capital). The composition for tax purposes of those distributions may change over time, thus affecting the after-tax return to investors. Therefore, a unitholder's rate of return over a defined period may not be comparable to the rate of return on a fixed-income security that provides a "return on capital" over the same period. This is because a unitholder in an income trust may receive distributions that constitute a "return of capital" to some extent during the period. Returns on capital are generally taxed as ordinary income or as dividends in the hands of a unitholder. Returns of capital are generally non-taxable to a unitholder (but reduce the unitholder's cost base in the unit for tax purposes).

### **2.3 How do the distribution policies of the income trust and the operating entity affect an investor's rate of return?**

The distribution policy of the income trust generally stipulates that payments that the income trust receives from the operating entity (such as interest payments on the debt and dividends paid to common shareholders) will be distributed to unitholders. The distribution policy of the operating entity will generally stipulate that distributions to the income trust will be restricted if the operating entity breaches its covenants with third-party lenders (such as maintaining specified financial ratios or satisfying its interest and other expense obligations). Other operating entity obligations such as funding employee incentive plans or funding capital expenditures will frequently rank in priority to the operating entity's obligations to the income trust. In addition, the operating entity, or the income trust, might retain a portion of available distributable cash as a reserve. Funds in this reserve may be drawn upon to fund future distributions if distributable cash generated is below targeted amounts in any period.

### **2.4 What cover page disclosure do we expect about distributable cash?**

To ensure that the information described in sections 2.1, 2.2 and 2.3 is adequately communicated to investors, language on the prospectus cover page substantively similar to the following would be helpful:

The pricing of the units has been determined, in part, based on the estimate of distributable cash for the year ended • on page •. Although the income trust intends to make distributions of its available cash to unitholders, these cash distributions are not assured. The actual amount distributed will depend on numerous factors including the operating entity's financial performance, debt covenants and obligations, working capital requirements, future capital requirements and, if applicable, the deductibility for tax purposes of interest payments on the debt of the operating entity [these details can be tailored according to the specific set of circumstances in each transaction]. The market value of the units may deteriorate if the income trust is unable to meet its cash distribution targets in the future, and that deterioration may be material.

The after-tax return from an investment in units to unitholders subject to Canadian income tax will depend, in part, on the composition for tax purposes of distributions paid by the income trust (portions of which may be fully or partially taxable or may constitute non-taxable returns of capital). The composition for tax purposes of those distributions may change over time, thus affecting the after-tax return to unitholders. 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 return of capital is •. Returns on capital are generally taxed as ordinary income or as dividends in the hands of a unitholder. Returns of capital are generally non-taxable to a unitholder (but reduce the unitholder's cost base in the unit for tax purposes).

An investment in the units is subject to a number of risks that should be considered by an investor. See "Risk Factors".

## **B. Distributable cash – non-GAAP measures**

### **2.5 What disclosure do we expect about the income trust's estimate of its distributable cash?**

Distributable cash is often presented in a manner, and based on financial measures, that is not prescribed by generally accepted accounting principles (GAAP). Frequently, income trusts refer to "EBITDA" (earnings before interest, taxes, depreciation and amortization) and "adjusted EBITDA" as being relevant measures of their performance (on the basis that investors are concerned primarily with cash flow). Income trusts frequently derive their distributable cash estimates from these amounts. In presenting adjusted EBITDA, income trusts commonly make and incorporate assumptions about how the operating entity's business will be conducted post-offering. These include assumptions about capital expenditures, financing costs and administrative expenses, resulting in a distributable cash figure. Therefore, we expect any assumptions made to be clearly explained.

We remind issuers to refer to the guidelines contained in CSA Staff Notice 52-303 – *Non-GAAP Earnings Measures*.

**C. Short-term debt**

**2.6 Why are we concerned about the operating entity's short-term debt?**

We are concerned about debt obligations that are renewable within 5 years or less that the operating entity has negotiated with persons other than the income trust (referred to as short-term debt). Those obligations typically rank before the operating entity's obligations to the income trust and, consequently, to unitholders' entitlement to receive distributable cash. Although many non-income trust issuers have similar, or less conservative, capital structures, we are particularly concerned about the sensitivity of income trusts to cash flows. Specifically, we are concerned about reductions in distributions that might arise from increases in interest charges on floating-rate debt, a breach of financial covenants, a refinancing on less advantageous terms, or a failure to refinance.

