TORYS

2013 CAPITAL MARKETS MID-YEAR REPORT

Torys examines the trends and forces charting the path forward in capital markets

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CAPITAL MARKETS MID-YEAR REPORT

Two themes emerge in this year's mid-year report: Canadian investors' appetite for yield products and complexities associated with non-domestic issuers.

We have commented on Canadian investors' appetite for yield products in past mid-year capital markets reports. This year it's the same, only more so. Through April 30 this year, $10.76 billion in equity capital has been raised on the TSX (down from $17.25 billion in the comparable period in 2012); $2.0 billion of the 2013 funds were raised in the real estate (REIT) sector, by far the largest of the eight sectors the TSX ranks, excepting financial institutions. The four new international listings on the TSX in 2013 are cross-border REITs. High-yield bonds are an increasingly prominent part of the Canadian capital markets.

Our report includes a review of the 20-year history of the Canadian REIT industry – the quintessential yield product – which began with RealFund in 1993. We also assess the greater role the bond market is playing in Canadian infrastructure funding, and provide a review of the growing Canadian high-yield debt market, including how it differs from the U.S. market.

Advisers continue to develop structures to effectively deliver yield products to meet demand. Issues arise in the design of efficient cross-border distribution of cash flows to investors. We outline innovative approaches that have led to growth in cross-border income fund IPOs in Canada. Many recent CBIFs have been in the real estate sector, marrying the Canadian yield appetite to the increasing strength of the U.S. real estate market. We also note another development relating to non-domestic issuers: the marked decline of Chinese companies listed in the United States.

Our report also addresses issues around two of the pillars of the Canadian equity markets: recent oil and gas capital activity and an analysis of why no Canadian bank has issued non-common share equity in 2013.

We look forward to the rest of the year. Several IPOs are in the pipeline, so it will be interesting to see if they make it to market and whether we see any resurgence outside of real estate.

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CANADIAN HIGH-YIELD DEBT MARKET

Canadian market continues to be active

By Kevin A. Fougere, Janan Paskaran and Amanda Balasubramanian

The Canadian high-yield debt market has continued to see increasing activity over the past year, with six publicly announced deals to date in 2013, as equity markets in Canada remain weak and investors continually look for yield-related investment products. These recent offerings cover a wide range of sectors, including healthcare, grain processing and media, with a notable increase in the number of oil and gas-related offerings.

High-yield bond issuances have always signified a greater degree of risk in respect of an issuer's ability to repay the debt, given their nature as non-investment-grade securities with ratings typically lower than BBB (Moody's). However, recent issuances by oil and gas-related issuers would appear to evidence a greater market of issuers with a higher risk profile that may be able to tap this market. With equity markets being relatively soft, oil and gas producers have had difficulty attracting sufficient capital to fund their capital expenditure programs. To make matters more challenging, the traditional Canadian first lien secured debt market has remained conservative in its approach to the amount of first lien leverage it will allow borrowers to incur, because Canadian oil and gas lending banks have remained disciplined and not overly aggressive with their oil and natural gas price decks and risk models. Issuers without sustained oil and gas production have also historically been challenged to raise capital in the Canadian high-yield market; yet several recent issuances would suggest that near-term production may be sufficient to satisfy investors' risk profiles. Recent offerings evidence a growing demand for issuances by oil and gas-related issuers – for example, offerings by oilsands companies Southern Pacific Resource Corp. ($260 million at 8.75%) and Athabasca Oil Corp. ($550 million at 7.50%), environmental waste company Tervita Corporation ($200 million at 9%) and oil and gas issuers Trilogy Energy Corp. ($300 million at 7.25%) and Paramount Resources Ltd. ($300 million at 7.65%).

Range of Deals

$75 million
to
$600 million

Without the pricing penalties seen in the United States, Canada offers a more flexible market for issuers looking for high-yield debt in smaller amounts.

The soft equity markets have also made financing M&A transactions more difficult for acquirors. However, the growth of the high-yield market in Canada has allowed issuers to finance acquisitions through the use of such debt. An example of this is the recent offering by Canadian Energy Services & Technology Corp. of $225 million seven-year senior unsecured bonds, which was primarily used to repay a bridge facility that was part of a US$240 million acquisition of a private specialty chemicals company.

One of the advantages of the Canadian market is that an issuer can size a deal as small as $75 million and as large as $600 million; in the United States, a pricing penalty is typically levered on any deals smaller than $250 million. Accordingly, for issuers looking for a relatively smaller amount of high-yield debt, the Canadian market may be more appropriate. The smaller deal size naturally leads to a smaller group of investors, making it more likely for a Canadian issuer to be able to negotiate covenants that may be less traditional and more tailored to their individual needs, as has been evidenced in recent deals. For example, in Athabasca's recent Canadian dollar offering, the asset sale covenant and several critical financial definitions were expanded beyond the typical formulation and customized to Athabasca's needs.

Covenants in Canadian high-yield deals have historically followed the U.S. model, though Canadian covenants have tended to be tighter and provide greater protection to investors as a result. However, recent issuances have demonstrated more flexibility and pragmatism in Canadian covenants than in the past and, as noted above, are able to tailor certain covenants. For example, typical high-yield covenants would limit the ability of an issuer to distribute cash to its shareholders; however, the covenants being utilized in certain issuances have recently included the flexibility to permit dividend-paying companies to continue to pay dividends (with some flexibility to continue to increase the amount of such dividends) so that equity participants will continue to support the shares of such issuers. This was evidenced by the recent issuance by Canadian Energy Services & Technology Corp. Moody's has also recently noted a general deterioration (from an investor's perspective) in the covenant protections in Canadian high-yield issuances, which, from an issuer's perspective, means greater flexibility.

In the context of recent high-yield bond issuances by Canadian issuers, both in the Canadian and the U.S. investor markets, Canadian banks that hold first lien secured debt of such issuers are willing to allow their borrowers with oil and gas reserve-based borrowing base loans to incur this additional high-yield debt (whether or not it is secured); however, the cost of that is typically a "grind" on the maximum borrowing base value that the senior lenders will attribute to the borrower's producing assets. The magnitude of the grind varies, but 25% of the borrowing base is typical in the Canadian market, though that can vary depending on the size of the offering and the interest rate (and amortization schedule, if any) of the high-yield bonds. The alternative, though not as common, would be to set aside a portion of the proceeds of the high-yield issuance into a debt service reserve account to cover interest on the bonds over a period of time, typically two years. Either way, Canadian banks are recognizing that the traditional first lien debt market is insufficient to satisfy the debt load requirements of many of their Canadian clients in capital-intensive industries. And the Canadian banks are broadening and developing their own capabilities in bringing these products to their clients.

Canadian banks are recognizing the insufficiency of the traditional first lien debt market to satisfy the debt load needs of Canadian clients in capital-intensive industries.

The Canadian market has also seen issuances with certain features that have been utilized in the United States and elsewhere, such as second lien secured debt and PIK (pay-in-kind) debt to address the demands of the market.

