

MSC NOTICE 2003-47

REQUEST FOR COMMENT:

NOTICE OF PROPOSED NATIONAL POLICY 41-201

INCOME TRUSTS AND OTHER INDIRECT OFFERINGS

Dated: October 24, 2003

This notice accompanies proposed National Policy 41-201 (the Policy), which we are publishing for a 60-day comment period. We invite comment on the Policy generally. In addition, we have raised a number of questions for your specific consideration.

Introduction

The Policy is an initiative of all members of the Canadian Securities Administrators (the CSA or we). The Policy is expected to be implemented as a policy in all jurisdictions in Canada.

The purpose of the Policy is to provide guidance and clarification to market participants about income trusts and other indirect offering structures. We want to ensure that everyone investing in income trust offerings has access to sufficient information to make an informed investment decision.

We also 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 better ensure that the intent of the regulatory requirements is preserved.

Background

Over the past eighteen months, we have seen a significant increase in the number of income trust offerings in our market. We have also seen a number of corporate issuers convert into income trusts. By publishing the Policy, we are setting out our views about issues relating to income trusts and other indirect offerings.

Summary and Discussion of the Policy

The Policy has 5 parts.

Part 1 - Introduction

Part 1 establishes the purpose and the scope of the Policy. When we refer to an income trust in the 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, but does not include an entity that falls within the definition of “investment fund” contained in proposed National Instrument 81-106 *Investment Fund Continuous Disclosure*.

Part 1 also discusses income trusts generally, as well as the principal differences between direct and indirect offerings.

Specific Requests for Comment

- Do you agree that the scope of the Policy is appropriate?
- Do you think that the discussion about indirect offerings is clear? Do you agree with the distinctions that we make between direct and indirect offerings?
- As currently drafted, the Policy is targeted to all market participants, including issuers, their advisors, and investors. Do you think that the format of the Policy is easy for market participants to follow? Do you think that the Policy would be easier to follow if it were divided into a number of different parts? For example, do you think that separating the descriptive part from the core guidance would be helpful?

Part 2 - Prospectus Disclosure: Unique Attributes of Income Trusts

Part 2 provides guidance on prospectus disclosure. The main purpose of the guidance is to ensure that the unique attributes of income trusts are described in a simple and clear manner. Our goal is to ensure that investors have access to sufficient information to make an informed investment decision.

Specific request for comment

- We are considering whether to give direction regarding the risk factors that issuers describe in relation to the operating entity. Do you agree that this guidance would be appropriate?

Part 2 is divided into 6 parts:

A. Distributable Cash

We understand that income trust offerings are principally sold on the basis of distributable cash. We provide guidance in this section about prospectus disclosure relating to distributable cash. The purpose of the recommended disclosure is to clarify: (i) what distributable cash means, (ii)

whether an income trust's distributable cash provides an investor with a consistent rate of return, and (iii) how the distribution policies of the income trust and the operating entity affect distributable cash.

Specific Request for Comment

- We recommend that issuers include in their cover page disclosure a breakdown of the anticipated distributable cash figure that sets out its estimated "return on" versus "return of" capital. We believe this breakdown would provide investors with important information regarding their investment. Do you agree with this recommendation?

B. Distributable Cash: Non-GAAP Measures

To ensure that investors understand that distributable cash is not a measure based on generally accepted accounting principles (GAAP), we remind issuers to refer to the guidelines contained in CSA Staff Notice 52-303 – *Non-GAAP Earnings Measures*.

We note that section 2.5 of the Policy describes the disclosure that has frequently been included in income trust prospectuses in the past. In particular, many issuers have derived the distributable cash figure from non-GAAP earnings measures such as "EBITDA" and "adjusted EBITDA". We also note that CSA Staff Notice 52-303 *Non-GAAP Earnings Measures* will soon be superseded by CSA Staff Notice 52-306 *Non-GAAP Financial Measures*. CSA Staff Notice 52-306 specifically recommends that any reconciliation of the distributable cash amount should begin with the closest GAAP measure rather than a non-GAAP measure. We believe that this approach complements the objective of section 2.5 of the Policy, which is to ensure that a clear explanation of any assumptions made in estimating distributable cash is provided.

C. Short-Term Debt

We are concerned about debt that is renewable within a period of 5 years or less, that the operating entity has negotiated with persons other than the income trust. We refer to that debt as short-term debt (which differs from the characterization of short-term debt from an accounting perspective).

We are specifically concerned about short-term debt because of that debt's potential impact on distributable cash. Short-term debt typically represents an obligation of the operating entity that ranks before the operating entity's obligations to the income trust (and, consequently, to unitholders' entitlement to receive distributable cash). An income trust may reduce or suspend distributions under circumstances directly linked to the short-term debt. For example, a reduction in distributions may occur following increases in interest charges on floating-rate debt, a breach of financial covenants, a refinancing on less advantageous terms, or a failure to refinance.

We recommend that issuers disclose the principal terms of the operating entity's short-term debt in their prospectus. We also explain that we consider the operating entity's credit agreement with a lender other than the income trust to be a material contract if terms of that agreement have a direct correlation with the anticipated cash distributions.

We expect the income trust to include a separate risk factor about the operating entity's short-term debt in its prospectus, and to file the agreement as a material contract on SEDAR upon its execution.

D. Stability Ratings

In this section, we describe stability ratings and discuss why we believe that they offer useful information to investors. We are concerned about use of measures in the prospectus that are not based on GAAP because use of those measures can make it difficult or impossible for investors to compare income trusts.