**2.7 What disclosure do we expect about short-term debt?**

We expect the principal terms of the operating entity's short-term debt to be included in the income trust's prospectus. This would include the following information about the debt:

- (a) the principal amount and the anticipated amount to be outstanding when the offering is closed,
- (b) the term and interest,
- (c) the term at which the debt is renewable, and the extent to which that term could have an impact on the ability to distribute cash,
- (d) the priority of the debt relative to the securities of the operating entity held by the income trust,
- (e) any security granted by the income trust to the lender over the operating entity's assets, and
- (f) any other covenant(s) that could restrict the ability to distribute cash.

**2.8 Are agreements relating to the operating entity's short-term debt material contracts of the income trust?**

We consider that in most cases, agreements relating to the operating entity's short-term debt that have been negotiated with a lender other than the income trust, will be material contracts if terms of those agreements have a direct correlation with the anticipated cash distributions. For example, distributions from the operating entity to the income trust may be restricted if the operating entity fails to maintain certain covenants under a credit agreement. If the agreement contains terms that have a direct correlation with the anticipated cash distributions, and will be entered into on or about closing, we expect it to be listed as a material contract in the prospectus. We also expect a copy of that agreement to be filed on SEDAR upon its execution.

**2.9 Do we expect the income trust to include a separate risk factor about short-term debt?**

Yes. We expect the income trust to include a separate risk factor about the operating entity's short-term debt in the income trust's prospectus. We recommend that the risk factor include a discussion of the following points:

- (a) the need for the operating entity to refinance its short-term debt when the term of that debt expires,
- (b) the potential negative impact on distributable cash if the debt is replaced by new debt that has less favourable terms,
- (c) the impact on distributable cash if the operating entity cannot refinance the debt, and
- (d) the fact that distributions from the operating entity to the income trust may be restricted if the operating entity fails to maintain certain covenants under the credit agreement (such as a failure to maintain certain customary financial ratios).

**D. Stability ratings**

**2.10 What is a stability rating?**

A stability rating is an opinion of an independent rating agency about the relative stability and sustainability of an income trust's cash distribution stream. Standard & Poor's (S&P's) and Dominion Bond Rating Services (DBRS) currently provide stability

ratings on Canadian income trusts. A stability rating reflects the rating agency's assessment of an income trust's underlying business model, and the sustainability and variability in cash flow generation in the medium to long-term. The objective of these stability ratings is to compare the stability of rated Canadian income trusts with one another.

**2.11 Does an income trust need to obtain a stability rating?**

No. However, the CSA believes that stability ratings offered by rating agencies, such as S&P's and DBRS, can provide useful information to investors.

We believe that choosing to invest in income trust units is, in substance, a decision to purchase the cash flow generated by the operating entity. The presentation of distributable cash in an income trust prospectus is often the best measure available to an investor of the issuer's potential to generate and distribute cash. However, as discussed in this policy, we are concerned that the use of non-GAAP measures by income trust issuers makes it difficult or impossible for investors to compare income trusts. Therefore, it is difficult to compare the risk of investing in one income trust relative to the risk of investing in another. We believe that stability ratings can supplement the presentation of distributable cash in the prospectus to provide an independent opinion on the ability of an income trust to meet its distributable cash targets consistently over a period of time relative to other rated Canadian income trusts.

**2.12 Do we expect an income trust to disclose whether it has or has not received a stability rating?**

Yes. We expect the income trust to state on the prospectus cover page whether it has or has not received a stability rating. If an income trust chooses not to obtain a stability rating, we recommend that the income trust describe on the prospectus cover page its reasons for choosing not to obtain a rating.

**2.13 What disclosure do we expect about an income trust's stability rating?**

As described above, if an income trust has received a stability rating, we expect the rating to be described on the cover page of the prospectus. To assist investors, we recommend that the income trust explain within the prospectus that a stability rating measures an income trust's stability relative to other rated Canadian income trusts rather than relative to all income trusts. We expect the explanation to be substantively similar to the following:

- has assigned a stability rating of • to the Units. The rating is based on a rating scale developed by •, which characterizes the stability of cash distribution streams. •'s stability analysis encompasses the variability and sustainability of a cash distribution stream in the medium to long-term with a single stability rating of • through •. Variability in the distribution stream refers to changes in the distribution from period to period over a business cycle, while sustainability of the distribution stream refers to the length of time that distributions can likely be made. Together, these two characteristics are referred to by • as the stability profile of the issuer. The stability rating scale is organized such that a rating of • signifies the lowest level of cash distribution variability and the highest level of cash distribution sustainability, while a rating of • signifies the highest level of variability and the highest amount of uncertainty in the sustainability of the cash distribution stream. A rating is not a recommendation to buy, sell or hold any security, and may be subject to revision or withdrawal at any time by •.