Some recent Canadian secured second lien high-yield issuances have also differed from typical U.S. secured second lien deals in two important aspects. First, while second lien secured bondholders typically have an indefinite standstill on enforcing their security (until the first lien holders are paid in full), they are in the meantime usually afforded all the rights of unsecured creditors because the standstill does not apply to the exercise of those rights. However, in a few recent Canadian high-yield transactions, that structure was altered so that the standstill would apply to all the rights of secured lien holders (secured or unsecured), but the standstill period was not indefinite and had a relatively short life (with a range from 60 to 120 days). Second, and this concept applies to unsecured high-yield bonds as well, the traditional first lien permitted debt basket is the greater of a fixed number at closing and a percentage of either a company's consolidated net tangible assets or a company's EBITDA (or some derivation of either). However, in some recent high-yield bond issuances of Canadian oil and gas producers, a third element has been added to the permitted debt basket – the borrowing base. In this context, the borrowing base is essentially the highest amount that the first lien revolving lenders are willing to lend at any particular time in the future. This gives first lien debt flexibility to the issuer, but conversely the bondholders have less certainty about how much first lien debt will rank ahead of their bonds. Canadian investors in high-yield bonds appear to have become comfortable with this concept on the basis that, as noted above, Canadian banks are relatively disciplined and conservative in determining the maximum commitment amount available to their borrowers through the relative "black box" borrowing base concept.

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REAL ESTATE INVESTMENT TRUSTS

Two decades of REIT innovation

By Patricia Koval and Simon Knowling

In June 2013, the Canadian real estate investment trust (REIT) industry will mark its 20th anniversary. The first Canadian REIT was created in 1993 – a phoenix rising from the ashes of the then-embattled Canadian real estate mutual fund industry. Throughout the year before that, retail, office and industrial real estate across Canada had experienced plummeting valuations and prices, and Canadian real estate mutual funds faced a redemption crisis. Investors in those funds were entitled to redeem their units for the net asset value per unit, which was primarily determined by often year-old real estate valuations. These investors, motivated by the ability to preserve their savings by redeeming units at prices based on significantly higher valuations than ascribed to the "break-up" value of the underlying real estate, forced Canadian real estate mutual funds to suspend their redemptions – in many cases, into near insolvency.

This gave the Canadian real estate mutual fund industry, as well as the capital markets players who drove it, an unparalleled opportunity to search for and create a better model for collective ownership of real estate assets for Canadian investors. In June 1993, after a lengthy period of study, as well as protracted discussions with Canadian securities regulators, provincial land transfer tax regulators, the Canada Revenue Agency, the Toronto Stock Exchange and existing investors, RealFund (formerly a real estate mutual fund) was reborn as a closed-end trust and subsequently listed on the Toronto Stock Exchange. It was quickly followed by two other mutual fund "converts" – Canadian Real Estate Investment Trust (CREIT), which listed in September 1993, and RioCan Real Estate Investment Trust (RioCan), which listed in November 1993; both adopted the innovative RealFund structure. While RealFund was absorbed into RioCan several years later, both CREIT and RioCan are thriving today. Torys LLP is proud to have played a critical role in the creation of the Canadian REIT structure and the birth of the REIT industry; we were the legal architects of the RealFund structure and continue to this day our involvement with CREIT and RioCan, as well as with many other REITs.

By 1994, it became evident to the Canadian real estate industry and the Canadian capital markets that the new REIT structure was popular with retail investors, including RRSP and other registered plan investors. At first instance, REITs could, and did, offer attractive yields (i.e., annualized distributions divided by unit price), with stable distributions paid regularly, usually monthly. As well, it was clear that REITs offered the potential for growth in value. The exchange-trading mechanism, compared to the former redeem-for-cash disposition method, quickly demonstrated that it could provide both the liquidity and the depth that capital markets required. For retail investors, the yields – and especially the after-tax yields generated by the REIT's "flow-through" tax character – when compared with yields offered by alternative available yield instruments, made REITs extremely popular. Institutional investors, too, soon became comfortable with REITs, particularly after the initially perceived risk regarding unitholder liability dissipated.

Torys LLP is proud to have played a critical role in the creation of the Canadian REIT structure and the birth of the REIT industry.

Owners of Canadian real estate assets, too, saw the benefits of the monetization of their assets at prices based on the income-producing yield potential. The result was that the Canadian REIT industry grew quickly, with more and more new REITs coming to market, particularly during times of low interest rates. Canadian investors have demonstrated with REITs, as they did with royalty trusts and income trusts, that they have a virtually insatiable demand for yield. For as long as interest rates remain at near historically low levels, we expect that initial public offerings of new REITs will continue. At the same time, there has been a regular flow of additional equity, conventional debt or convertible debt offerings by established REITs, providing yet more opportunities for investors. Most REITs holding retail, office, industrial or residential real estate were not seriously affected by the Canadian government's SIFT tax imposition in 2006; recent amendments have ameliorated issues that arose in connection with the SIFT rules and the so-called REIT exception, thus further cementing the viability of REITs as attractive investment vehicles. With the rapid growth of the REIT industry, there are now a number of Canadian REITs, including the new Choice Properties REIT, with assets valued at over $7 billion, and these REITs rank among the largest publicly traded vehicles in Canada.

From 1993 to date, the original REIT structure has remained much the same – although through time, concerted focus on tax planning has led to innovations that have broadened the asset classes underlying REITs. Commencing in the early years of the last decade, cross-border legal planning, particularly Canadian and U.S. tax planning, has resulted in a number of viable structures that, in the applicable circumstances, have allowed Canadian REITs to invest tax-effectively in real estate located in the United States, Europe or elsewhere. Innovation in this regard continues, since there appears to be significant Canadian investor demand for these vehicles, including Canadian REITs that invest in assets located exclusively outside Canada (in August 2011 Dundee International REIT was the first REIT formed to invest in assets located exclusively outside Canada). At the same time, in 2013, global investors are themselves investing in Canadian REITs, corresponding to their interest in Canadian real estate assets in general. We expect this trend, too, to continue, although for Canadian tax reasons, most Canadian REITs cannot accommodate having a majority of their investors outside Canada. This factor has limited Canadian REITs in exploring multijurisdictional listings. More recently, a new generation of REITs has qualified as REITs for both Canadian and U.S. income tax purposes. We expect this structural innovation to allow for many more REITs to be formed that own exclusively U.S. assets and that enable vendors of those assets to retain a substantial ownership interest in the REITs.

While much has remained the same, some important changes in the REIT industry have taken place as it has matured. The earliest REITs were externally managed vehicles, with managers earning a variety of fees, including annual asset management fees, acquisition and disposition fees, mortgage fees, financing fees, development fees, and property management fees. Over time, "internalization" of management became popular, as REITs and their investors sought to optimize the costs of management and related expenses. Today, there are REITs whose managements range from the traditional externally managed model to a partially internalized model with an independent CEO and CFO supported by the promoter's organization, to REITs with only internal management. As investors – particularly institutional investors – increasingly focus on costs and governance, we expect that the trend to internalization will continue. Indeed, most new REITs with external management structures incorporate a forward-looking concept of internalization in their management agreements.

