



**S&P MARKET CONSULTATION:
DO INCOME TRUSTS BELONG IN THE
S&P/TSX COMPOSITE INDEX?**

S&P Canadian Index Services
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Dear S&P/TSX Composite User:

The rapid growth of income trusts has been a defining feature of the Canadian capital market in recent years:

- As of the end of September 2004, there were 160 “operating entity”¹ income trusts listed on the TSX, with a combined market capitalization of \$107 billion. Since 1997, the market capitalization of the S&P/TSX Capped Income Trust Index has grown at an annualized rate of 37%.
- While trusts were more typically based in the real estate and energy sectors in the early years, today, nine out of the 10 GICS[®] – Global Industry Classification Standard sectors are represented by one or more income trusts listed on the TSX.
- Trusts now represent 9% of the total market capitalization of the TSX.

However, because trusts are not corporations, the present rules that govern the S&P/TSX Composite Index (“the Composite” or “the Index”) make trusts ineligible for inclusion in the Index. If trusts *were* to be included, the impact would — not surprisingly, given the facts above — be dramatic.

In Appendix A, we present a simulation of what the Composite would look like if income trusts had been eligible for inclusion as of the Third Quarter 2004 index rebalancing. The total market capitalization of the Composite would increase by 8% with the addition of 56 new constituents. There would also be a significant shift in sector weights, with Energy increasing by 2.5 percentage points and Financials declining by 1.3 points.

The size and make up of the trust sector, and calculations similar to those in Appendix A, have led a number of market participants to call for the inclusion of trusts in the Composite. If the Composite is to be truly representative of the economic activity in Canada, then trusts, which dominate the real estate sector, account for a large and growing component of the energy sector, and continue to branch out into new sectors, surely belong in the Index.

At the same time, some market participants, while recognizing the importance of the sector, believe that income trusts should *continue* to be excluded from the Composite, due to their very different structural characteristics and legal status. For these participants the differences raise very serious concerns regarding the suitability of trusts as an investment — particularly for institutions.

As an index provider, Standard & Poor’s faces a dilemma. A good index should be representative of the asset class or sector that it is intended to reflect. This would be an argument in favour of including trusts in the Composite. At the same time, a good index should be investable — it must be possible for real world investors to replicate the investments made by the index, otherwise the index is not meaningful. Normally, “investable” means that the index constituents should be listed on an exchange and meet certain minimum liquidity standards. But an index that includes securities that a large number of market participants, as a matter of policy, cannot or will not trade can also be said to be not investable. This would be an argument for continuing to exclude trusts from the Composite.

As a means of resolving this dilemma, and consistent with the consultative approach that we take to index management, S&P invited members of the Canadian Index Advisory Panel (“the Panel”), a broadly representative group of index users in Canada, to address the following question in written submissions²:

¹ It is income trusts that invest directly in operating businesses that have been the focus of debate regarding inclusion of income trusts in the Composite. There has been no call for including fund of fund or structured products that invest in multiple income trusts.

Should income trusts be eligible for the S&P/TSX Composite Index? In your response please give reasons why you are for or against inclusion and indicate in particular, whether your opinion is dependent on limited liability legislation for income trusts being introduced in Ontario.

In the course of the submission period, S&P also received requests from market participants who are not Panel members who wished to make submissions. These submissions were welcomed as further input to the consultation process and are also reflected in this paper.

In total we received 17 submissions from a broad cross-section of our user community. The paper has summarized the submissions and organized their contents by theme. Our goal is to present all of the different arguments in a single document that will serve as background for informed discussion of this question. We also present several proposed alternatives to outright inclusion of trusts in the Composite.

Submissions from Panel members are presented on an anonymous basis. Comments from CAIF/CIPPREC, PIAC, and the CCGG are cited with attribution.