**E. Determination of unit offering price**

**2.14 What disclosure do we expect about the determination of the price of an income trust's units?**

We do not currently ask that income trusts obtain a third-party valuation of the operating entity interests to be acquired (unless that valuation is otherwise required under securities legislation). However, if a third-party valuation is obtained, we expect the income trust to describe the valuation in the prospectus and to file the text of the valuation on SEDAR. We expect the description to identify the parties involved, the principal variables and assumptions used in the valuation (particularly those which could, if adversely altered, cause a deterioration in the value of the issuer's investment). If no third-party valuation is obtained, we expect the prospectus to disclose that fact and to state that the value was determined solely through negotiation between the operating entity security holders and the underwriter(s).

**F. Executive compensation**

**2.15 What disclosure do we expect the income trust to provide about executive compensation for the operating entity?**

We believe that the executive compensation of the operating entity's executives is important information for investors. We expect the income trust to provide that information in its prospectus as though the operating entity is a subsidiary of the income trust at the time that a final receipt for the prospectus is issued. We also remind issuers of their obligation under securities legislation to provide unitholders with executive compensation disclosure on a continuous basis.

**2.16 What disclosure do we expect about the income trust's management contracts and management incentive plans?**

We believe that the material terms of management contracts and management incentive plans are relevant information for investors if terms of those contracts or plans have an impact on distributable cash. For example, if the term "distributable cash" is defined in a unique way in a management contract, we expect that term of the contract to be described. We expect disclosure about those contracts and plans to be included in the prospectus. If those contracts and plans have not been finalized, we expect the anticipated material terms to be described in the prospectus.

**2.17 Do we expect management contracts and management incentive plans to be filed on SEDAR?**

We expect the material contracts and plans referred to in section 2.16 to be filed on SEDAR. If those material contracts and plans have not been finalized before filing the final prospectus, we expect the income trust to provide an undertaking from the income trust and the operating entity to the securities regulatory authorities that those contracts and plans will be filed as soon as practicable after execution. 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.

**Part 3 - Continuous disclosure**

**Reporting obligations relating to the operating entity**

**3.1 What continuous disclosure do we expect about the operating entity?**

We believe that an income trust's performance and prospects depend primarily on the performance and operations of the operating entity. To make an informed decision about investing in an income trust's units, an investor generally needs comprehensive information about the operating entity, including: (i) the operating entity's interim and annual financial statements together with corresponding management discussion and analysis for those periods, (ii) complete business disclosure about the operating entity of the scope expected in an annual information form, and (iii) press releases and material change reports about any material changes in the business, operations or capital of the operating entity.

In addition, if the operating entity is a party to a "related party transaction" as defined in Ontario Securities Commission Rule 61-501 *Insider Bids, Issuer Bids, Going Private Transactions and Related Party Transactions* (Rule 61-501) and in the CVMQ's regulation entitled *Policy Statement No. Q-27 Protection of Minority Securityholders in the Course of Certain Transactions* (Q-27) (and any successor to Q-27), compliance with those rules will be expected.

To the extent the securities legislation in some CSA jurisdictions is ambiguous about whether the disclosure described above about the operating entity is required by a reporting issuer that is an income trust or other non-corporate entity, we expect the issuer to file an undertaking with the regulatory authorities prior to receiving a receipt for a final prospectus. We expect the undertaking to provide that while the issuer is a reporting issuer:

- (i) in complying with its reporting issuer obligations, the income trust will treat the operating entity as a subsidiary of the income trust; however, if generally accepted accounting principles prohibit the consolidation of financial information of the operating entity and the income trust, we expect that, for as long as the operating entity (and any of its significant business interests) represents a significant asset of the income trust, the income trust will provide unitholders with separate financial statements for the operating entity (and any of its significant business interests),
- (ii) the income trust will obtain a commitment from the operating entity to comply with Rule 61-501 and Q-27, as applicable, as if the operating entity were a reporting issuer and the income trust's unitholders held directly those securities of the operating entity which are held directly or indirectly by the income trust, and
- (iii) the income trust will annually certify that it has complied with this undertaking, and file the certificate on SEDAR concurrently with the filing of its annual financial statements.