Specific Requests for Comment

- Do stability ratings play a valuable role in an investor's decision?
- We are concerned that investors may have difficulty comparing income trusts. Do stability ratings offer an appropriate and effective means of comparison? Is there a more appropriate or effective method?

E. Determination of Unit Offering Price

We describe the disclosure that we expect in the prospectus about how the price of an income trust's units is determined. We understand that in most cases, the price is determined by negotiation between the operating entity security holders and the issuer's underwriter(s). If, however, a third-party valuation is obtained by the issuer, we expect the issuer to describe the valuation in the prospectus and to file the text of the valuation on SEDAR.

F. Executive Compensation

We believe that the executive compensation of the operating entity's executives is important information for investors. We understand that in many cases, disclosure about the compensation paid to the operating entity's executives is not included in the prospectus because the operating entity does not become a subsidiary of the income trust until after the receipt for the final prospectus is issued. In other cases, that disclosure is not included because the income trust does not control the operating entity. Because we believe that information about the executive compensation relating to the operating entity's executives in both scenarios is important, we expect it to be disclosed in the prospectus.

We describe the disclosure and documents that we consider to be material, and that we expect to be described and filed.

Part 3 - Continuous Disclosure

Continuous Disclosure about the Operating Entity

We believe that an income trust's performance and future prospects depend primarily on the performance and operations of the underlying operating entity. We want to ensure that unitholders are provided with comprehensive information about the operating entity on an ongoing basis. We describe the undertakings that we believe will satisfy this concern. We also recommend that disclosure about these undertakings be included in the prospectus.

As one alternative to undertakings, we considered recommending that the operating entity become a reporting issuer (through the deeming process or otherwise). We determined that the costs of that approach outweighed the benefits, and that not all of our concerns would be addressed with that approach.

Specific Request for Comment

- We are considering asking that issuers who disclosed expected distributable cash to provide, on an annual basis, an updated comparison of distributed and distributable cash to the expected distributable cash figure. We are also considering recommending that issuers include in this annual update a breakdown of distributed and distributable cash between the "return on" versus "return of" capital to allow investors to analyze the tax attributes of their return.

What do you think of these recommendations?

Comparative Financial Information

We offer guidance about the comparative financial information that we expect income trusts to provide in situations where the transfer of the operating entity's business into the income trust is accounted for at carrying amounts.

Recognition of Intangible Assets

In this section, we remind issuers that GAAP requires the appropriate recognition of all intangible assets on an acquisition accounted for under the purchase method. We further encourage issuers 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.

Insider Reporting

We describe the undertaking that we expect an income trust issuer to file with the relevant securities regulatory authorities with respect to insider reporting obligations.

We also outline our concerns about others that may possess material undisclosed information about the income trust. Specifically, we are concerned that these persons may: (i) not fall within the definition of "insider", or (ii) not be contemplated by the undertaking. We indicate that in these types of situations, we may request that additional undertakings be provided. For example,

when an income trust does not control the operating entity (such as when the income trust owns less than 50% of the operating entity's voting securities), we would request that "insiders" of the operating entity report all trades in units of the income trust as if they were insiders of the income trust.

With respect to the filing of Form 55-102F6 "Insider Report", particularly the description of the insider's relationship(s) to the reporting issuer in Box 2 "Insider Data", we expect issuers and insiders to use their best judgment to choose the code that best corresponds to their relationship(s) with the reporting issuer. We note that it is possible to include additional comments in the "General Remarks" section in order to clarify the nature of the relationship(s) with the reporting issuer.

Part 4 - Liability

We describe the regulatory framework relating to prospectus liability, and how that framework applies to indirect offerings. We discuss the disclosure about the accountability of vendors in indirect offerings that we believe would be helpful to investors, as well as our concerns about the nature and extent of the representations and indemnities provided by vendors to the income trust in the acquisition agreement. We do not specifically discuss potential unitholder liability for activities of the income trust because a number of CSA jurisdictions are in the process of drafting or adopting legislation to address this particular concern.

Finally, we discuss the concept of "promoter" and its application to indirect offerings, and the disclosure that we expect about the implications of the operating entity being identified as a promoter.

Part 5 - Sales and Marketing Materials

We outline our concerns about sales and marketing materials, particularly relating to use of the term "yield". We expect income trust issuers to provide copies of all green sheets to securities regulators when filing the preliminary prospectus. We describe certain information that we expect green sheets to contain.

Reliance on Unpublished Studies, Etc.

In developing the Policy, we did not rely on any significant unpublished study, report, decision or other written materials.

Comments

Please provide your comments by December 23, 2003 by addressing your submission to the securities regulatory authorities listed below. **Due to timing concerns, we will not consider comments received after December 23, 2003.**

Submissions should be addressed to the following securities regulatory authorities:

Ontario Securities Commission
Alberta Securities Commission
British Columbia Securities Commission
Commission des valeurs mobilières du Québec
Saskatchewan Financial Services Commission
The Manitoba Securities Commission

You do not need to deliver your comments to all of the CSA member commissions. Please deliver your comments to the following, and they will be distributed to all other jurisdictions by CSA staff.

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If you are not sending your comments by e-mail, please send a diskette containing your comments (in DOS or Windows format, preferably Word).

We cannot keep submissions confidential because securities legislation in certain provinces requires that a summary of the written comments received during the comment period be published.

Please refer your questions to any of:

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