S&P would like to thank all the Panel members and other organizations that took the time to provide what were very insightful and thoughtful comments on this question. It is gratifying to see the interest that the market takes in the S&P/TSX family of indices, and in the Composite in particular. We can assure market participants that we appreciate the sense of ownership displayed and that we will take all of the views expressed into very careful consideration in arriving at a final decision on this issue.

Finally, in drafting this paper we have attempted to be as concise as possible, avoiding overlapping or duplicate comments, while at the same time providing an accurate reflection of the rich and nuanced variety of views expressed. To the extent that we have achieved this goal, the authors of the various submissions can take credit. To the extent that we have fallen short, the usual disclaimers apply.

Stephen Rive
Vice President
S&P Canadian Index Services

² The following organizations also made submissions: the Canadian Institute of Public and Private Real Estate Companies (CIPPREC), the Canadian Association of Income Funds (CAIF), the Canadian Coalition For Good Governance (CCGG) and the Pension Investment Association of Canada (PIAC). CIPPREC and CAIF made a joint submission referred to in this paper as “CAIF/CIPPREC.” The CAIF/CIPPREC submission can be downloaded at http://www.caif.ca/content/CAIF_Submission20Sep2004.pdf. The PIAC submission focused on the corporate governance aspects of the question and highlighted points made in an earlier PIAC paper, “Income Trusts, An Information Paper,” Spring 2004, which can be down loaded at <https://www.piacweb.org/assets/IncomeTrustsAnInformationPaper.doc>.

I. Responses to the Question

This section organizes the responses to the question under a number of key themes.

Unlimited legal liability

Whereas common shareholders cannot be held liable in litigation against their company for amounts beyond their original investments, the same may not be true for unitholders of trusts. This has been a key concern in the debate for some time. Indeed, many of those in *favour* of including trusts in the Composite conceded that the issue of unlimited liability needed to be addressed before income trusts should be eligible.

One submission summed up the problem in this way: “The most likely scenario for unlimited liability is agency, which is that if you are deemed to have control over the actions of a trustee, then you and the trustee are deemed to be one and the same, and the courts would make you liable for the actions of the trustee. This is of particular concern to large institutional investors who may have a large position and are more likely to be perceived as controlling a trustee’s actions.”

CAIF/CIPPREC suggest the likelihood of even a large investor facing unlimited liability is small. For that to happen, the unitholders would have to be seen as the “mind and management,” or alter ego, of the trust. “To date, no court has found that an operating trust merely constitutes the alter ego of even a dominant unitholder. It would be absurd to conclude that a passive index investor, or typical active institutional investor using the index as a benchmark, could possibly be perceived as being a dominant investor in a particular income fund.”

While recognizing that the legal consensus would suggest that the likelihood of trust holders facing unlimited liability is extremely remote, PIAC, for example, concludes that the “consequences of a worst-case unlimited liability scenario, regardless of how unlikely it is to occur, are too damaging to ignore.” Another submission stated: “Because the consequences . . . could be catastrophic to a pension fund, the possibility of such an event cannot be ignored.”

Other submissions, some citing the work of Mark Gillen of the Faculty of Law at the University of Victoria, concede that a remote possibility of unlimited liability exists, but argue that for “passive” investors, trusts present the *same* risks of unlimited liability as common shares.³

Do current and planned legislative changes address the problem of unlimited liability?

Many submissions on the “yes” side noted that legislation at the provincial level has either addressed, or is in the process of addressing, the liability issue by providing for limits comparable to those for common shareholders. CAIF/CIPPREC provided the following summary:

- In Quebec, income trusts have enjoyed limited liability protections for 10 years under the 1994 Revised Civil Code.
- Alberta’s Bill 34, the Income Trusts Liability Act, passed in Spring 2004 and has been in effect since July 2004.
- Ontario is expected to pass the Trust Beneficiaries’ Liability Act, proposed in June 2004.