We recognize that there are circumstances where the income trust does not have direct access to the operating entity's financial information. For example, in situations where the income trust holds less than a 50% interest in an operating entity, it may be difficult for the income trust to have direct access to that operating entity's financial information. In those types of scenarios, we expect the income trust to ensure that it can follow the guidance described in this section 3.1 either through terms of the acquisition agreement or otherwise.

### 3.2 Comparative financial information

Most income trusts are the continuation of an existing business that was previously operated under a different legal form (for example, a corporation). We believe that the change in legal form does not alter the substance of the business operations and therefore does not prevent an income trust from presenting comparative financial information for the underlying business during its initial interim and annual periods.

In situations where the transfer of the operating business into an income trust is accounted for at carrying amounts, we expect the income trust to provide complete financial statements with comparative figures that also reflect the operations of the business under the previous legal entity.

Recognizing that the legal structure of the entity has changed, and to ensure the continuity and the comparability of the periods presented for the statements of operations and cash flows, an income trust may want to present, using columns: (i) the results of the reporting period relating to the previous legal entity prior to the inception of the trust, (ii) the results of the reporting period from the creation of the income trust to the balance sheet date, and (iii) the results for the complete reporting period that would represent the aggregate of the results of (i) and (ii) on a pro forma basis. We expect the results for the complete reporting period to be shown in the financial statements. The information for the period prior to and after the creation of the income trust may be shown within, or in the notes to, the financial statements.

For those acquisitions accounted for by the purchase method, we expect income trusts to provide comparative financial information for the predecessor business in their interim and annual MD&A. Examples of relevant comparative information would include, but would not be limited to, the following:

- Revenues/Sales
- Cost of Sales
- Gross Margin
- General and Administrative Expenses, and
- Net Income

### 3.3 Recognition of intangible assets

We remind income trust issuers that GAAP requires the appropriate recognition of all intangible assets on acquisitions to be accounted for under the purchase method. We encourage income trusts to provide a description of the method used to value the intangible assets in the offering document, so that investors may assess the objectivity of the valuation process.

### 3.4 Are “insiders” of the operating entity also insiders of the income trust for purposes of insider reporting obligations?

Consistent with our belief that the performance and prospects of the income trust depend on the performance and prospects of the operating entity, we believe each person who would be an “insider” (as that term is defined in applicable securities legislation) of the operating entity if the operating entity were a reporting issuer should comply with insider reporting requirements as if that person were also an insider of the trust.

To the extent the securities legislation in certain CSA jurisdictions is ambiguous about whether insiders of the operating entity are also insiders of the income trust or other non-corporate entity, that issuer is expected to file an undertaking with the regulatory authorities prior to receiving a receipt for a final prospectus. We expect the undertaking to provide that for so long as the income trust is a reporting issuer, the income trust will take the appropriate measures to require each person who would be an insider of the operating entity if the operating entity were a reporting issuer to file insider reports about trades in units of the income trust (including securities which are exchangeable into units of the trust). The income trust is expected to annually certify in the certificate described in section 3.1(iii) above that it has complied with this undertaking.

We are concerned that additional persons that may possess material undisclosed information about the income trust may: (i) not fall within the definition of “insider” (as that term is defined in applicable securities legislation) or (ii) not be caught by the undertaking. As a result, there may be situations where we will request that additional undertakings be provided. The income trust will need to obtain the contractual commitments from the persons and entities in order to comply with these undertakings.

## Part 4 - Prospectus liability

### 4.1 What is the regulatory framework?

The central element of the prospectus system is the requirement that disclosure of all material facts relating to the offered securities be provided so that investors can make informed investment decisions.

Although the prospectus serves a role in marketing securities, from a regulatory perspective, it is also a disclosure document that can give rise to liability. To provide discipline on prospectus disclosure, and to protect the integrity of the Canadian public markets, securities legislation imposes liability on certain persons involved in a public offering for any misrepresentation (as defined in applicable securities legislation) in a prospectus. Specifically, where a prospectus contains a misrepresentation, investors have the right to either rescind their purchases or to claim damages from the issuer or selling security holder that sold the securities, every director of the issuer, any promoters of the issuer, the underwriter(s) and certain other parties. Each of those parties (including each selling security holder) is jointly and severally liable for the damages experienced by investors as a result of the misrepresentation(s). We note that although "selling security holder" is not defined under applicable securities laws, the term is generally considered to mean persons who are selling securities of the class being distributed under the prospectus.

