

## Income Funds

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### CSA INVITES REACTION TO CANADA'S FIRST INCOME TRUST POLICY

On October 24, 2003, the Canadian Securities Administrators (CSA) published for comment National Policy 41-201 – *Income Trusts and Other Indirect Offerings*. The Policy, which is the first regulatory instrument that focuses directly on the income trust structure, provides guidance and clarification to market participants by expressing the regulators' views on how the existing securities regulatory framework should apply to income trusts and other indirect offerings. Comments on the Policy are due by December 23, 2003.

The Policy addresses a number of issues of central and fundamental importance to the income trust market, such as prospectus disclosure, continuous disclosure, liability, and sales and marketing materials, and its potential impact is significant.

Moreover, the Policy deals not only with income trusts but with any form of "indirect offering", and its provisions could have application to offerings undertaken by more conventional non-trust issuers where the proceeds are used to fund a business acquisition from a vendor not at arm's length from, or "involved" with, the public issuer.

The Goodmans Income Funds Group has produced a webcast presentation outlining the key elements of the Policy and what it means for the income trust sector and the capital markets generally. The webcast can be accessed from the Goodmans' website at [www.goodmans.ca](http://www.goodmans.ca).

### SIGNIFICANT ELEMENTS OF THE POLICY

#### Vendor Liability

The provisions of the draft Policy that may have the greatest impact are those concerning vendor liability. The essence of the CSA's concern is that in an indirect offering structure, such as an income trust, persons involved in and benefiting from the public offering process may not be assuming appropriate responsibility for the disclosure in the prospectus. In other words, the vendors who are initiating and/or facilitating a public offering (to finance the acquisition of their business) are not assuming the liability to which they would be subject if their interests were being sold directly under the prospectus. This concern is addressed by the Policy in two ways.

First, under the Policy a vendor selling in an operating business to an income trust in exchange (directly or indirectly) for a "significant" portion of the proceeds raised by the income trust under a public offering will be considered to be a "promoter" of the offering for the purposes of applicable securities laws. This is meaningful because promoters of an offering are required to sign the prospectus and assume statutory liability for prospectus misrepresentations. The potential liability is broad: joint and several liability for up to 100% of the gross offering proceeds. Under Canadian securities laws it is not necessary (as it is at common law) for an aggrieved investor to prove that it relied on the misrepresentation to succeed in an action for damages. Application of statutory liability would represent a significant change in approach in the income trust market; in recent income trust transactions vendors have typically assumed a negotiated contractual level of responsibility

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for prospectus misrepresentations (which is commonly subject to restrictions and limitations not applicable under the statutory liability framework), but have not signed the prospectus primarily on the bases that:

- vendors do not, by virtue of receipt of proceeds alone, fall within the commonly understood and applied definition of promoter, which by its terms requires (and which has been widely interpreted as requiring) involvement in the offering that extends beyond receipt of proceeds; and
- the assumed contractual responsibility (negotiated on behalf of the public predominantly by the underwriters, whose interests in ensuring that proper responsibility for the prospectus is assumed are aligned with those of the public investors) offered sufficient protection to the investing public.

Second, the Policy provides that vendors that do not sign the prospectus as promoters (presumably because their interests are not “significant”, though the Policy is not clear on this point) but are considered to be “active vendors” because they are involved in the offering process, are expected to assume (as part of the contract pursuant to which the operating business is sold to the income trust) “appropriate responsibility” for the prospectus disclosure. In determining what constitutes appropriate responsibility, the Policy reflects the regulators’ perception that vendors’ contractual responsibility will be inappropriately limited if, for example, it is an unduly small percentage of the proceeds received by the vendor, it has a short survival period relative to the three year statutory limitation period, and/or it is subject to other significant restrictions and limitations (such as material deductibles, thresholds or qualifications). “Active vendors” include control persons of the operating business, persons exercising influence over the offering process, and members of the operating business’ management.

The Policy also addresses disclosure issues related to the issue of vendor liability, emphasizing the need for issuers to provide clear disclosure on the nature and extent of vendors’ liability. Of note in this regard, the Policy specifically states that where (as is often the case in income trust prospectuses) the operating entity itself signs the prospectus as promoter and the vendors are not retaining a significant inter-

est, the prospectus must clearly disclose that the operating company’s signing offers little or no protection to investors because investors exercising their statutory rights, would effectively be making claims against themselves. Notably, an operating entity signing a prospectus as promoter is not a substitute under the Policy for the vendors signing the prospectus themselves as promoters or otherwise taking “appropriate responsibility” for the prospectus disclosure.

The broad principles articulated in the Policy could have application in a wide range of contexts; for example, the provision in the Policy stating that a vendor which directly or indirectly receives a significant portion of the proceeds of an offering should sign the prospectus as a vendor, viewing in isolation (and arguably out of context) might support imposition of liability on the owners of a corporate shareholder effecting a conventional secondary offering. Conversely, if the principles expressed in the Policy are not extended to more conventional offering structures, the effect of the Policy may be to create an imbalancing disincentive for certain offering structures.

The implications of the vendor liability provisions of the Policy are clearly significant, and it can be anticipated that much of the marketplace comment will focus on these provisions.