Another important change has come in the nature of investments and activities that REITs are permitted to make and undertake. The earliest REITs contained tightly prescribed investment restrictions and operating policies (some remaining from the securities law rules governing real estate mutual funds, as well as some emanating from prudent management concerns). Among the strictest restrictions or guidelines were those that limited construction and development of properties owned by a REIT or new properties to be acquired by it. Today, as REITs and the market's understanding of them have matured in concert, these investment guidelines and operating policies have been substantially relaxed;

REITs – Major Milestones

1992
Retail, office and industrial real estate experienced plummeting valuations.

1993
First Canadian REIT, followed quickly by two other funds (still thriving today).

2006
SIFT tax imposition had only a limited impact to REITs (compared with other income trusts/funds).

2011
Increase in internationalization of REITs, with the emergence of the first REIT to invest solely in assets outside Canada.

2013
20th anniversary of REITs, with assets valued at over $7 billion, continued popularity and increasing interest in Canadian REITs from global investors.

many REITs are now engaged in both construction and development to the extent permitted by applicable tax rules. Moreover, REITs often now collaborate in responsible development with other organizations. Intensification opportunities, especially in urban Canada, are now a particular focus of many Canadian REITs. We expect that this too will continue through 2013 and 2014.

Overall, after the first 20 years, it can be said that Canadian REITs have been an overwhelming success story in the Canadian capital markets. We expect this success to continue in the foreseeable future.

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BASEL III

Why has no bank issued any subordinated debt or preferred shares in 2013?

By Blair Keefe

As of October 31, 2012, the six largest banks in Canada had approximately $68 billion[1] of non-common capital instruments outstanding and routinely issued over $8 billion per year to help fund the growth in the banks' balance sheets and to fund ongoing redemption of subordinated debt and preferred shares. However, to date in 2013, there has not been one single offering of subordinated debt or preferred shares by a Canadian bank. This article discusses the reasons for the dramatic change.

Background

Almost two and a half years ago, the Basel Committee released new requirements that all non-common capital instruments issued on or after January 1, 2013 must contain provisions that require the instruments to be converted into common shares (so-called non-viable contingent capital, or NVCC) if the relevant regulator determines that the bank is no longer viable. Capital instruments without NVCC features that were outstanding on January 1, 2013 will no longer qualify as capital and are required to be phased out. These transition rules, particularly in the first few years, are quite generous, which significantly decreases the need for new offerings of NVCC-compliant instruments for some time.

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[1] According to their annual financial statements prepared as of October 31, 2012, the largest six banks had the following aggregate non-common capital instruments outstanding (including innovative tier 1 capital instruments): TD Bank C$16.963B; RBC C$15.089B; BNS C$16.662B; BMO C$7.020B; CIBC C$8.207B; and NBC C$4.252B.

Generous Phase-Out Rules for Existing Capital Instruments

Subordinated debt will play a smaller role in the capital structure when Basel III's changes to the asset-to-capital multiple come into effect.

The transition rules fix the base of the nominal amount of all non-NVCC-compliant instruments outstanding on January 1, 2013,[2] and cap their recognition at 90% commencing on January 1, 2013; the cap is reduced by 10 percentage points each subsequent year. However, when a redemption occurs after January 1, 2013, the nominal base is not reduced for purposes of the calculation. Therefore, if a bank had, say, $1 billion of non-qualifying capital outstanding on January 1, 2013, and redeemed $200 million during 2013, then that $200 million would serve as "amortization shelter," enabling the bank to treat all $800 million of its non-qualifying capital outstanding as eligible until 2015. Given the amount of capital that will be eligible for redemption at par between 2013 and 2015, these transitional rules should permit most, if not all, of the existing outstanding non-qualifying capital to receive full capital credit, especially during the first few years of this transition.

The Importance of Common Share Equity Under Basel III

Under the new Basel III rules, common share equity has become the predominant form of capital, and non-common capital has become less important. As a result, banks have been stockpiling undistributed earnings, which has driven their total capital significantly above minimum required levels. In addition, subordinated debt will become particularly less important in the capital structure when the asset-to-capital multiple becomes based on total tier 1 capital rather than on total capital under the Basel III rules in 2018.

Investor Uncertainty over Future Dilution

In October 2011, the Financial Stability Board (FSB) issued a paper titled "Key Attributes of Effective Resolution Regimes for Financial Institutions." The paper provided that resolution authorities should be able to convert all or part of the unsecured and uninsured creditor claims into equity or other instruments of ownership of the financial institution under resolution in a manner that respected the hierarchy of claims in liquidation. Some observers hoped that this requirement could be satisfied with the bridge banking regime that was inserted into the *Canada Deposit Insurance Corporations Act* during the financial crisis. However, the peer review of resolution regimes published by the FSB on April 11, 2013 confirmed that bridge banking powers did not by themselves meet the bail-in written resolution powers. In addition, the federal government announced in its April budget plan that it proposed to implement a "bail-in" regime for systemically important banks and

[2] The transition rules are applied separately to non-qualifying tier 1 and tier 2 capital instruments. Capital instruments issued after September 12, 2010 that do not meet one or more of the Basel III criteria for regulatory capital (other than the NVCC requirement) were excluded from regulatory capital effective January 1, 2013.

that the government would consult with stakeholders on how best to implement the regime in Canada. However, it will likely take at least a year for those consultations to take place and for implementing legislation to be passed by Parliament.

The lack of clarity as to how the bail-in regime will function with NVCC creates uncertainty for potential investors in NVCC instruments because after their instruments are converted into common shares, their position may be significantly diluted further if the bail-in debt trigger is breached.

The lack of clarity as to how the bail-in regime will function with NVCC creates uncertainty for potential investors in NVCC instruments.

Cost of Capital Will Increase Significantly

In contrast with other capital innovations over the years, there is no "first mover advantage" for the issuer of NVCC instruments. In fact, it is widely expected that the first issuances of NVCC instruments will require a significantly higher dividend coupon or interest rate to compensate investors for the perceived additional risk over existing instruments. Over time, it is expected that this risk premium will decrease as the market becomes more reassured that the possibility of the trigger event occurring is remote. Therefore, no economic incentive exists for any institution to be the first to spend time and money developing and marketing this new form of capital.

Hope That the NVCC Requirements Would Be Changed

There was some hope in the industry that OSFI might be willing to revisit the contractual NVCC requirements given the refusal of other major jurisdictions (most notably the United States) to impose a contractual NVCC requirement and the linkage between NVCC and bail-in debt (which is expected to be imposed in Canada and other jurisdictions on a statutory basis).[3] However, in a speech on May 7, 2009, Mark Zelmer, the Assistant Superintendent at OSFI, made it clear that OSFI will require that all the terms and conditions surrounding the conversion process be clearly spelled out ahead of time in the instrument documentation.[4]

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[3] "Should OSFI Rethink Contractual Non-Viable Contingent Capital Requirements?" Torys Bulletin, February 22, 2013.

[4] "Let there be light: How more transparency could promote a safer financial system" Remarks by Assistant Superintendent Mark Zelmer of the Office of the Superintendent of Financial Institutions Canada to the BMO First Annual Reserve Management Conference, Toronto, Ontario, May 7, 2009.