³ In reviewing the legal opinions on this question, Gillen has written: “If institutional investors were reading these opinions carefully they would have either had to abandon their fear of investing in income trusts or divest themselves of shares.” Mark R. Gillen (University of Victoria), “Income Trust Unitholder Liability: Risks and Legislative Response” (paper prepared for the Capital Markets Institute, University of Toronto, December 2003) p. 3.

- Legislation is also being considered in British Columbia (where CAIF has provided draft legislation for consideration), Nova Scotia, and Manitoba.

CAIF/CIPPREC estimate that legislative changes in Quebec, Alberta, and Ontario could cover 88% of all income trusts by 2005, and they note that the percentage would be much higher if only trusts that meet the Composite's size requirements are considered.

It is worth noting, however, that these actual and proposed legislative changes have not satisfied all participants in the “no” camp. One submission, for example, raised doubts regarding the effectiveness of the recent Alberta legislation in protecting trust unitholders, citing a statement from Alberta Treasury in a request-for-comment that “statutory limited liability will apply to a beneficiary unless that beneficiary takes an active role in directing or administering the income trust.” The submission goes on to make the following points:

- We wonder whether shareholders of corporations have similar liability worries if they take similar “active roles” in the company as contemplated for in the legislation.
- Determining whether a beneficiary has played an “active role” will require the court's interpretation in the context of both the liability legislation and existing trust statutes. It remains uncertain as to whether a clear definition will be crafted or whether the province will leave it up to the courts to decide. Passive investors would not be well served by such uncertainty.
- It can probably be generalized that investors, portfolio managers, and analysts understand the nature of liability risk as it relates to being shareholders or corporations. It is doubtful whether there is a similar degree of understanding of the liability profiles of income trusts, at least presently — especially given that various liability legislation efforts are still in flux and untested in the courts.

In short, while many participants have seen unlimited liability as the key obstacle to including trusts in the Composite, and looked to recent legislative changes for the removal of this obstacle, it is clear from the comments above that this remains a very serious concern for some users of the Index.

Legal and structural differences

Opponents of inclusion say that a number of legal and structural differences make income trusts inappropriate for inclusion in the Composite. These can be grouped under three headings: **corporate governance, disclosure and transparency, and unitholder rights.**

Corporate Governance

The CCGG in its submission expressed the very broad concern that — in contrast to corporations — the governance practices of income trusts have never been systematically studied or evaluated and that these practices vary widely from one income trust to another. The CCGG states that governance practices should be examined thoroughly and understood completely prior to any inclusion of trusts in the Composite.

Indeed, even some proponents of including trusts in the Composite made the point that the lack of standardization among trusts can be problematic. Therefore, while it may be the case that trusts are not inherently weaker in the area of corporate governance, investors must rely on a case-by-case review of individual declarations of trust to know exactly where they stand — there is no legislative equivalent to the Canada Business Corporations Act (CBCA) that sets a standard for all. This can lead to higher monitoring costs on the part of investors.

Opponents of inclusion focused on the following specific areas where, in their view, trusts fell short of corporations in respect of corporate governance:

- In a trust, unitholders elect the trustees, and the trustees in turn appoint the members of the operating company's board, but unitholders may assume they are electing those who monitor the activities of the operating company.
- Trustees have a fiduciary duty to oversee distributions, but the amount of power they have over the operating company underlying the trust is unclear. Unitholders believe the trustees can intervene if management is incompetent, but the amount of power trustees have varies considerably from trust to trust. Trustee knowledge and experience also varies widely due to the low compensation levels.
- On the operating company's board of directors, members that represent the original sponsor may have a degree of control that is not proportionate to their economic interest. This can leave unitholders with little recourse for making a change in management.
- Decision-making in the operating business may be carried out by an entity other than the reporting entity. "Many governance rules apply only at the reporting level," one respondent wrote. "As a result there is a disconnect between where the governance rules are applied and where the key decisions are being made."
- Because trust law is relatively flexible and allows, but does not require, trusts to mimic corporations, investors "would have to take on the onerous task of considering on a case-by-case basis how each income trust differs from a business corporation."
- Some underlying operating entities are managed through external management contracts, creating a further removal of control and loss of transparency.

