



INVESTMENT INDUSTRY ASSOCIATION OF CANADA
ASSOCIATION CANADIENNE DU COMMERCE DES VALEURS MOBILIÈRES

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February 16, 2011

The Honourable James M. Flaherty
Minister of Finance
Department of Finance Canada
31st Floor, East Tower
140 O'Connor Street
Ottawa, Ontario K1A 0G5

Dear Minister:

Re: Address Needs of Junior Issuers and Small Dealers by Reversing Tax Change

On behalf of the Investment Industry Association of Canada (IIAC), I am writing to ask that the former tax treatment of broker warrants – a relatively little-known financing and cash cost of financing option – be restored. Specifically, we request that these instruments be prescribed as a “prescribed property” under paragraph 142.2(1)(e) of “excluded property” in the Income Tax Act (Canada) (ITA) and therefore not be a “tracking property” that is a “fair value property” of the taxpayer for the taxation year¹. We think this change will help hundreds of regional junior issuers to grow, with minimal if any impact on government revenues. In addition, restoration of the previous regime will also assist Canada’s smaller independent regional dealers to continue to service this important sector of the market. The enclosed attachment describes the issue in greater detail, demonstrating that this is an opportunity to provide stimulus essentially without incurring a tax expenditure. Indeed, the likelihood of renewed issuance opportunities and reduced issuing cash cost is likely to contribute to job and tax revenue growth.

We believe that the effect of the original tax amendment on broker warrants was unintentional and ask you to consider a regulation exempting broker warrants or a technical Income Tax Act change in the 2011 budget. We would be pleased to discuss this with your officials at any time.

Yours truly,

¹ Part of amendments to the *Income Tax Act and Regulations in Legislative Proposals and Explanatory Notes Related to the Taxation of Financial Institutions*, published in draft on November 7, 2007 and assented to in 2009. The IIAC wrote to Finance on July 10, 2008 and engaged in useful discussions with officials on the subject. Our members have now had a chance to evaluate the impact of the change in tax treatment and remain concerned by its effect on their clients and their firms, and ultimately the Canadian economy.



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IMPACT OF TAX CHANGES ON BROKE WARRANT ISSUERS AND UNDERWRITERS

1. Tax Policy Regarding Warrants

We agree that requiring unexercised traditional warrants to be valued, and unrealized profits on these warrants to be recognized as income and taxed, is appropriate tax policy within the current tax system. Traditional warrants, frequently attached to bonds or preferred shares, are sold as part of such securities to investors, and typically entitle the holder to buy the underlying stock of an issuing company at a fixed price until the warrants' expiry date. They are issued by many companies in the public market as a "sweetener," allowing the issuer to attract potential buyers while paying lower interest rates or dividends. They differ in many ways from broker warrants, as evident from the table below.

2. What Are Broker Warrants and Why Are They Important?

Unlike in the case of traditional warrants, broker warrants are issued to underwriters only by issuers that are almost exclusively in the junior capital market. Such issuers include small resource firms looking for mineral, metal or energy deposits or research and innovation firms, both representing key sectors of the Canadian economy and areas of high risk for capital providers. These warrants are a capital-raising option and a cost-reducing strategy that enables issuers that may lack the income track record of larger companies, or smaller companies in less risky areas of endeavour, to access financing. The table below highlights some of the material differences between broker and traditional warrants.

Feature	Broker Warrant	Traditional Warrant
Issuers	Mainly junior issuers – issuers without an earnings record	Usually mid- to large-sized firms in senior markets
Underwriter profile	Mainly small or mid-sized dealers	Mainly large dealers
 HOLDERS	Dealers	Investors
Term	Typically 18 months to two years	Typically 18 months to two years
Tradable	Never or extremely rarely transferable	Always or usually tradable
Other restrictions and constraints	Often have a hold or restricted period imposed where the warrant cannot be exercised; in almost all cases, broker warrants are not transferable without consent, and, even when transferable, may not be traded for long periods	Rarely an issue