Concerns About Unintended Consequences

The industry continues to have serious concerns about the possibility of market manipulation and death spirals created through the terms and conditions of NVCC instruments.[5] However, the banks continue to work with their advisers to develop terms and conditions that minimize those concerns. Ideally a single structure would be adopted by the industry, which would allow for better understanding and transparency with investors.

Implications

In our view, it is unlikely that there will be any issuances of NVCC instruments until at least the fall of this year and possibly not until 2014. We also anticipate that, with the generous phase-out provisions for the existing non-conforming capital and the increased focus on common share equity, it will be a long time before the NVCC instruments will come close to matching the amount of non-common capital outstanding today.

[5] "Canada Pushes Embedded Contingent Capital" Torys Bulletin, May 28, 2010.

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U.S. CAPITAL MARKETS

Rigorous enforcement, delistings and shareholder litigation mark recent developments

By Mile T. Kurta and Leslie McCallum

Level of Enforcement and Litigation Reach a New High

Enforcement actions by the Securities and Exchange Commission approached near record-breaking levels in 2012, resulting in the payment of more than $3 billion in penalties and disgorgements. In addition, the SEC has filed more insider trading cases in the last three years than in any comparable period in its history, targeting over 400 individuals whose illicit profits or losses avoided totalled $600 million. Although a general rise in enforcement actions has taken place across the board, there has been significant increase in enforcement actions against investment advisers and broker-dealers.

A number of factors have led to this escalation: most notably, claims that the SEC failed to adequately protect investors in the years leading to the financial crisis brought about a reinvigorated focus on bad actors. Furthermore, it may be easier to enforce the laws in place than to undergo the arduous and time-consuming process of making new laws (especially considering the SEC has yet to finalize rules called for under the Dodd-Frank Act and the JOBS Act). Perhaps the most interesting development is the prosecutors' use of investigative methods typically associated with organized crime prosecutions, such as the wiretaps used in the criminal case against Raj Rajaratnam.

Despite budgetary concerns at all levels of the U.S. government, a decrease in enforcement actions is not expected anytime soon – Mary Jo White, the recently sworn-in SEC Chair, is herself a former U.S. federal prosecutor.

Chinese Companies Need More Than the JOBS Act

Although the JOBS Act was passed just over a year ago to facilitate capital raising in the United States, allegations of accounting fraud, diminished investor confidence and a regulatory impasse over audit work papers have caused many Chinese companies to exit the U.S. capital markets in the past two years. A large number of Chinese companies went public in the United States in 2010 through IPOs or reverse mergers, but in 2011, the trend began to reverse. In 2012, only two Chinese companies went public in the United States; so far in 2013, only one Chinese company has filed an IPO registration statement.

Late last year, the SEC charged the Chinese affiliates of the Big Four accounting firms with violating U.S. securities laws.

In addition to the relatively weak demand for stocks of Chinese companies listed in the United States, SEC investigations of numerous U.S.-listed Chinese companies in respect of possible accounting wrongdoing have caused further difficulties. The Dodd-Frank Act authorizes U.S. regulators to obtain the relevant audit work papers, but Chinese audit firms have refused to provide these papers to the U.S. Public Company Accounting Oversight Board (PCAOB), which oversees the public company auditing profession, on the basis that doing so would violate Chinese state secrecy laws. Late last year, the SEC charged the Chinese affiliates of each Big Four accounting firm with violating U.S. securities laws. The audit firms' failure to provide their work papers threatens their registration with the PCAOB, which in turn means that the financial statements of the Chinese companies that they audit could not legally be filed with the SEC. Without SEC-compliant financial statements, these companies ultimately cannot remain listed on U.S. stock exchanges. The PCAOB had originally set December 31, 2012 as the deadline for deregistering all the delinquent audit firms; so far, that extreme step has not been taken. The U.S. and Chinese regulators recently signed a Memorandum of Understanding that establishes a framework for the exchange of audit documents, which the PCAOB calls an "important step toward cross-border enforcement cooperation." The ultimate effectiveness of the non-binding MOU will depend partly on the parties' good faith in adhering to its terms as individual cases arise. In the meantime, according to the PCAOB, since 2010 approximately 126 Chinese issuers have been delisted from U.S. stock exchanges or "gone dark" – that is, stopped filing reports with the SEC.

There is some measure of irony in this situation occurring simultaneously with the implementation of the JOBS Act, since the express purpose of that legislation is to facilitate capital formation in the United States by smaller emerging companies, both U.S. and foreign. Three Chinese companies that have gone public in the United States since the JOBS Act was enacted qualified as “emerging growth companies” (EGCs) and were eligible to take advantage of less onerous SEC rules with respect to disclosure and corporate governance for up to five years post-IPO; it is likely that other Chinese companies would also qualify as EGCs but may no longer see the U.S. markets as appealing.

Significant stock ownership will not necessarily prevent a compensation committee member from consideration as independent.

Executive Compensation: Rules of Engagement for 2013

The Dodd-Frank Act placed new responsibilities on the compensation committees of public companies, similar to the responsibilities placed on audit committees several years ago under the *Sarbanes-Oxley Act.* The NYSE and Nasdaq have now finalized the necessary changes to their listing rules, including heightened independence standards for compensation committee members and new responsibilities regarding retaining compensation advisers. Although these rule changes and the mandatory say-on-pay requirements under Dodd-Frank are perhaps less controversial and costly than the internal control and auditor attestation rules imposed by Sarbanes-Oxley, their impact is significant in terms of public companies’ relationships with their institutional investors, their preparation for annual meeting season and the functioning of their compensation committees.

Under the new listing rules, compensation committees must have the authority to retain their own compensation consultants, legal counsel and other advisers. Advisers are not required to be independent, but compensation committees must at least consider their independence before hiring them. This is meant to be a check on compensation committees hiring advisers whose judgment could be clouded by conflicts of interest or perverse incentives. In determining whether a compensation committee member is independent, boards of directors must broadly consider all factors and relationships that could affect the committee member’s independence from management. In finalizing the new rules, the NYSE and Nasdaq both reiterated the existing principle that significant stock ownership alone will not necessarily preclude a finding of independence.

Foreign private issuers, including Canadian MJDS (Multijurisdictional Disclosure System) companies, are exempt from the new U.S. listing requirements, but Canadian best practice guidelines and disclosure requirements relating to compensation committees and their advisers align closely with the U.S. reforms. One exception to this is Nasdaq’s new requirement that compensation committee members not accept, directly or indirectly, any consulting, advisory or other compensatory fees from the issuer or any subsidiary. This fee prohibition mirrors the rule for audit committee members in both the United States and Canada, but neither the NYSE nor Canadian rules impose an outright prohibition on such fees for compensation committee members. These fees must, however, be taken into account in considering whether a compensation committee member is impaired in his or her ability to exercise independent judgment.

Although the new compensation committee requirements have only recently been finalized, the Dodd-Frank say-on-pay rules have been mandatory for U.S.

In the spirit of good corporate governance, many Canadian public companies have voluntarily adopted "say-on-pay" executive compensation voting for their shareholders.

public companies since 2010. The implementation of say-on-pay partially can be credited with increasing the level of engagement between public companies and their major shareholders. An important backdrop to discussions that take place between companies and their institutional shareholders – and potentially affecting the outcome of the say-on-pay vote – is the policy position of Institutional Shareholder Services (ISS), the largest proxy advisory firm. ISS has described executive compensation as "the perennial top governance topic for investors." ISS has a policy that companies that failed to achieve a 70% approval rate for their say-on-pay in 2012 faced the possibility of a negative vote recommendation from ISS in 2013 if the company failed to engage with shareholders and address the underlying issues contributing to the poor result.

