



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

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July 7, 2011

Mr. Alexander Johnstone
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Dear Alex:

Re: Additional Background re Broker Warrants and Tax Policy Matters

We appreciate your continuing efforts to review the mark-to-market taxation of broker warrants. Further to our July 10, 2008 and February 16, 2011 submissions, April 8 call and May 2 follow up e-mail, below is additional information regarding broker warrants that may help you complete the additional due diligence underway. As requested, we are providing: (1) information on broker warrants that we think may be helpful in the absence of much available information through the internet and other sources and (2) some tax policy considerations.

I. Additional General Information

a. The regulator's view regarding the value of broker warrants

While we know that regulatory and tax purposes and requirements differ, we think that the value that the brokers' primary regulator effectively ascribes to broker warrants is relevant to the consideration of broker warrant taxation. The Investment Industry Regulatory Organization of Canada (IIROC) has determined that the assets for which broker warrants are received as part of compensation are to be treated as Non-Allowable Assets for purposes of firms' risk-adjusted capital (RAC) calculation. RAC is a critical part of the regulator's early warning (EW) system designed to provide advance warning of a dealer member encountering financial difficulties, anticipating capital shortages and/or liquidity problems.

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The value of broker warrants – whatever value is attributed to them – is deducted from RAC because they are illiquid and the receipt of value is out of the dealer member's control due to being contingent on a wide range of factors. Details of the RAC calculation can be found at http://www.osc.gov.on.ca/en/Marketplaces_srr-iiroc_20110304_sn-nca-amd-form1.htm.

Of note, not only must the value of broker warrants be excluded from RAC, but also requiring brokers to pay taxes on the basis of a “constructed” mark-to-market value of broker warrants has a further negative impact on RAC. The tax provisions are deducted from net income that adds to RAC – a double whammy even *before* the cash outlay effect of paying taxes early when the related income may never arise.

b. Valuation issues – accounting rules and practical application

CICA S.3855.04 provides that fair value is the only relevant measure for derivative financial instruments, such as broker warrants, and requires them to be measured at fair value. CICA S.3855.19(j) defines fair value as “the amount of consideration that would be agreed upon in an arm’s-length transaction between knowledgeable, willing parties who are under no compulsion to act” (*emphasis added*). The “no compulsion to act” is of relevance in the situation where the *Income Tax Act* changes referenced in the industry’s July 10, 2008 and February 16, 2011 submissions effectively force a decision to act in a way other than how the holders would act in the ordinary course of business.

CICA S.3855.73 states: “The best evidence of fair value is a published price quotation in an active market” and CICA S.3855.A47 indicates that recent transactions can be used to help derive price. As discussed in the earlier correspondence, there is no active market or market at all for broker warrants as such warrants are not transferrable. Also, while the security that the broker warrant entitles the broker to buy has a market, it frequently is not active as discussed below.

CICA S.3855.73 also provides that: “When the market for a financial asset or financial liability is not active, an entity establishes fair value by using a valuation technique. The chosen valuation technique makes maximum use of inputs observed from markets, and relies as little as possible on inputs generated by the entity”. This is not always possible due the lack of a market for these warrants.

To help in determining an appropriate valuation technique to be used for the valuation of broker warrants where there is no active market, CICA S.3855.A47 indicates that recent transactions, discounted-cash-flow analysis and option-pricing models are possible valuation techniques to consider. A realistic estimate reflects how the market could be expected to price the broker warrant, and the inputs to the valuation technique represent market expectations and measures of the risk-return factors inherent in the broker warrant.

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The Black-Scholes Option Pricing Model is frequently used to price warrants in an active market. Black-Scholes assumes that the pricing of the warrants is based on retail value – in fact, the brokers receiving broker warrants would price securities on a wholesale basis and the non-transferability also militates against use of the retail value determined by Black-Scholes. CICA S.3855.A49 discusses inception profit and acknowledges that it cannot be recognized until the realizable value of the retail value can be reasonably measured. This suggests that, for broker warrants reasonably to be measured, the Black-Scholes method must further be reviewed in relation to the attributes of the underlying security. These attributes include:

- i. There is continuous (active) trading in the underlying stock
- ii. It is possible to short-sell and reliably borrow the underlying stock
- iii. The level of market volatility of the underlying stock is low
- iv. The time to maturity when valued is more than 12 months.