Minister Flaherty
 Re: Exempting Broker Warrants
 February 16, 2011

Feature	Broker Warrant	Traditional Warrant
Reasons (other than market price) that warrants may not be exercised	May lead to follow-up financings and/or to the underlying security being suspended, both of which events may prevent all or part of the broker warrant position from being exercised at certain times or ever; also, dealers will rarely exercise broker warrants without first raising the purchase price through sales to avoid additional capital charges for regulatory purposes	Not applicable
Volatility	Trading prices (and underlying share prices) considerably more volatile than those of typical warrants and shares – most expire worthless as they are issued by junior issuers in the early stages of development, which are inherently more risky propositions	Typically less volatility
Salability/ lack of liquidity	May not be able to be sold back into the market if they are in the money, as many of the issuers that use broker warrants do not have significant liquidity and the attempted sale of these securities may have a negative effect on the value of the issuer's securities	Rarely, if ever, an issue
Valuation model	No standard and can be highly subjective as the Black-Scholes model cannot price warrants effectively because it assumes the ability to trade/transfer warrants (see 3. below); even with adjustments, the Black-Scholes model can yield nonsensical results and no other standard models have been identified	Black-Scholes valuation or equivalent model, with some adjustments
Systems/ operational issues	Complex and manual process due to the amount of data-gathering (see 3. below)	Largely automated for listed issues based on easily accessible current prices and widely accepted formula

3. Economic Impact of Current Immediately Taxable Treatment

Taxing broker warrants has affected both junior issuers and the almost exclusively small and mid-sized investment firms servicing this market.

Issuer Impact:

Underwriter interest in such issuers declined as the underwriter cost-benefit analysis shifted into the red in some cases. The support of the underwriters is critical to junior issuers as:

Minister Flaherty
Re: Exempting Broker Warrants
February 16, 2011

- These issuers have fewer financing options that are often essential for their survival, as a minimum in these issuers' early years of operation. They would face a higher cash financing cost in the absence of broker warrants – selling commissions would likely increase by as much as 25%. Also, as the selling commission does not apply in the case of warrants' exercise, broker warrants result in maximum financing after fees and an even lower overall cost of capital for the issuer.
- The underwriter accepting the broker warrants in lieu of traditional compensation encourages a more active following of the issuers' stock and market-making, helpful to the future growth of the issuer.
- Larger firms do not typically cater to this market.

The effect of reduced capital-raising alternatives is less growth potential for small and medium-sized companies seeking financing, particularly those listed on public markets. This is contrary not only to the interests of these issuers, their investors and the intermediaries, but also to the Canadian economy, which relies on such businesses to generate economic activity and growth.

Also, taxing unrealized gains may lead to some behaviour being driven by tax, rather than business considerations. Firms may be compelled to exercise warrants sooner than desirable to lock in a gain rather than pay tax on an apparent gain that may not exist at the warrant's exercise date. This will put greater downward pressure on prices of the related stocks, which is in neither the issuer's, the investor's, nor the public's best interest.

Dealer Impact:

Not only is tax paid on gains that may not materialize (and even if there are gains, an underwriter may choose not to exercise due to illiquidity and the possible effect on the value of the issuer's underlying securities or the dealer's regulatory capital requirements), it must be paid from earnings from other parts of the business, leading to a secondary economic impact.

Moreover, the taxation of unrealized capital gains on all broker warrants is labour-intensive. Fairly straightforward in the case of traditional warrants of listed issuers, which typically use the Black-Scholes or an equivalent model and data feeds from market data providers, it is considerably less so in the case of broker warrants. The conventional Black-Scholes model presumes constant volatility, no barriers to trading, perfect liquidity, and that the warrant will only be exercised on expiration date – as these conditions essentially do not apply in the case of broker warrants, the Black-Scholes model cannot realistically be used to value broker warrants. Other valuation tools have drawbacks also (and poor models, or incorrect model assumptions, proved to be partly to blame for the recent financial crisis).

Although Excel or equivalent spreadsheets help with the computations, the broker warrant valuation process is of necessity more manual and complicated. This is due to the absence of or difficulty in obtaining certain data (e.g., price of the underlying security, price volatility,

Minister Flaherty
Re: Exempting Broker Warrants
February 16, 2011

trading volumes, market depth at the bid price); the need to consider market actions, status of the ongoing relationship with the issuer and other factors; and the fact that the calculation must be done twice (even for what prove to be out-of-the money warrants), instead of only at the exercise date. Warrant exercise price and quantity data must be entered, verified, monitored, updated with monthly closing prices for the underlying security, and we are as yet unaware of any service providers that offer feeds of quotes into a database of broker warrant data. Although data access can be equally challenging in the case of unlisted traditional warrants, this complex process is more challenging for small dealers to comply with due to smaller staff complements and it is the smaller dealers that tend to issue broker warrants.