Whereas Dodd-Frank made say-on-pay mandatory for U.S. public companies, in Canada the practice has not been legislated. Mitigating this cross-border difference, however, is the fact that following Dodd-Frank and the earlier adoption of say-on-pay in the United Kingdom, a substantial number of Canadian public companies have decided, as a matter of good corporate governance, to voluntarily provide shareholders with an annual advisory vote on executive compensation. As in the United States, average shareholder support for say-on-pay resolutions has been high.

Despite generally high shareholder approval rates, say-on-pay has given rise to a new breed of shareholder litigation that companies must be prepared for in connection with their annual meetings. Lawsuits have been brought to enjoin say-on-pay votes, with the plaintiffs alleging that the disclosure in the company's proxy circular concerning executive compensation is inadequate and amounts to a breach of the directors' fiduciary duties under state law (even though the disclosure may comply with SEC rules). In some instances, companies have proactively reached out to their institutional investors to garner support for their executive compensation disclosure. A notable example of such institutional shareholder support occurred when Microsoft was sued over its say-on-pay disclosure and the California State Teachers' Retirement System intervened on Microsoft's behalf. CalSTRS informed the court that Microsoft's disclosure was sufficient for it to make an informed decision about how to vote on say-on-pay. In general, the say-on-pay lawsuits have had little success in court, but a few companies, motivated in part not to disrupt their annual meeting timetable, have settled quickly instead of launching a defence. The most significant practical impact of say-on-pay lawsuits is the unfortunate need for public companies to consider their litigation strategy as part of their regular annual meeting preparations.

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THE ROLE OF CAPITAL MARKETS IN P3 FINANCING

Increasing infrastructure demands in Canada and abroad create opportunity

By Daniel A. Ford

The Infrastructure Deficit

The Public Sector Accounting Board defines an infrastructure deficit as "the added investment in infrastructure assets that would be required to maintain them at appropriate levels and in a good state of repair." By some estimates, the total infrastructure deficit in Canada (federal, provincial and municipal) exceeds $400 billion. As a result, addressing the infrastructure deficit has become a policy imperative. At the same time, governments at all levels face ballooning public debt, unsustainable deficits and a weary taxpayer base with little tolerance for increased tax levels to fund further government programs, regardless of merit. To remain competitive in the global marketplace, Canada must take steps to alleviate the infrastructure deficit – and without further delay. With little in the way of politically palatable alternatives, governments have been forced to consider alternative and cost-effective measures for the procurement and, more importantly, the funding of their infrastructure needs. Public-private partnerships, or P3s, provide a solution to those needs.

What Are P3s?

P3s are contractual arrangements formed between a public agency and a private sector entity for the delivery and financing of public infrastructure projects.

Canadian P3 Pioneering

200 P3 Transactions

A history of nearly 200 P3 projects in Canada has positioned us as a world leader in executing the structure.

P3s can take various forms: design-build, build-finance, design-build-finance, design-build-finance-maintain (DBFM) and design-build-finance-maintain-operate (DBFMO). The hallmark of a successful P3 structure is an appropriate allocation of risk and value for money for the public agency. More important, the structure enhances on-time and on-budget delivery of the asset, and in the longer-term structures (DBFM/DBFMO), maintenance and life-cycle discipline that ensures longer asset life. Apart from these desirable attributes, at the core of many of these structures is the private financing component of P3s. Since P3s typically comprise both debt and equity, for contracts with a fixed pricing structure, lenders' and equity providers' oversight of their investments acts as a second level of project control to ensure timely and complete contractual performance.

The Transaction Record for P3s

Although P3 procurement has been highlighted in the press more recently, it has a relatively long and successful track record in Canada, with nearly 200 transactions having been completed or in process. Canada is a recognized world leader in the utilization of the procurement model, and the "Made in Canada" approach to P3s, which is both efficient and financeable, has brought many global financial institutions into the Canadian market. Indeed, in the early days of P3 in Canada, the participation of European and Japanese financial institutions, with a more flexible appetite for long-term debt structures and a greater familiarity with P3 infrastructure development, was critical to the success of the longer-term P3 structures. During those early days, many P3 participants expressed mild frustration at the lack of involvement by capital markets players. It seemed only logical that financial institutions such as life insurance companies and pension funds, with their vast pools of capital and appetite for long-term returns (to match long-term liabilities), were well suited to the funding of P3s. At the time, the reason most cited by capital markets participants for not getting involved in P3 deals was a combination of deal size and documentation/transaction complexity, which, with relatively limited "back-room" resources, made the transactions a low investment priority.

The Advent of Capital Markets Participation

As the years passed from the early days of P3 to those of the "credit crunch," and as European and Japanese financial institutions retrenched in their home markets, their participation in P3s waned. This limited the supply of long-term money for P3 projects. Fortunately for P3 market participants at that time, more traditional capital markets participants, facing an uncertain market, turned their minds to investment products with long and, more importantly, predictable and respectable returns. As a result, capital markets participants focused greater attention on the P3 market and developed greater familiarity and expertise with the model. Indeed, their participation played a critical role in sustaining P3 deal flow during those difficult times.

Deal Structures and the Capital Markets Track Record

Capital markets participation has centred, although not exclusively, on longer-term P3 structures (DBFM/DBFMO). These structures typically involve a lump sum payment from the public agency once construction of the infrastructure asset is complete, and periodic service payments as compensation for maintenance/life-cycle/operations services over the balance of the contract term (25–35 years). Accordingly, short-term money, which is to be repaid with the lump sum payment, is required over the construction phase (two to five years). This component of the debt is often fulfilled by the traditional banks and is sized accordingly. In addition to the short-term debt, there is an equity component of funding and, although gearing (debt to equity ratios) for P3 transactions has varied over time, the current ratios range from 85:15 to 90:10, with some occasional outliers.

While long-term bank debt from European and Japanese financial institutions remains available for the role, the long-term piece of the funding puzzle is, together with equity, more currently filled by a capital markets component that normally takes the form of a bond offering, typically as a private placement. The issue amount is funded in full into a segregated account on financial close and deployed to pay construction and development costs – typically drawn in priority to the short-term debt. Pricing for the bonds is usually pegged off the bid-yield on Government of Canada (GOC) Bonds, determined by a linear interpolation of GOC Bonds approximating the average life of the bonds, plus an issue spread. Tenor for the bonds approximates the contract term, less a tail of typically 6 to 12 months. Debt service on the bonds and equity returns are funded from periodic service payments made by the public agency under the P3 contract, which is structured to fund those financial payments and the "pure" cost of service performance. While there is certainly construction risk for both short- and long-term lenders, the bonds are exposed to payment risk in the form of penalties that the public agency may impose if there are performance defaults by the private sector partner. Accordingly, as additional security, bondholders typically require debt service reserves, liquid security in the form of letters of credit and, on occasion, bonding. If a conventional approach is taken to the structuring of the P3 bond investment, the result is an investment-grade product with typical ratings (when rated) in the range of BBB+ to A, with an average of A- (S&P). Although there are certainly some exceptions, it is commonly understood in the market that to attract sufficient investor attention relative to the complexity of the transaction, sizing of the bond issue needs to be in the $75 million plus range.