### 4.2 How does the regulatory framework about prospectus liability apply to indirect offerings?

In an indirect offering, the issuer uses the proceeds to acquire a business (and perhaps to repay indebtedness), and the disclosure (including financial disclosure) in the prospectus describes both the acquired business and the issuer. The proceeds are not retained by the issuer, and any prospectus misrepresentation that adversely affects the value of the acquired business may diminish the issuer's ability to satisfy a damages claim.

An underwriter's statutory liability in an indirect offering is the same as it is in a conventional direct offering. Underwriters sign a certificate about the disclosure contained in the issuer's prospectus and are potentially liable for a misrepresentation in the prospectus.

With respect to prospectus liability, what is different in the context of an indirect offering is that the former owners of the operating entity (referred to as vendors) who sell their ownership interests in the operating entity to the issuer and who are effectively accessing the public markets to liquidate their holdings, are not generally considered to be "selling security holders" within the meaning of securities legislation, as they are not selling the securities being offered under the prospectus. As a result, vendors who indirectly receive part of the proceeds of the offering in exchange for their operating entity interests do not (unless they qualify as promoters, which issue is addressed below) have statutory liability for a prospectus misrepresentation as they would if their operating entity security interests had been distributed directly to the public. Vendors of businesses to conventional issuers undertaking a direct offering would also not be considered "selling security holders" although they indirectly receive offering proceeds. However, as noted above, we believe those circumstances differ from an indirect offering because access to the public markets is being initiated primarily not by those vendors but by the issuer.

### 4.3 Promoter liability

#### 4.3.1 What is the meaning of promoter?

Persons that are promoters of an issuer within the meaning of securities legislation are required to sign the issuer's prospectus in that capacity. As a consequence, those persons assume joint and several liability for prospectus misrepresentations up to a maximum amount equal to the gross proceeds of the offering. The term "promoter" is defined differently in provincial securities legislation across the CSA jurisdictions. It is not defined in the *Securities Act* (Quebec), and a broad approach is taken in Quebec with respect to examining those persons who would be considered promoters. We believe 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.

#### 4.3.2 What constitutes the "business" of the income trust issuer?

In the context of indirect offerings, there appears to be uncertainty about whether the "business of an issuer", as that phrase is often used in the definition of "promoter" in some of the CSA jurisdictions, refers to the business of the issuer (the income trust) or to the business of the operating entity. More specifically, the question is whether the test depends on a person's involvement in the founding, organization or substantial reorganization of the operating entity's business, or whether involvement in the founding, organization, or substantial reorganization of the income trust itself will qualify a person as a promoter.

We believe that in most cases, the business of the income trust issuer is primarily to complete the public offering and to acquire the operating entity interest. Therefore, we generally focus on a person's involvement in the founding, organization, or substantial reorganization of the income trust itself.

We also believe that any person who initiated or took part in the formation, organization or substantial reorganization (as those terms are often used in the definition of “promoter”) of the operating entity would not cease to be a promoter under the offering solely due to use of an indirect offering structure. The relationship between the income trust and the operating entity is not sufficiently at arm’s-length to support this result. The question of whether a person takes part in the founding, organizing or substantial reorganizing of the income trust’s business and of the operating entity’s business is one of fact. Therefore, we would expect this determination to be made by the income trust and the underwriter(s) after reviewing the relevant facts.

**4.3.3 What disclosure do we expect about the implications of the operating entity being identified as a promoter?**

Where the operating entity signs the prospectus as promoter but the vendors are retaining no interest, or a nominal interest, in the operating entity upon closing of the offering, the right to claim damages from the operating entity for misrepresentations offers limited or no additional benefit to investors. This is because all or a substantial majority of the interests in the operating entity are acquired by the income trust. Therefore, we expect the prospectus to describe that, despite the operating entity’s statutory liability for a misrepresentation in the prospectus, there will be little or no practical benefit to investors who choose to exercise those rights against the operating entity. This is because a successful judgment would result in a deterioration of the operating entity’s value (frequently the sole asset of the income trust) and a resulting decline in the value of the investor’s securities. It is also likely that the operating entity would have a limited ability to satisfy the claim.