It should be noted that variations in values over different periods that could give rise to taxes payable in one period and tax refunds in another is an administrative and cash flow complexity not only for dealers, but also for the Canada Revenue Agency (CRA).

Combining the impact on issuers and dealers

With rare exceptions, the underwriters accepting broker warrants are small to mid-size dealers. Indeed, the majority of financings on the TSX Venture Exchange involves small dealers as lead or syndicate underwriters. It is noteworthy that:

- 202 or 70% of initial public offerings (IPOs) in 2009 came from the TSX Venture (TSXV)
- The TSXV represented 61% of total issuers and 68% of new listings in 2009
- Over 150 of these issuers have graduated to the TSX since 2007.

We believe that this clearly establishes the link between small dealers, small issuers that start on the TSXV, and these issuers' ability to grow and move to the TSX. It should therefore also be a concern that the predominantly small dealers serving smaller issuers are facing significant cost pressures at this time. This is in large measure due to increasing regulation and compliance costs, and to related demands for increased technology to address regulatory concerns that largely were not (if at all) of these small dealers' making. In fact, many concerns arose from actions outside our borders.

Where small size makes it difficult for underwriters accepting broker warrants to compete on the basis of economies of scale, these firms have built business models that enable them to compete instead on the basis of their underwriting and corporate finance specialization for small private and public issuers, personalized service and a regional focus. That said, over 10 small dealers were wound up/merged or were taken over since January 2009 and there are increasing regulatory, economic and operational barriers to entry for start-up firms. **A reduction of specialized dealers and fewer or no new entrants cannot but lead to less choice, reduced competition and increased impediments to industry evolution.**

Minister Flaherty
Re: Exempting Broker Warrants
February 16, 2011

4. Summary

We believe that an exemption for broker warrants from the standard tax treatment of mark-to-market property is appropriate and will benefit the three stakeholder groups below, without disadvantaging anyone of whom we are aware:

- Small issuers will be able to access capital that they might not otherwise have been able to obtain and at a lower cost by providing some upside to the dealer. In turn, these issuers can access more capital in the future, with no additional issue costs, if the broker warrant is exercised.
- While the dealer foregoes a portion of the current fee in exchange for a potentially larger fee in the future, in the process, the dealer is encouraged to continue to follow and support the issuer beyond the closing, serving both issuer and investor clients and the regional economies where most of such issuers are located.
- Federal and provincial tax coffers benefit from additional taxes on the dealers' profit, upon the future exercise of the warrants, and as the issuer ideally grows and starts earning steady income, especially to the extent the issuer expands and creates new jobs.

The value of the above benefits, we believe, would be found to exceed the cost to government of the current recently mandated tax treatment: as broker warrants are almost always exercised within two years (and many expire worthless), there is a time difference only, and the time value of money is trivial in this low interest-rate environment. In fact, the time value of the tax revenues to the government may be outweighed by the higher cost to small underwriters of valuing, calculating gains, remitting and declaring a loss the following year. In this, the work associated with the tax treatment is an example of a measure that the Red Tape Reduction Commission, promised in last year's budget and announced on January 13, 2011, is considering as a way to lower the burden of complying with federal regulatory requirements. As the Commission webpage notes, removing unproductive red tape would represent "... a low-cost way to stimulate the economy and boost productivity as Canada emerges from the global recession."

5. Recommended Exemption

We request that broker warrants be prescribed as a "prescribed property" under paragraph 142.2(1)(e) of "excluded property" in the Income Tax Act (Canada) and therefore not be a "tracking property" that is a "fair value property" of the taxpayer for the taxation year. For purposes of the regulation, the following definition of broker warrant could be used.

"A broker warrant is effectively an option granted by an issuer to the dealer(s) concurrent with a capital financing that provides the dealer(s) with the right, but not the obligation, to acquire securities of the issuer at any time (subject to restrictions) during a defined future period at a predetermined price, which is generally at or above the price of the capital financing. Securities regulators

Minister Flaherty
Re: Exempting Broker Warrants
February 16, 2011

generally restrict the trading in the security and any derivative securities by the subscribers and the dealer(s) for a prescribed period (typically four months).”

As can be seen from the above, and in contrast to traditional warrants, broker warrants are held by dealers rather than investors broadly, no benefit is immediately conferred upon the dealer by the issuer, and there is no certainty that the broker warrant will be exercised for a profit.