The track record for capital markets financing of P3 transactions is robust, with approximately 30 bond financings having taken place over the last five years in Canada, ranging from a low of $50 million dollars to in excess of $1.4 billion dollars. By all accounts, the demand will remain robust as long as deal flow remains healthy. In addition, the infrastructure asset sectors in which capital markets financing is deployed vary from hospitals, courthouses and correctional facilities to roads and bridges – and public transit is on the horizon. As one might

Canadian P3 Financings: the Last Five Years

- 30 bond financings
- $50 million to $1.4 billion
- Increasingly diverse range of asset sectors

The last five years have seen diverse financing of the P3 structure in Canada, with increased availability in long-term capital markets funding.

expect, since the passage of the "credit crunch" and with increased interest in P3s, the available supply of long-term capital markets funding has increased. As a result, pricing margins have come in from a high of roughly 400 bps in 2009 to a current range of 200-250 bps; and while, historically, most bond financings were structured as club deals, underwritten deals are becoming the norm.

The sheer demand that will flow from the infrastructure deficit bodes well for future capital market investment opportunities in P3 structures.

The Roundup

Recent history has shown that a robust capital markets opportunity exists in P3 transactions; the structures are disciplined and now time tested. Although not all of Canada's infrastructure needs will be met with P3s, the sheer demand that will flow from the infrastructure deficit bodes well for future capital markets investment opportunities in these structures. Public transit appears to be the next significant sector in which P3 can play a major role, and the projects that have been planned to date and that are on the horizon will require significant capital investment.

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OIL AND GAS CAPITAL MARKETS

Private equity and foreign investment emerge as sources of financing

By Scott R. Cochlan, Neville Jugnauth and Leah Dickie

In March 2013, Torys LLP, in association with mergermarket, released the *Canadian Oil & Gas 2013 Outlook* (the mergermarket Report),[1] which provided an analysis of certain key challenges and opportunities for companies in the oil and gas sector. The analysis was based on interviews with 100 senior corporate executives and investment bankers. In this article, we look back at how such challenges and opportunities manifested in the first quarter of 2013 with regard to the capital markets and what new trends may be developing for the remainder of the year.

As 2012 came to a close, commentators noted the general scarcity of traditional financing available for issuers in the oil and gas sector. Equity markets had steadily declined over the past three years. Between 2010 and 2012, equity financings conducted by oil and gas issuers listed on the TSX decreased from $11.2 billion in 2010 to $8.9 billion in 2012, a drop of 20%.

The first quarter numbers for 2013 show that these trends appear to have continued or even worsened. According to the TSX's market intelligence group report, the equity capital raised by oil and gas issuers listed on the TSX and TSXV in the first quarter of 2011 was approximately $3 billion, declining to $2.3 billion

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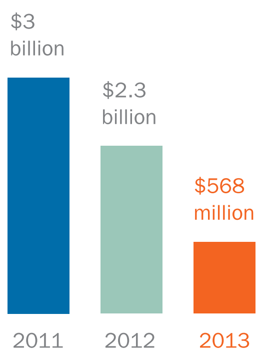
[1] Available at http://www.torys.com/Publications/Pages/AR2013-5_Canadian_Oil_and_Gas_2013_Outlook.aspx.

Decline in Equity



The recent steep decline in equity financing in the oil and gas sector has stirred speculation on how issuers will fill the void.

and $568 million for the same period in 2012 and 2013, respectively.[2] Deal volume has declined correspondingly, from 142 deals in the first quarter of 2011 to 98 deals and 68 deals over the same period in 2012 and 2013, respectively.

Further, low natural gas prices and the gap between Canadian crude oil prices and West Texas Intermediate (WTI) have reduced the cash flow available to producers. By some estimates, as many as half of the resource issuers listed on the TSXV have less than $200,000 in working capital, potentially putting these issuers in the position of having to find alternative sources of financing for their operations.

With the lack of equity and working capital available to resource issuers, commentators have been left to speculate on how these issuers will fill the void in 2013. A number of common theories emerged at the end of 2012, including an expectation of increased foreign investment in the Canadian oil and gas sector through less traditional structures, an expectation of increased merger activity involving junior and intermediate companies and selective private equity investment in the oil patch through both acquisitions and financing.

Foreign Investment

The year 2012 ended with the Canadian government's announcement of its more stringent review policy for foreign enterprises seeking to invest in the oil sands. As stated in the mergermarket Report, the commonly held view among commentators at the time was that this change in policy would lead to more joint ventures with Canadian partners or other similarly structured transactions as an alternative to the takeover of Canadian oil companies.

To date in 2013, no blockbuster takeovers have occurred like those of Nexen or Petronas, and the transactions that have been concluded have mostly, as predicted, been structured as joint ventures. The most notable deal in the foreign investment arena in Q1 2013 was the asset disposition by Suncor Energy Inc. of its conventional natural gas properties to a partnership owned by the U.K.'s Centrica PLC and Qatar Petroleum for $1 billion. Other transactions involving foreign investment announced in the first quarter included joint ventures between AltaGas and Idemitsu, and Progress, Petronas and Japex.

Perhaps more notably, though, is the absence of foreign players in Q1 2013. Commentators have speculated on the reasons for their non-appearance. China's growth slowed in the first quarter of 2013, and there is some sense that foreign investors are taking a wait-and-see approach in light of the pending approval of TransCanada Corp.'s Keystone XL pipeline.

[2] Unless otherwise noted, all dollar amounts refer to Canadian dollars.

Bill C-60, which will implement changes to the Investment Canada Act with regard to investment by state-owned enterprises (SOEs), had its first reading on April 29, 2013. If passed unamended, the bill will broaden the definition of SOE to include entities influenced by a foreign government or agency and will give the Minister of Industry the ability to apply control-in-fact tests to determine whether an entity is an SOE. The level of discretion given in the bill has been noted by some commentators to vary substantively from the position asserted in December 2012 and to further raise the level of uncertainty about the federal government's treatment of SOEs. Foreign investors may be waiting to see how the application of the new restrictions will affect the industry, or they may be taking the time to readjust their investment strategies to focus on investments in smaller players or alternative assets such as shale gas, which may be subject to less scrutiny.

It is uncertain when foreign investment will again ramp up in the energy industry. However, when it does, it is almost certain that it will be a buyer's market.

There is also speculation that foreign investors have been deterred by the price differential between WTI and Canadian heavy oil. Though it has historically hovered near $18 a barrel, in December that gap surged to more than $40. More recently, the differential has settled to normal levels, with June deliveries seeing a differential of $16.50, as of April 26, 2013.