We believe this type of disclosure would be helpful to investors who may not understand the implications of the operating entity being identified as a promoter of the income trust, as is often the case.

Conversely, where the vendors retain a meaningful interest in the operating entity, the characterization of the operating entity as promoter will offer an additional benefit because the value in the operating entity held by vendors as their retained interest would be available to satisfy a damages claim without investors suffering a corresponding decline in the value of their securities of the income trust.

**4.4 Contractual accountability**

**4.4.1 What accountability for prospectus disclosure is typically assumed by vendors through contractual arrangements?**

Our review of indirect offering prospectuses indicates that in situations where vendors have not signed the prospectus, they typically assume, by contract, responsibility for matters relating to the operating entity’s business. Vendors typically provide representations and warranties about the operating entity and its business to the issuer under the agreement (the acquisition agreement) pursuant to which the vendors sell, and the issuer acquires, the operating entity interests. As well, in several indirect offerings, the vendors have provided a representation in the acquisition agreement about the absence of any misrepresentation in the prospectus (a prospectus representation).

**4.4.2 What are our concerns about the application of the regulatory framework to indirect offerings?**

We are concerned that:

- (i) investors in indirect offering structures may not appreciate that there is not always a statutory right of action against the vendors as there would be in a direct offering if the vendors were considered “selling security holders”,
- (ii) prospectus representations may not be given by vendors in circumstances where we would consider that representation to be appropriate, and
- (iii) prospectus disclosure of the vendors’ representations and warranties, and limitations, in the acquisition agreement may not be sufficiently detailed or clearly set out to permit investors to understand the vendors’ contractual accountability.

**4.4.3 What disclosure do we expect about the accountability of the vendors?**

To address the concerns described in section 4.4.2, we expect prospectuses relating to indirect offerings, where part of the proceeds are being paid to vendors, to:

- (i) include a clear statement that investors may not have a direct statutory right of action against each vendor for a misrepresentation in the prospectus unless that vendor is a promoter or director of the issuer, or is otherwise required to sign the prospectus,

- (ii) include a detailed description of the vendors' representations, warranties and indemnities contained in the acquisition agreement (and any significant related limitations) and details about the negotiations (including the parties involved), together with a summary of these items in the summary section of the prospectus, and
- (iii) identify the acquisition agreement as a material contract and provide disclosure advising investors to review the terms of the acquisition agreement for a complete description of the vendors' representations, warranties and indemnities, and related limitations.

We also expect the summary of the relevant acquisition agreement provisions to include clear disclosure about the following:

- (i) the aggregate cash proceeds being paid to the vendors for the sale of their operating entity interests,
- (ii) the nature of the representations and warranties provided by the vendors, including any significant qualifications, and specifically whether a prospectus representation is provided,
- (iii) the period of time that the representations and warranties will survive after closing,
- (iv) any monetary limits on the vendors' indemnity obligations, and
- (v) any other limitations on, or qualifications to, the vendors' indemnity obligations, such as deductibles or other thresholds that preclude indemnity claims against the vendors that are not, individually or in the aggregate, above a certain value or provide that any such claim will exclude or deduct that value or another prescribed amount from the total indemnity claim.

We expect the summary of the acquisition agreement terms to provide investors with a clear description of the extent to which the vendors are supporting, with meaningful indemnities, the representations and warranties in favour of the issuer.

CSA staff may consider recommending against the issuance of a receipt for a prospectus if vendors receive cash proceeds from an indirect offering by selling their operating entity interests and do not take appropriate responsibility (directly or indirectly) for the information provided as a basis for the offering through the acquisition agreement, or as a result of signing the prospectus, or otherwise.

#### **4.4.4 What are our concerns about the nature and extent of the representations and indemnities provided by vendors in the acquisition agreement?**

Circumstances, including the nature of the operating entity and its business and the nature and extent of the vendors' interests (individually and in the aggregate) and their involvement in the operating entity, will affect the types of representations, warranties and indemnities that can reasonably be expected to be provided to the issuer by vendors in the context of an indirect offering.