Proponents of inclusion say legal and structural characteristics of income trusts do not, overall, present risks that are greater than those faced by common shareholders, and they counter with variations on the following points raised in the CAIF/CIPPREC submission:

- Many income trusts have been established only recently and therefore incorporate the latest practices in corporate governance. In addition, in contrast to many public companies, income trusts have long separated the roles of chairman and CEO, and have maintained independent majorities on their boards of directors.
- The fund's trustees are bound by the highest fiduciary duties — a standard at least as high as that imposed on corporate directors.
- Distributing excess cash flows produces beneficial governance effects. Since trusts do not retain free cash flow, they must return to the capital markets or their lenders to fund new projects. The scrutiny and discipline imposed by capital markets and lenders keeps management from extending the trust beyond its core competencies. In addition, the focus on cash flows can be seen as an advantage over the corporate focus on GAAP-based performance metrics, which have shown to be easily manipulated.
- The vast majority of income funds, according to CAIF/CIPPREC, have internal management structures. CAIF/CIPPREC go on to point out that "Where external management structures are used, disclosure of the arrangements is generally transparent,

the market is familiar with these arrangements, and the characteristics of the particular industry in which the income fund operates are such that it makes sense to externalize certain activities.”

- Income trusts must comply with securities legislation, and with the rules and policies of securities regulators and stock exchanges, as must public corporations. Income trusts are *not* subject to the provisions of the CBCA. However, an income trust must comply with its declaration of trust, which typically addresses the most significant matters covered under the CBCA.

The following additional points were raised in support of trusts being included in the Composite from a corporate governance perspective:

- Yes, in some trusts, the sponsor controls a number of board seats in the operating company that is disproportionate to its economic interest. But this is no different from the multiple-voting shares of many companies in the Index. Existing corporate members of the Index have their own corporate governance issues, such as dual class share structures — we should not be setting the bar higher for income trusts.
- Finally, income trusts cannot change their fundamental investment objective without a unitholder vote. Corporations need no such approval.

Disclosure and Transparency

Under the heading of Disclosure and Transparency, the “no” camp makes the following points:

- With a trust structure the underlying corporation is no longer a public entity. As a private company, it is no longer subject to the same disclosure requirements as public companies.
- In addition, the trust is not required to disclose detailed financial statements of its operating company. Income trusts are also not required to disclose management compensation. Without detailed disclosure, investors cannot make informed decisions.

To which the “yes” side responds:

- It is unfair to generalize that all trust structures are more complex than all corporate structures. Several corporations in the Composite today have organizational structures that are just as complex as income trusts — again, we should not be setting a higher standard for trusts, however desirable improvements in this area might be.
- In February 2004, the Canadian Securities Administrators (CSA) issued a report on the disclosure practices of 40 income trusts and found no material concerns. In addition, the CSA recently issued National Instrument 51-102, “Continuous Disclosure Obligations,” which will improve disclosure practices and provide additional assurance that trusts are worthy of inclusion in the Index. As of March 30, 2004, it applies to all issuers, including income trusts, that are eligible for inclusion in the Index.
- In addition, since trusts must make monthly distributions, management focuses on generating cash flow, not on boosting GAAP-based net income, which is easily

manipulated. Cash distributions offer a great degree of transparency and material changes in the business quickly become apparent.

Unitholder Rights

Parties opposed to inclusion of income trusts in the Composite have identified three key gaps in investor rights that, in their view, distinguish unitholders of an income trust from shareholders of a corporation in Canada:

- Unitholders lack oppression remedies (Right of a shareholder to bring an action against a corporation in the event of corporate misconduct).
- Unitholders may not file derivative actions (Right to sue the management of a company on behalf of the company, where management has acted in a manner that is harmful to the company).
- Unitholders do not have access to appraisal remedies (Right of minority shareholders to demand an independent valuation of their shares in the event of a buy-out).