It is uncertain when foreign investment will again ramp up in the energy industry. However, when it does, it is almost expected to be a buyer's market. Several of British Columbia's Montney shale gas players, including Talisman Energy Inc. and Canadian Natural Resources Ltd., are contemplating the disposition of their assets. Murphy Oil Corp. had been seeking to sell its share in the Syncrude Canada Ltd. oil sands project and its Montney shale assets, but recently took the assets off the market, presumably after failing to find an acceptable buyer. Such a large availability of assets and potential transaction parties allows bidders to take their time and apply pressure to pricing.

M&A Activity

At the end of 2012, commentators noted their expectation that the dearth of capital raising opportunities available to junior and intermediate companies would lead to consolidations as a means of achieving economies of scale through the reduction of general and administrative expenses and as a way to possibly attract investment to the larger resulting entity.

Overall Canadian M&A activity is significantly down in the first quarter of 2013. Statistics from mergermarket show the value of Canadian M&A at US$14.4 billion

Funding From Private Equity

$600 million

Private equity has remained a relatively static source of funding for oil and gas, with $600 million worth of investment to date in 2013.

in the first three months of 2013 compared with the US$35.5 billion worth of deals in the same period of 2012, making it the lowest first quarter by value since 2010. The number of Canadian M&A deals completed was also down in the first quarter of 2013, sliding to 124 deals from 140 deals in the first quarter of 2012. According to PricewaterhouseCoopers, the energy sector's share (which includes infrastructure and renewable energy) of total Canadian M&A shrunk in the first quarter of 2013. In comparison with the fourth quarter of 2012, energy deals in Q1 2013 fell from 28.5% to 19.4% of deal value and from 15.1% to 11.9% of deal volume.

The top deal in the oil and gas sector in the first quarter of 2013 was Imperial Oil Ltd.'s $1.98 billion purchase of a 50% stake in Celtic Exploration Ltd. However, there is a sense that many of the factors currently deterring foreign investment – poor commodity prices, glut of and uncertainty regarding necessary infrastructure expansion – may also be tempering M&A activity between junior and intermediate companies. A value gap has emerged between sellers who are looking at long-term potential and buyers who are looking at the current economics of the deal.

Private Equity

While the consensus at the end of last year was that private equity would rise to fill the some of the cracks left by the evaporation of the pool for equity financing, it was generally thought that such funding would only be offered selectively. As stated in the mergermarket Report, the majority of senior executives and investment bankers surveyed expected that private equity would concentrate on the companies valued in excess of $500 million. Additionally, it was expected that firms with strategies focused on distressed buying opportunities would be interested in both large midstream activities and companies with non-conventional gas assets hurt by low natural gas prices.

Private equity investment in Canadian oil and gas players had been relatively static last year after a significant drop between 2010 and 2011. In 2010, total private equity investment in the Canadian oil and gas sector was $2.6 billion, slipping to $1.4 billion in 2011 and $1.6 billion in 2012.[3] To date in 2013, private equity investment in this sector has been approximately $0.6 billion.

A significant number of these deals were going-private transactions for companies seeking to leave the markets, a trend that has gained traction in recent weeks. In the first two weeks of May 2013, at least three going-private transactions were announced in the Canadian oil and gas sector. Most recently, Wenzel Downhole Tools Ltd. announced that it had entered into an agreement with Basin Tools L.P. according to which Basin will acquire all Wenzel's shares.

[3] ARC Financial.

It also appears that investment in private equity funds focused on Canadian oil and gas is seen as an attractive option for investors. In 2012, ARC Financial Corp. closed its ARC Energy Fund 7 with $1 billion raised and is currently in the process of investing the fund. Camcor Partners recently announced the closing of its Camcor Energy Fund VII, which is focused on oil and gas issuers based in the Western Canadian Sedimentary Basin, at its cap of $350 million, including its largest contribution yet from foreign participants.

As we look ahead to the remainder of 2013, there is no sign that there will be a rapid resurgence of the public equity markets or commodity prices. However, as evidenced by the announcements in recent weeks, it does appear that private equity, including some funding from foreign investors, may be emerging to fill those cracks for certain players in the oil and gas sector.

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INNOVATION IN CROSS-BORDER TRUSTS

New approaches continue to emerge – particularly for REITs

By Karrin Powys-Lybbe, Simon Knowling and Corrado Cardarelli

In Torys' *Capital Markets 2012 Mid-Year Report,* we wrote about cross-border income funds (CBIFs) and predicted that there would be more CBIF transactions in the future, including, in particular, CBIF transactions involving cross-border real estate investments. This past year has seen a strong continuation of this trend.

To recap, Canada's tax laws were changed following the announcement on October 31, 2006 to provide for the concept of a "SIFT trust" and to subject a SIFT trust to an entity level tax that would emulate a corporate level tax. A SIFT trust is defined to include a publicly traded trust that owns "non-portfolio property" (NPP). In turn, NPP is defined to include an interest of 10% or more in securities of a Canadian corporation, a Canadian trust or a partnership that has a sufficient nexus to Canada, and any property that is used in carrying on a business in Canada. There are two main exceptions to the concept of a SIFT trust. The first is an explicit exception for a "real estate investment trust" (REIT). The second is a more subtle exception that derives from the definition of NPP itself and applies to trusts that directly or indirectly carry on business or own assets entirely outside Canada. The SIFT rules are therefore clear that a trust that carries on business or owns assets only outside Canada will not be subject to the SIFT rules, even if the interests it owns in Canadian corporations, trusts or partnerships have a nexus to Canada.

Recent proposed changes will make it easier to structure interests in foreign real property to meet the REIT exception to the SIFT rules.

The REIT exception is by now fairly well understood and does not generally include real property ownership limitations that restrict real property situated in Canada. Indeed, recent proposed changes provide recharacterization rules that will make it easier for a trust that owns real properties outside Canada to meet the REIT exception tests. These rules will recharacterize revenues in the form of dividends on shares or interest on debt into rent from real property (for the purposes of one of the REIT exception tests). In this way, these revenues become "good revenues" for the REIT exception tests if the interest or dividend payments are ultimately derived from rent from real property. This will make it easier to structure interests in foreign real property to meet the REIT exception tests. These recharacterization rules are fairly new and have not yet been relied on to their fullest extent. It remains to be seen whether they will be a factor in subsequent transactions.

With respect to public offerings in Canada of CBIFs involving U.S. assets and businesses, the biggest challenge has been trying to find a way around the U.S. so-called inversion rules. These rules will generally apply when the U.S. owners of the business being taken over by a foreign entity (such as a Canadian income fund) have a retained interest in the U.S. assets/business being taken public. The existence of a retained interest, in turn, normally depends on whether (a) the U.S. business/assets can be taken public all at once, providing a complete monetization for the owners; or (b) whether the market will permit only a partial sale (or the underwriters require the owners/promoters to continue to have skin in the game in the form of a retained interest for a period of time following the initial public offering). In general, a retained interest by the former U.S. owners at the level of the income trust or an equivalent interest in one of its subsidiaries (including at the level of the U.S. assets/business) will result in the income trust being "inverted" under the U.S. tax rules if the U.S. owners are considered to own an interest of over 80% in the income trust (disregarding for this calculation interests obtained in the public offering). Interests in subsidiary entities are considered equivalent to an interest in the public trust for this purpose if the retained interest holders have distribution rights that are substantially equivalent to the distribution rights of the holders of the public income trust securities. When inversion is found to occur, the Canadian income trust is treated as a U.S. corporation for U.S. income tax purposes. This means that the income trust would be subject to U.S. tax on its worldwide income, and distributions paid to Canadian unitholders would be subject to U.S. withholding tax (with the associated issues of whether such withholding tax would be at treaty-reduced rates and whether Canadian unitholders would be entitled to a foreign tax credit for the U.S. withholding tax).