CICA S.3855 requires there to be sufficient observable market inputs reasonably representing market expectations for a particular valuation technique to be used. If the above variables and assumptions cannot be met, then the Black-Scholes model will be determined to be unreliable and the broker warrants will be valued at their intrinsic value. One member firm has agreed with its auditors that the Black-Scholes model will be used to value broker warrants except where two or more of the above conditions do *not* apply, in which case value would be based on factors that market participants would consider in setting a price for a non-transferable warrant. **Attached are details of a sample member valuation policy, which was presented for industry consideration as a standard practice in 2008 when IIAC members sought to ascribe some value to the warrants for regulatory purposes.** This includes as #5 an additional cost to which a broker warrant holder can be subject, before the tax impact.

A member advised that, during 2010 on the basis of applying the attached valuation policy, Black-Scholes was used six times on a portfolio of 52 issuers, up from one item in 2009 out of a portfolio of 30 issuers. The increase in use of Black-Scholes in 2010 was attributed to the increase in the number of issuers that had been added to the list of "Highly Liquid" securities determined by IIROC as a result of a highly active commodity market that increased trading levels in the securities of issuers that more typically issue broker warrants. **Other members concur that this type of percentage is reflective of their business.**

c. Confirming term

As discussed, there is little to be found by standard means of enquiry on broker warrants due to the particular market of issuers targeted, however, one release published does confirm the short-term nature of broker warrants (<http://www.newswire.ca/en/releases/archive/November2010/30/c9140.html>).

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d. Confirming lack of market price

As discussed, there is no public market, meaning no market price, for broker warrants (<http://www.newswire.ca/en/releases/archive/November2010/30/c9140.html>).

II. Tax Policy Considerations

There are a number of principles cited as representing good tax policy, with the three most frequently referenced being fairness, neutrality and administrative/compliance simplicity.

Of particular importance is **neutrality**, minimizing distortions in the economy and interfering as little as possible in the decisions of people – issuers or investors in our case – in the marketplace. As noted in our February 16 submission, we referenced the types of issuers and brokers that use broker warrants: 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.

The current *Income Tax Act* reflects government policy in regard both to smaller entities and particular sectors, e.g., oil/gas/commodity and research/innovation/technology firms. Both categories have more advantaged tax treatment, we believe, due to significant expenditures required, the high risk that many investments will not be successful and, at the same time, their importance to Canada's economic growth.

The *Income Tax Act* provides tax relief to:

- small businesses through a lower tax rate and deductions (as, we believe, small business is considered a job and economic growth generator);
- oil/gas/energy through Canadian resource property, Canadian exploration expense, Canadian development expense and Canadian oil and gas property expense treatment (as we believe that the oil and gas industry is credited, in part, with helping lead Canada out of recession and will continue to support growth as global energy demand is projected to increase significantly); and
- to research and innovation firms through accelerated capital cost deductions and scientific research and experimental development tax credits (as, we believe, the government supports attraction of higher-value-added businesses and jobs).

In terms of the tax policy principle of **fairness**, our February 16, 2011 letter mentions that traditional warrants are different in many material ways from broker warrants and that brokers compensated in this way are very limited in number. We believe that reasonable people will agree that restoring the former non-mark-to-market tax treatment will be seen as fair and not as leading to an unlevel playing field between competitors as broker warrants differ so significantly from traditional warrants in terms of issuers, underwriters and trading/non-tradability.

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Finally, in terms of ***administrative simplicity***, while the final paragraph in section 1.b above suggests that there is still some use of Black-Scholes, the data also reflects the uncertainty in many market scenarios of when at least two attributes will apply. Even in these situations, as mentioned in our February 16, 2011 letter, there is considerably more tracking and analyzing, which is largely a manual and extremely time-intensive process.