In response, those in favour of including trusts in the Composite make the following points:

- Oppression and appraisal remedies are lacking for shareholders in the United States and many other jurisdictions.
- It appears that exclusion of these two remedies in respect of trusts is deliberate and reflects a lesser need for them, first, because of the distribution of the trust's excess cash flow (usage of cash flow is a major area of concern addressed by these remedies) and, second, because of the requirement for unitholder approval of a change in fundamental investment objective (another major area of concern addressed by the remedies).
- The oppression remedy is primarily of concern with respect to private companies and not with respect to listed issuers on the TSX.

Are income trusts a separate asset class from equities and therefore inappropriate for the Index?

Some opponents to the inclusion of income trusts in the index argue that they are not equities. The question of whether or not income trusts are equities is obviously key to considering their inclusion in the Composite, since the Composite is intended to reflect the performance of the Canadian *equity* market.

One way to address this question is by looking at statistical correlations between the returns of trusts and other asset groups. S&P therefore calculated, as further background information for this paper, the correlations between selected indices that appear in Appendix B.

The data show that income trusts, as represented by the S&P/TSX Capped Income Trust Index, correlate much more closely with equities (the Composite) than they do with bonds (Scotia Capital Domestic Bond Universe Index). At the same time, it is worth noting that income trusts in Canada *do* show a much higher correlation with bonds than do Canadian equities — suggesting, as some argue, that income trusts are a kind of “hybrid” between equities and bonds.

But some participants argue that these arguments pre-suppose that income trusts are an asset class, as opposed to an alternative means of bringing asset classes to market.

Appendix B shows, for example, that when we control for different sector weights between indices, by pairing the S&P/TSX Capped Energy Trust Index with the S&P/TSX Capped Energy Index (the stock index), the correlation between trusts and equities is much higher: 0.7984. This suggests that on an “apples to apples” basis, when sector biases are removed, income trust and stock returns behave in a similar manner.

Those who believe that income trusts are not equities make the following points:

- Income trusts share characteristics with fixed-income securities and preferred shares, including redemption and limited life features, and could be considered a hybrid.
- Unlike equities, their cash distributions are often a mixture of dividends, interest, and capital gains.
- Analysts and the investment community treat them as a different asset class, with totally different research coverage and dedicated funds. Analysis by one respondent showed trust performance differs enough from both equities and bonds to be considered a separate asset class.
- Investors invest in equities for the purpose of achieving long-term capital appreciation. The investment purpose of income trusts is for enhancement of current income — they are “no growth” investments. Therefore inclusion of trusts in the Composite would render it useless as a benchmark. If trusts are added to the Index, pension funds and passive indexers may adopt a different benchmark because it will no longer represent their investment universe.
- Standard & Poor’s already publishes separate indices on income trusts. If investors want exposure to income trusts, they can amend their benchmarks and invest in those narrower indices.

Those who believe that they are equities argue as follows:

- First and foremost, income trusts have a residual claim on earnings. For some, this is the defining characteristic of equity and therefore the chief basis for their claim that trusts are equities.
- As for redemption or termination features of trust units, redemption could occur only “after the satisfaction of all outstanding obligations of the income fund,” according to CAIF/CIPPREC. And terms are extremely long, and for all practical purposes, indefinite.
- Some consider income trusts similar to high dividend-paying corporations, or simply as equities with 100% dividend payout ratios. Moreover, income trusts possess similar liquidity and trading characteristics to those of stocks currently in the Composite.
- Like common shares, unit prices react to news on the underlying fundamental activities of the trusts. Yes, they exhibit sensitivity to interest rates, but in a manner similar to that for high dividend-paying stocks.