One of the clear exceptions to the U.S. inversion rules is an income trust that has "substantial business activities" in the foreign (non-U.S.) jurisdiction – in other words, in Canada. In June 2012, draft regulations changed the concept of substantial business activities to provide for a bright-line type of test. The test requires more than 25% of the assets, employees and income of the overall enterprise to be located in or derived from Canada. At first instance, this exception does not seem to be very promising since an income trust that carries on substantial business activities in Canada would be subject to the SIFT rules. However, if the issuer qualifies for the REIT exception in Canada, the SIFT rules would not apply. This combination of (a) the REIT exception from the Canadian SIFT rules for Canadian activities and (b) the substantial business activities exception from the U.S. inversion rules was used in the January 2013 initial public offering of Agellan Commercial REIT. Agellan is a Canadian income fund that acquired rental real properties in the United States and rental real properties in Canada. The Canadian operations were exempt from the SIFT rules under the REIT exception but were of sufficient scale to result in the satisfaction of the substantial business activities exception from the U.S. inversion rules. As a result, the U.S. owners could retain an interest in the operating business with typical rights to exchange the interest for units of the Canadian income trust and the right to receive distributions that were essentially identical to the distributions received by public holders of the income trust units. In this regard, the Agellan offering followed the path of the earlier HealthLease Properties REIT, which completed its initial public offering in June 2012.

Going public as a U.S. corporation listed on the TSX is one way CBIFs outside the real estate arena are solving for U.S. inversion rules.

In November 2012, Crius Energy Trust completed its public offering using a structure in which the rights of the retained interest holders were not equivalent to the rights of the public unitholders. The distribution rights of the securities, including their rights on liquidation, were determined not to be substantially similar to the distribution rights of the public holders of the income trust units. In particular, the retained interest holders had limited liquidity rights, which involved the right to have their interests acquired by the income fund in limited circumstances and at prices that were not directly referable to the public units or the trading price of the public units. As a result, the former U.S. owners were not considered to have an interest of over 80% in the CBIF for U.S. tax purposes. This remains to date the only offering in which a solution to inversion was found in the case of a diversified business (sale of energy contracts) outside the real estate area or the ownership of U.S. oil and gas assets (which we discussed last year). The Crius Energy trust involved the right circumstances in which such a solution could be found and involved tailoring the distribution rights to satisfy the conflicting requirements of the retained interest holders and the rights of the public holder of the income trust units. In general, however, there is no easy fix or cure for the U.S. inversion rules outside the real estate area. In certain circumstances, when solving for inversion was not possible, the approach taken has been to go public as a U.S. corporation that lists its shares on the TSX initially. An offering in Canada by a U.S. corporation will also require clearance by the U.S. Securities and Exchange Commission unless a suitable exception to such clearance exists, which provides a path to U.S. markets now or in the future.

It is in the area of U.S. real estate assets where CBIF activity flourished in 2012/2013. In addition to the Agellan structure described above, two other approaches of significance were used: one was first used in 2012, and the other was an innovation that appeared in early 2013. The older approach was taken in the initial public offering by Pure Multi-Family REIT LP in July 2012, and subsequent offerings similar to it, in which a Canadian publicly traded partnership acquired a U.S. corporation that qualified as a REIT for U.S. tax purposes (and the partnership was not a SIFT partnership because it owned only U.S. properties). The issuers in these offerings did not have former U.S. owners with a retained interest so inversion was not an issue. These structures resulted in a U.S. corporation that qualified as a U.S. REIT going public in Canada by means of a Canadian publicly traded partnership. This allowed the U.S. owners to capitalize on the advantages of quicker timing to market and the viability of a smaller offering size in Canada. Since a partnership is not a taxpayer for Canadian tax purposes (nor for U.S. tax purposes), this structure essentially results in the holders of the partnership units being taxed as though they directly owned the shares of the U.S. REIT owned by the partnership. The main advantage of being a U.S. REIT for U.S. tax purposes is that the U.S. REIT is not subject to U.S. entity level taxation provided that it distributes essentially all of its earnings to its securityholders so that the issue of U.S. tax leakage is solved in a straightforward manner. However, this structure does not provide a solution for the U.S. inversion issue, so may not apply if the U.S. owners have a retained interest.

A newer and novel approach that appeared in 2013 is the use of a Canadian income trust that itself also qualifies as a U.S. REIT.

A newer and novel approach that appeared in 2013 is the use of a Canadian income trust that itself also qualifies as a U.S. REIT. For this to work, it is necessary to cause inversion (to embrace inversion rather than avoiding it). The Canadian income trust owns only U.S. properties so it is outside the SIFT rules. Because it is inverted, it becomes a U.S. corporation for U.S. tax purposes and, therefore, the Canadian income trust can elect to be a U.S. REIT for U.S. tax purposes. Assuming that the Canadian income trust satisfies the technical requirements to qualify as a U.S. REIT, this means that (a) the Canadian income trust is not subject to U.S. tax, provided that it distributes essentially all of its earnings to its unitholders – this is the key feature of this structure, which eliminates the typical downside of being viewed as inverted; and (b) issues relating to the rights of the retained interest holders are solved since the U.S. former owners can hold an interest that is exchangeable for units of the Canadian income trust and is entitled to receive distributions that are essentially identical to distributions received by holders of the income trust units. Distributions paid by the Canadian income trust to Canadian unitholders are subject to U.S. withholding tax (other than for tax-exempt entities such as RRSPs), but the Canadian unitholders are generally entitled to a Canadian foreign tax credit for U.S. withholding tax. This approach was followed in the offerings by Milestone Apartments Real Estate Investment Trust in May 2013 and by WPT Industrial Real Estate Investment Trust in April 2013. We believe a number of additional proposed offerings, not yet public, intend to use this approach in 2013.

We note that a clone of the Dundee International REIT offering from 2011 also occurred within the last year involving international (and non-U.S.) properties. This was the offering in April 2013 of Inovalis Real Estate Investment Trust, a Canadian income trust that indirectly owns rental real properties in France and Germany. These types of structures are possible because the Canadian income trust does not own properties in Canada or carry on business in Canada. In addition, the U.S. inversion rules are not a problem since these international structures do not involve U.S. assets or businesses. The challenge in these types of international structures is to find ways to reduce local taxes, as well as withholding taxes, in the international jurisdiction, before the earnings find their way back to Canada and into the hands of the Canadian unitholders.

In summary, the last 12 months have shown a strong trend in the use of CBIFs, particularly in the cross-border REIT space, with interesting and novel approaches becoming commonplace. This trend shows every sign of continuing, as markets permit. In addition, the Crius Energy Trust offering has shown that it is even possible, in the right circumstances, to find a cure for inversion in the case of a diversified business.

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