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

Ian C.W. Russell, FCSI
President and CEO

September 15, 2006

The Honourable James M. Flaherty
Department of Finance
140 O'Connor Street
Ottawa, ON
K1A 0GF

Dear Minister:

Re: Securities Lending and Proposed Legislation to Eliminate the Double Taxation of Large Corporation Dividends

The Investment Industry Association of Canada[1] (the "IIAC") urgently brings to your attention an issue with respect to the proposed legislation, released by the Department of Finance on June 29, 2006, to eliminate the double taxation of large corporation dividends (the "Proposed Legislation"). While the IIAC will be submitting under separate cover general comments on the Budget 2006 Income Tax Measures document released on August 31, we write today because the draft legislation fails to recognize the special treatment of listed public securities under securities lending arrangements in its application to dividends for lenders of such securities. This could seriously interfere with short-selling in the marketplace and damage the liquidity and efficiency of the capital markets in Canada.

Background

A prerequisite for liquid and efficient capital markets is the ability of buyers of stock to find sellers in almost all circumstances. While the sellers of stock are often the actual owners of such stock there are also, as you know, many short-sellers (i.e. so-called "market makers"). In this circumstance, they need to be able to borrow the shorted stock from an actual owner.

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[1] On April 1, 2006, the Investment Dealers Association of Canada (IDA) legally divided into a self-regulatory organization (SRO) and IIAC – the industry association. The Association represents the position of the Canadian investment industry on regulatory and public policy issues. Its mandate is to promote efficient, fair and competitive capital markets for Canada while helping its member firms succeed in the industry.

If, when a stock is borrowed or during the term of the securities loan, a dividend is declared on the stock, the borrower is typically required to pay a dividend compensation payment to the lender. Under subsection 260(5) of the *Income Tax Act* (Canada), a taxable lender is normally entitled to treat the dividend compensation payment as an actual dividend. However, under the proposed draft legislation, if the actual dividend would otherwise be an "eligible dividend" (i.e., a dividend entitled to the preferred dividend tax credit treatment), the Proposed Legislation precludes the dividend compensation payment from being treated as an "eligible dividend". This occurs because the dividend will not have been paid by the issuer and therefore the corporation cannot designate such a payment as an eligible dividend.

Concerns

The fee payable to a lender for a loan of stock typically ranges between 10 and 25 basis points on an annualized basis. However, if a taxable lender is not entitled to treat a dividend compensation payment as an eligible dividend, the added cost to the taxable lender will discourage taxable owners from lending stock in the future.

There are very large amounts of stock currently in the hands of taxable owners that are then, in many cases, lent out. The three major categories of such owners are financial institutions (i.e., banks and securities dealers), mutual funds, and individuals (including the tens of thousands of individual retail investors who maintain margin investment accounts at our member firms[2]). If these persons are unwilling to lend stock in the future due to the tax consequences of the Proposed Legislation, the volatility and bid-offer spreads in the Canadian capital markets can be expected to increase. More importantly, the liquidity and efficiency of the Canadian capital markets will decrease.

Recommendation

IIAC notes that the Department of Finance made no disclosure at the time of the announcement of the Proposed Legislation in November 2005 that dividend compensation payments might be treated different than actual dividends. IIAC recommends that there be the earliest possible announcement that the Proposed Legislation will be modified to provide that dividend compensation payments from borrowers to lenders of securities will be treated as “eligible” dividends in the hands of taxable lenders for tax reporting purposes. The early notice is needed because shares in margin accounts and elsewhere have been regularly loaned to borrowers during the preceding months of 2006. Unless the Proposed Legislation is remedied as recommended, these investors whose stock is borrowed will not receive the benefit of the more favourable tax treatment on “eligible dividends”. Furthermore, these investors will likely only become aware of these circumstances when they receive their 2006 tax reporting information in early 2007.

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[2] Typically, margin investors grant access to their portfolio holdings to their dealers for lending purposes. These investors therefore also may be in receipt of dividend compensation payments from their dealers. Margin investing is an important strategy for many investors in Canada trying to maximize returns and retirement savings. There is over $12 billion in margin debt outstanding in margin accounts which provide a valuable source of capital and liquidity to the Canadian capital markets.

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We trust that the intention was not to treat dividend compensation payments differently and we urge you to clarify this matter at the earliest opportunity. The IIAC would be pleased to further elaborate on the technical aspects of this issue with your officials at their convenience. Thank you for your consideration of our request

Yours very sincerely,

cc: Mark Carney
Bob Hamilton
Brian Ernewein
Joseph Lam