- One broker commentator noted that, “Analysts covering trusts today are generally not trust analysts, they are equity security analysts — they do not just rank trusts on a simple yield/price ratio (the primary valuation metric used by retail investors in the early stages of development of the trust unit marketplace). Instead, they develop detailed models on a name-by-name basis.” Another commentator noted that analysts use many of the same valuation methodologies and metrics to evaluate income trusts that they use to evaluate common shares.
- Finally some submissions noted that, in fact, although they tend to be mature businesses, trusts do offer some capital appreciation like traditional equities. Although they pay out all their excess cash flow, they do access capital markets to take advantage of growth opportunities. Besides, the Index already includes slow growth companies such as utilities in addition to those with high growth and high multiples. We should not discriminate against trusts that demonstrate similar characteristics.

Concerns for individual investors

Some commentators raised concerns for the impact on individual investors if trusts are to be included in the Composite. They argue that individual investors may not completely understand the intricacies of the income trusts and trust law, and they may not be aware that the corporate governance standards and protections that common shareholders enjoy do not apply to unitholders. They therefore may not understand their exposure to potential loss.

In addition, while shareholders can rely on well-established legal protections to define their rights, unitholders must carefully examine complicated and sometimes difficult-to-access trust declarations in order to confirm their rights. This would be particularly detrimental to unsophisticated index investors who assume they have the same rights as shareholders.

Other commentators, however, point out that, in fact, the needs of individuals, particularly those in retirement, suggest that including income trusts in the Index would better serve that segment of investors. Trusts will make up an increasingly large portion of retirement portfolios because asset managers will be shifting to income-generating securities to meet the need for income of an aging population.

Even individuals that have not reached retirement are increasingly demanding yield and more control over their portfolios in the wake of scandals in the equity markets, and this will grow as more baby boomers come to the end of their careers. Income trusts satisfy a demand for . . . “higher yield, less reinvestment of cash flow, and less opportunities for management-investor conflict. As such, they can only grow in popularity under any taxation regime.”

In addition, unlike the past, investors today are better educated on income trusts and appear to understand the risks, according to CAIF/CIPPREC.

Representativeness of the Composite

For those who believe that income trusts are not equities, representativeness is not an issue, since they do not believe that income trusts are a part of the equity “picture” in Canada. Indeed, from this perspective, the inclusion of income trusts would make the Composite *less* representative.

However, for a number of commentators, including some that, ultimately, oppose inclusion of trusts in the Composite, there is a very serious concern that the Composite is becoming less reflective of the Canadian economy — in violation of one of its key objectives.

With the recent proliferation of income trusts and the conversion of corporations to the trust structure, the Index no longer adequately represents energy, real estate, and other sectors. If trusts continue to be excluded from the Index, “there will be a continued weakening of the traditional Canadian indices as some existing constituents are re-engineered into trusts, making composite benchmarks less relevant.”

Several submissions noted that income trusts are found in nine of 10 GICS[®] sectors and offer investment opportunities in sectors where opportunities are limited. Including them in the Index, which currently lacks breadth, would add diversification benefits. Their “pure play” nature would also contribute to diversification.

In addition, income trusts, which tend to be mature businesses and have demonstrated cash flows, show a relatively low correlation with the Composite as it exists today and should therefore reduce the volatility of the Composite if they are included.

Another objective of the Index is to be a proxy of investment opportunities available to investors. It will fail to do this if it excludes a growing sector of the market.

Index turnover and transaction costs

Since trusts pay out all of their excess cash flow, they must finance their growth by issuing additional trust units. Opponents to inclusion argue that this will result in frequent and significant float adjustments, which will result in increased index rebalancing.

While some have raised concerns about the liquidity of income trusts, those in favour of inclusion do not expect that Index transaction costs would rise due to lack of liquidity. “Contrary to popular belief, liquidity of the Index would not be reduced materially, as the average float turnover for the trusts that qualify is only slightly lower than the average Composite Index stock (and that is without the benefit of the portfolio trading that takes place in the Index).”