Examples of circumstances where we have had concerns about vendors not taking this responsibility in the context of indirect offerings have included situations where:

- (i) certain vendors (active vendors), such as:
  - vendors that affect materially the control of the operating entity prior to the offering, and are involved in the offering process and/or the management or supervision of management of the operating entity prior to the offering,
  - vendors that influence (whether alone or in conjunction with others) the offering process, and
  - members of senior management of the operating entitysell a substantial portion of their interest in the operating entity to the issuer on closing but do not
  - a. sign the issuer's prospectus as promoter, or
  - b. provide a prospectus representation in the acquisition agreement;
- (ii) a vendor's obligation to indemnify the issuer if the prospectus representation is untrue, is limited to an unduly small percentage of the proceeds received by the vendor from the sale of the vendor's interest in the operating entity, and

- (iii) the vendor's responsibility for the information on which the offering is based is reduced unduly, having regard to the nature of the vendor's investment, as a result of the period during which claims may be asserted against the vendor for an untrue prospectus representation being significantly below the period in which claims may be asserted against the issuer for a prospectus misrepresentation.

If an active vendor's liability for an untrue representation in the acquisition agreement is conditional on the active vendor having knowledge of the inaccuracy, we expect that the active vendor would generally have a corresponding obligation to take reasonable steps to support the representation. For example, we would expect a non-management active vendor to make appropriate inquiries of management of the operating entity.

The CSA acknowledges that there may be constraints on the indemnities that certain vendors can provide and the survival period of those indemnities. In assessing whether the vendors have taken appropriate responsibility (directly or indirectly) for the information provided as a basis for the offering, we will generally assess the entire framework of representations, warranties and indemnities provided by the vendors as a group, as opposed to assessing each component or vendor individually. We believe this approach is consistent with the commercial realities within which the parties to those transactions allocate the risks and rewards of the transactions.

## **Part 5 - Sales and marketing materials**

### **5.1 What are our concerns about sales and marketing materials?**

Registrants often solicit interest from potential investors during the "waiting period" between the issuance of a receipt for a preliminary prospectus and the issuance of a receipt for the final prospectus, and in the period following the receipt for the final prospectus until the primary distribution is completed. Along with the distribution of the preliminary prospectus (or final prospectus, if then available) to potential investors, that process often involves the preparation and distribution of materials (such as green sheets) for the benefit of registered salespersons and banking group members. The information included in those materials is typically a simplified version of the disclosure in the preliminary (or final) prospectus, and must be limited to information included in, or directly derivable from the prospectus (the exceptions are information about the basic terms of comparable offerings and general market information not specific to the issuer).

Marketing materials used in the context of income trust offerings often include prominent reference to "yield". We are concerned that expressions of "yield" in those marketing materials may not be clearly understood, both because the term itself may have connotations or common usages that are not consistent with the attributes of income trust units and because the relationship between the "yield" described in the marketing materials and the information in the prospectus may not be clear.

"Yield" is generally used in the context of income trust offerings to refer to the return (other than a return of capital) that would be generated over a one-year period, as a percentage of the offering price of the units, if the amounts intended to be distributed by the income trust according to its distribution policy are so distributed.

### **5.2 What information do we expect the green sheets to contain?**

We are concerned that use of the term yield in these marketing materials may imply that the distribution entitlement is fixed. We expect expressions of "yield" to be accompanied by disclosure that, unlike fixed-income securities, there is no obligation of the income trust to distribute to unitholders any fixed amount, and reductions in, or suspensions of, cash distributions may occur that would reduce yield based on the offering price.

A related concern is that disclosure of a yield in marketing materials may cause confusion because yield is not typically disclosed in the prospectus. If marketing materials contain an expression of yield, we expect the statement to be tied to the prospectus disclosure (including, in particular, the pro forma presentation of distributable cash in the prospectus). Specifically, we expect expressions of yield in income trust offering marketing materials to be accompanied by disclosure indicating the proportion of the pro forma distributable cash (as set out in the prospectus) that the stated yield would represent.

In addition, if reference is made to tax efficiencies that may be realized on distributions (such as returns of capital to investors), we expect that disclosure to be clear and, to the extent practical, quantified. For example, the estimated "tax-free" portion of distributions for the foreseeable period, and the tax implications, should be clearly stated or cross-referenced.

### **5.3 Do we expect income trusts to provide us with copies of their green sheets?**

Yes. We expect income trust issuers to provide copies of all green sheets to the securities regulatory authorities when filing the preliminary prospectus, together with separate documentation providing a clear and concise explanation of how the yield figure (if contained in the green sheet) is derived from the prospectus disclosure. In addition, we may request that additional sales and marketing materials used in connection with an income trust offering be provided.