We hope that we have demonstrated that restoring the tax treatment of broker warrants is consistent with the three key tax policy principles and that all broker warrants, which are easy to identify on audit, will be restored to non-mark-to-market tax treatment.

Thank you again for your attention to this matter and we hope that the foregoing is helpful. Our members would be pleased to provide additional information should you require it through a further call or calls on a one-to-one or group basis.

Yours sincerely,

A handwritten signature in blue ink, appearing to read "Audra", is positioned below the "Yours sincerely," text.

Cc: Graham Nash

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Attachment

Sample Broker Warrant Valuation Considerations

1) *Is there a continuous market for trading in the security?*

The security must be liquid and therefore from an operational perspective we need an observable measure of what is not liquid.

The security will be considered thinly traded and therefore, the trading in the stock will be assumed to not be continuous if it trades less than 100 times per trading day and/or has an average trading value of \$1,000,000 or less per trading day. This is based on the definition of a highly liquid security per the Investment Industry Organization of Canada ("IIROC"), an observable measure as the list is compiled daily.

Per the IIROC website, the definition of a highly-liquid security:

A "highly-liquid security" is defined as a listed security or quoted security that:

- has traded, in total, on one or more marketplaces as reported on a consolidated market display during a 60-day period ending not earlier than 10 days prior to the commencement of the restricted period:
 - an average of at least 100 times per trading day, and
 - with an average trading value of at least \$1,000,000 per trading day; or
- is subject to Reg. M and is considered to be an "actively-traded security" under that regulation."

If the security does not meet the IIROC criteria for a highly-liquid security, then Black-Scholes would not be used as there would not be a broad population of market participants to establish a competitive market value.

2) *If the market is continuous, can the stock be reliably borrowed in order to establish and maintain a short position to avoid the buy-in market risk?*

IIROC requires \$1.50 as a base price for margin purposes. This is important as stocks below this value must be fully paid for and held in segregation. It would be a securities law violation for a firm to lend out such fully paid securities or to use them to cover short positions of their other clients or themselves. House rules [internal firm requirements] would raise the base price for margin purposes to \$3.00/share, hence shares trading below \$3.00 are usually fully paid for, in segregation and not available to be lent to cover short positions.

Therefore, the observable market for securities lending indicates a short position is not likely to be able to be established and maintained for Canadian stocks trading under \$3.00 per share and Black-Scholes would not be a reliable valuation technique.

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3) *If there is an active market and the security can be reliably borrowed, pricing is then based on the volatility of the underlying open market security.*

The greater the volatility, the greater the bid/ask spread and less the bid/ask size will be for the warrant. The greater these spreads are, the less likely that a transaction will be consummated for the warrant and the less reliable the Black-Scholes value will be as a measure of fair value. Therefore for underlying securities whose volatility over the previous 6 month or 12 month periods exceed 40%, the Black-Scholes method will not be used.

4) *If there is an active market, the security can be borrowed and volatility is such that a fair value can be reliably established, the spread between market price and exercise price should be considered to determine if the warrant is deep out of the money.*

This is particularly important when the time to maturity is short. Therefore, Black-Scholes will not be used in situations where the time to maturity is less than 12 months and the exercise price is 50% or greater than the current market price.

In circumstances where Black-Scholes is not to be used for the reasons noted above, the valuation technique to be used will be intrinsic value.

5) *Broker warrants exercisable into restricted shares*

In situations where the warrant has been obtained in a private placement transaction, generally there is a hold period of four months plus a day from the issue date of the warrant thereby restricting the ability to close out hedge positions established in accordance with the Black-Scholes model using the securities underlying the warrant. This hold period increases the “buy-in” risk during that period of time. Buy-in risk can result in the hedge being unwound involuntarily at up to a 15% premium to the current market price under rules established by the Canadian Depository for Securities. Therefore, establishing the hedge contemplated in the assumption underlying the Black-Scholes model must consider this risk and during the hold period the market price should be divided by 1.15 before applying the Black-Scholes model in addition to considering the factors discussed above.