Tax laws and friction in stock borrowing and lending for trusts

Some respondents noted that the tax laws allow certain securities to be borrowed and lent without income tax consequences for either party. They pointed out that this is critical to investability in respect of index constituents in that it allows investors to borrow stock to cover short sales. With income trusts, the “high cost of borrowing is a real obstacle in the investability . . . It’s also very difficult to have a short position in a high distribution stock, especially when the distribution is a combination of dividend, capital and interest with different tax issues depending on the holder.”

These respondents concluded that, because indexes are the basis for so much trading in futures and options contracts, income trusts should therefore not be eligible for the Composite until changes to the tax laws affecting borrowing and lending of income trusts are made.

CAIF/CIPPREC, however, noted the legislation introduced in February 2004 that would change the tax rules to change the definition of a “qualified security” to include listed units of income trusts.

“In proposing this change, the Department of Finance acknowledged that the attributes of listed mutual fund trust units (i.e., income funds), in the context of securities lending rules, are very similar

to those of listed stocks and bonds,” CAIF/CIPPREC noted. “Accordingly, while there may have been ‘investability’ issues in the past, we believe that income funds are now ‘investable’ with respect to short trading positions.”

Should tax leakage and the possibility of less favorable tax treatment keep income trusts from becoming eligible for the Index?

With the increasing popularity of income trusts in recent years, the federal government has become concerned that it is not capturing the tax revenues that it would if these investments had been in common shares. As a result, a number of those opposed to inclusion raised the point that there is a growing risk that the favorable treatment of income trusts will be changed.

“There is significant tax risk in the income trust market,” according to one respondent. “The substantial revenue loss by federal and provincial governments makes it a virtual certainty that the government will introduce legislation to eliminate this tax loophole.” In support of this view, some respondents quoted federal government estimates from the last budget of revenue losses as high as \$1 billion.

The impact on valuations would be dramatic. “If income trust taxation is brought into line with corporate taxes, we would expect that income trusts would decline in value 25% or more almost immediately.”

Those in favour of inclusion generally believed that raising tax issues is a red herring. The Index should represent the universe of available investments, regardless of their tax treatment. The potential taxing of income trusts remains a concern, “but no more than the differing tax treatment of dividends, capital gains and ordinary income that are all subject to legislative change at any time.” If the tax law is changed, it will be signaled far in advance to avoid a shock wave in the markets.

Furthermore, some noted that the lost tax revenue has been exaggerated and may be a myth. CAIF/CIPPREC referred to a study by HLB Decision Economics Inc. that they funded in 2004 that found that the leakage amounted to approximately \$102 million. In fact, if the present value on deferred taxes, which amounted to \$223 million, is factored in, tax revenues show a net gain of \$121 million.

Government revenues may actually be increasing as a result of the growth in income trusts. Tax rates on individuals, including pensioners, are higher than on corporations, so the federal government may be capturing more tax revenue as a result.

Should the possible reintroduction of limitations on trust ownership by pension funds keep trusts from becoming eligible for the Index?

Related to the tax leakage issue is the legislation that the federal government introduced in 2004 that was designed to limit ownership of income trusts by registered pension plans in order to reduce perceived leakage. After vocal opposition by some pension plans, it withdrew the proposal and is now consulting with the industry about the matter.

Opponents to inclusion argue that, unlike the more speculative concerns over action that the government might take, the pension plan ownership limitations were very real and that, “If similar measures were introduced in the future and income trusts were included in the index, the Index would become less investable to registered pension plans.”

Others counter that, given the opposition of pension plans, the government may not reintroduce the proposal, which discriminates against one class of investors. But if it does, “then the Index Committee can examine those investments to which the discrimination applies with a view to then dropping them from the Index.” For the “No’s,” however, the risk of higher Index turnover that such a reversal would represent is not worth taking, given that the government has already signaled its intention to act.