## Stability Ratings

Another notable change to current practice that would result from the Policy concerns stability ratings (ratings of cash flow stability published by independent agencies). The provisions concerning stability ratings are informed by the regulators’ stated view that stability ratings have increased importance in the income trust market, because income trust securities are priced and valued based on cash flow, and issuers often calculate and present distributable cash differently, which makes comparisons of income trusts impractical.

While the Policy does not require that income trusts obtain stability ratings, it recommends that if an income trust chooses not to obtain a stability rating it must disclose its reasons for not doing so on the prospectus cover page. (This would apply, like the vendor liability provisions, not just to an income trust’s initial public offering but to all subsequent offerings.) This requirement may provide an incentive for income trust issuers to obtain a rating, even in

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circumstances where the benefits of a rating may not be compelling (because they focus on only one measure of investment merit, stability, and not on others such as organic growth prospects or accretive acquisition opportunities) and/or the costs (resources and time) are not considered justifiable.

## Prospectus Disclosure

Much of the guidance contained in the Policy stems from the CSA's concerns that the application of existing disclosure requirements to indirect offering vehicles is unclear and that certain fundamental and unique attributes of income trust securities may not be well understood in the market. In many respects, the provisions of the Policy relating to income trust disclosure requirements mirror requirements that have evolved through prospectus comment processes in recent income trust transactions. Specifically, it is the regulators' view that because investors are effectively buying interests in the operating business, normal disclosure requirements (such as timely disclosure, continuous disclosure and insider reporting) that would apply to the income trust also should apply to the operating business. Nevertheless, the Policy does focus on certain specific disclosure issues, including:

*Executive Compensation:* Information concerning executive compensation at the operating company level for the period prior to the income trust's initial public offering is required to be included in the income trust's prospectus (the regulators regard this information as universally relevant, although there are circumstances where the reorganizations of businesses that often form part of income trust transactions fundamentally re-orient compensation schemes and frameworks, casting some doubt on the material relevance of historical compensation). In addition, the material terms of management contracts and management incentive plans that may have an impact on distributable cash are required to be disclosed and the documents publicly filed.

*Distributable Cash:* Given the significance of cash flow to income trust offerings, specific disclosure about the calculation of distributable cash is required, including cover page disclosure concerning: the significance of distributable cash, risk factors that could have an impact on distributable cash, and how an investors' after-tax return from an investment in units of the income trust is determined.

*Non-GAAP Financial Information:* Because distributable cash is often presented in a manner, and based on financial measures, that are not prescribed by GAAP, the Policy reminds issuers of the guidelines contained in CSA Staff Notice 52-303 – *Non-GAAP Earnings Measures* (these guidelines generally require that non-GAAP measures be identified as such, and that presentations of non-GAAP information be accompanied by suitable cautionary disclosure and prominent disclosure of equivalent GAAP measures).

*Short-Term Debt:* The Policy reflects the CSA's belief that the amount of income trusts' short-term debt (i.e., debt that is renewable within a period of five years or less) is of particular relevance to investors because the income trust units' value is tied to cash distributions that could be significantly affected by breaches of, or changes in, that debt or if that debt is not renewed or is renewed on less favourable terms. The Policy recommends that an income trust prospectus provide detailed disclosure (including risk factor disclosure) concerning the short-term debt and requires that short-term credit agreements be publicly filed.

## Marketing Materials

The regulators' concerns with respect to the use of "green sheets" and other marketing materials in connection with income trust offerings appear to arise from the fact that those materials almost invariably include references to "yield". The CSA are concerned about the use of the term "yield" itself, as the term has connotations associated with fixed income securities; consequently, the Policy requires disclosure explaining that entitlements to distributions are not fixed and may vary. More substantively, in the regulators' view expressions of yield in marketing materials must be tied to the disclosure in the prospectus. As such, green sheets containing references to yield will have to be accompanied by disclosure indicating the proportion of the *pro forma* distributable cash that the stated yield would represent (i.e. a payout ratio, based on the *pro forma* distributable cash that would have been generated by the issuer in its most recently completed period giving effect to the income fund transaction), and issuers will be required to provide the regulators with documentation setting forth a mathematical reconciliation of expressed yield with the prospectus disclosure.

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## Other Key Elements

Consistent with the regulators' perspective that income trusts are new structures imposed on *existing* businesses with relevant operating histories, and that investors effectively are purchasing interests in the operating business, the Policy provides that related party transactions involving the operating entity will be treated as if they were related party transactions for the income trust (meaning that requirements for formal valuations and special securityholder approval may apply), and income trusts' continuous financial disclosure is expected to provide comparative financial information for the period preceding the offering.

## CONCLUSION

The Policy could result in some significant changes to the vibrant income trust market, affecting the disclosure provided to investors, the manner in which offerings are marketed to investors, and the liability that vendors selling into the market would have to accept. The breadth of the principles articulated in the Policy could materially affect other corporate finance structures.

In the interim, notwithstanding that the Policy has not been finalized and is subject to comment, it is a policy that reflects the regulators' perspective on how the existing regulatory framework applies to indirect offerings, such that the principles embodied in the Policy may well be applied even prior to formal adoption.

Goodmans will closely monitor the comment process, and the market's reaction to the Policy, and provide further insights as this development unfolds. We would be very pleased to discuss the Policy in detail, to assist in submission of comments on the Policy, or more generally to address any questions concerning the income trust sector, and invite you to contact any member of the Goodmans' Income Funds team.

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