II. Suggested Solutions

Respondents generally recognized that the inclusion of trusts is not a simple “yes or no” question. Many of those opposed set out conditions that they felt would need to be met in order for trusts to be eligible at some future date. And many of those in favour suggested intermediate alternatives to outright, immediate inclusion in the Composite. These views are summarized in the following points:

- “Liability and governance risks should be equalized for common shares and income trust units . . . This would make the risk profile of income trusts and corporations more homogeneous and a resulting benchmark more relevant.”
- The Canadian Securities Administrators should develop a National Instrument that provides a governance regime consistent with the regime for corporations.
- “Effective and uniform liability legislation needs to be passed in all relevant jurisdictions prior to considering all income trusts to be included.”
- Maintain the status quo. “S&P already has indices related to income trusts. If investors decide they want exposure to those securities, they have the freedom to make the explicit decision to amend their investment benchmark.”
- Publish two indexes, a Super Composite including trusts and one excluding trusts. Adding trusts to the Index would make the historical returns invalid. Having two indexes would help clients understand the change. Having two indexes would also mean that fund managers wishing to include trusts in their benchmark would have the ability to switch to the Super Composite at a time of their choosing.
- Allow for inclusion in the Index only trusts domiciled in provinces such as Alberta that have legislation providing protections similar to those provided to shareholders.
- Trusts should be phased into the index in an orderly and gradual manner over many quarterly index rebalances.

Appendix A:

Simulation of Income Trust Inclusion in the Composite

The tables below show the impact that the inclusion of income trusts would have had on the Composite if the Composite rules in respect of float market capitalization and liquidity had been applied to income trusts for the Third Quarter 2004 index rebalancing (i.e., data as of end of August 2004).

Note that this simulation is provided for guidance only, based on existing rules and market data. It should not be interpreted as an indication of S&P's intentions on this question. Nor should it be considered a forecast of what would actually happen if trusts were in fact to be included in the Composite. A number of factors — market conditions, rule changes, Index Committee discretion — could cause the actual make-up of a Composite that included income trusts to differ substantially from the picture presented here.

Table 1 shows the impact on some key macro statistics for the Composite. Table 2 shows the impact that the inclusion of income trusts would have on the sector weights of the Composite, based on the GICS[®] industry classification system.

TABLE 1: Impact on Key Composite Statistics

	Existing Composite	Composite With Income Trusts	Change
Number of Constituents	223	279	56
Market Cap of the Index (bill.)	\$831	\$895	\$64
Indicated Dividend Yield	1.82%	2.36%	54 bps.

TABLE 2: Impact on Composite Sector Weights

GICS [®] Sector	Sector Before	Weight (%) After	Change
10 - Energy	17.57	20.09	+2.52
15 - Materials	16.61	15.95	-0.65
20 - Industrials	5.99	5.99	+0.00
25 - Consumer Discretionary	6.44	6.43	-0.01
30 - Consumer Staples	4.37	4.22	-0.15
35 - Health Care	1.72	1.60	-0.12
40 - Financials	33.86	32.55	-1.31
40401010 - Real Estate (sub-ind. of Financials)	0.57	1.64	+1.07
45 - Information Technology	7.01	6.51	-0.50
50 - Telecommunication Services	4.98	4.68	-0.30
55 - Utilities	1.45	1.97	+0.52

Source: S&P Canadian Index Services

Appendix B:
Are Income Trusts Equities?

Selected Correlations

**TABLE 1: Correlation Coefficients of Monthly Total Returns For Selected Indices
(December 1997 – September 2004)**

INDEX PAIRING	CORRELATION COEFFICIENT
S&P/TSX Capped Energy Index versus S&P/TSX Capped Energy Income Trust Index	0.7984
S&P/TSX Composite Index versus S&P/TSX Capped Income Trust Index	0.4790
S&P/TSX Capped Income Trust Index versus Scotia Capital Domestic Bond Universe Index	0.3256
S&P/TSX Composite Index versus Scotia Capital Domestic Bond Universe Index	0.0723

Source: S&P Canadian Index Services, Scotia Capital Markets