

**EXTRACT FROM CANADIAN SECURITIES INSTITUTE
CFO TEXTBOOK – CHAPTER 13 (UPDATED AS OF 2011)**

INTRODUCING AND CARRYING ARRANGEMENTS

Evolution of Introducing Broker/Carrying Broker Rules

Type 1

Type 2

Type 3

Type 4

Prescribed Contractual Agreements

Summary of Salient Features

Activity Matrix for Identifying Introducing/Carrying Broker Types

Frequently Asked Questions (FAQs)

- Structure
- Jitney or Omnibus Arrangements
- Foreign Affiliates
- Customers
- RRSPs
- Balance Sheet
- Banking/Financing
- Deposits/Offsets/Margin
- Segregation/Concentration
- Documentation
- Audit

References

Service contract relationships between securities firms are an important factor in the securities business. They allow small firms to enter into the business and provide full service to their clients without bearing the large start-up and maintenance costs of operating a back office. They also allow established firms to lower the costs of operating their back office by selling excess capacity to other dealers.

Carrying brokers are securities firms that offer back office services and facilities to other Dealer Members, which are known as introducing brokers. The services provided by a carrying broker include the execution, clearing and settlement of trades, the custody of funds and securities, the maintenance of books and records of customer transactions and the financing of customer positions. IROC presently has four classifications, or types, of "introducing/carrying arrangements".

Type 1 introducing brokers are required to clear all trades through the carrying broker. This allows the carrying broker to properly supervise the business of the introducing broker and gives the carrying broker all the information it needs to carry out joint supervision and compliance responsibilities under the Type 1 arrangements.

Disclosure is a fundamental requirement of these Type 1 introduction arrangements. Although Type 1 introducing brokers have an obligation to continuously disclose the introducing relationship on all correspondence with their clients, introducing brokers of all other categories have the option of making an annual disclosure. All introducing brokers must make the necessary disclosure when an account is opened.

With the exception of foreign subsidiaries and foreign affiliates, both introducing brokers and carrying brokers must be IIROC Dealer Members. Except for Type 1 arrangements, compliance supervision is the sole responsibility of the introducing broker. For Type 1 arrangements, the compliance responsibility is shared between the introducing broker and the carrying broker.

To address the increasing number of service arrangements that were entered into in the 1990s, the SROs and industry Dealer Members undertook to study the regulatory issues of these arrangements. The study made recommendations to allow these service arrangements to continue in a manner consistent with the objectives of the regulations.

EVOLUTION OF INTRODUCING BROKER/CARRYING BROKER RULES

Before July 1997, IIROC Rule 35 defined a distinct category of membership in IIROC, called an "introducing broker." An introducing broker is an investment dealer who does not clear or settle trades and does not have the facilities to act as a custodian for client securities or cash, but relies upon another dealer, the "carrying broker," to provide these services. In general, the manner of operations is that of an incorporated salesperson. Since the introducing broker does not take responsibility for the capital required by clients' accounts and since it handles no client assets, it is given a lower minimum capital requirement (\$75,000 versus \$250,000) and lower insurance requirements (\$200,000 versus \$500,000).

The carrying broker assumes the responsibility for Business Conduct Compliance, although this function could be delegated to the introducing broker if there is a compliance infrastructure in place that is acceptable to IIROC. The purpose of Rule 35 was to increase efficiency and competition in the securities markets by allowing smaller firms to become Dealer Members while at the same time offering their clients equivalent services and investor protection similar to that offered by regular Dealer Members of IIROC.

Until the Rule was amended in 1997, the number of introducing brokers applying for IIROC membership was increasing significantly. In addition, there were many applications for exemptions to the requirements of IIROC Rule 35, to accommodate variations in the operations of applicants that did not fall into the single category of introducing broker. These applicants wanted to keep their own client relationships and at the same time contract out

their back office operations. For example, they would issue all client correspondence in their name only (not jointly with the carrying broker), which is a condition of Rule 35. Exemptions were allowed by IIROC provided that the introducing broker was held responsible for Business Conduct Compliance and they met the same minimum requirements of capital adequacy and insurance as all other regular Dealer Members of IIROC.

The introducing broker rules created a special category of IIROC membership. They offered decreased capital and insurance requirements, but imposed stricter discipline by not allowing the introducing broker to handle cash or securities and requiring full disclosure of the carrying broker's role to clients. This allowed small firms to compete in the marketplace by offering the same services and customer protection as regular Dealer Members. The key to this arrangement was the requirement that both the introducing broker and carrying broker had to be Dealer Members.

Arrangements referred to as "Servicee/Servicor" arrangements also evolved. In a competitive marketplace, securities firms tried to rationalize their operations by providing quality service to their clients at the lowest possible cost. For many securities firms, this was accomplished by entering into a service arrangement with an SRO Dealer Member that provided back-office trading, settlement, clearing, custody and maintenance of books and records of client transactions, or any combination of these services. This arrangement, unlike the introducing broker rules, required the serviced firm (or servicee), if it was a Dealer Member of an SRO, to meet the capital, insurance, and Business Conduct Compliance requirements of the SRO. Moreover, the clients of the serviced broker were not made aware that a third-party service provider (or servicor) actually handled trading, settlement, clearing, or record keeping when the clients were dealing with the servicee.

SROs raised the following concerns about these service arrangements:

1. A securities registrant that was serviced by a Dealer Member might not be an SRO Dealer Member and might therefore fall outside of the regulatory oversight of an SRO and customer protection by the Canadian Investor Protection Fund (CIPF). This meant that SRO standards in the servicee broker's dealings with its clients would not be enforceable.
2. Some clients inevitably became aware of the relationship between the servicee broker and the servicor because often the servicee had to direct its clients to the servicor to deposit or collect cheques or securities. As a consequence, these clients became confused about which firm they were dealing with, or they may have had the impression that they were dealing with the servicor.
3. A client-broker relationship is a principal-agent relationship. In most cases, the agent (broker) may have delegated powers or duties to another party but only with the consent of the principal (client). Therefore, inadequate disclosure to the servicee's clients raised legal issues.
4. Accounts governed by the introducing broker rules were considered accounts

of the carrying broker and were therefore covered by CIPF.

5. The accounts governed by a service arrangement might have been considered a net broker account and might not have been covered by CIPF. If the servicer was an SRO Dealer Member and became insolvent, CIPF considered a credit balance owing to the serviced company as a net broker account that was not covered by CIPF. The appointed receiver would have had to return any segregated securities to the serviced firm for its clients.
6. If the serviced firm became insolvent, the receiver would have collected the receivables owing from a servicer (if a net credit) in order to meet the obligations of the servicee and other creditors. Segregated securities would have been retrieved and returned to the clients. If the serviced firm was an SRO Dealer Member, CIPF would have provided coverage to clients for any shortfall within the prescribed limits.
7. The implementation of the new capital formula on April 1, 1993 required that an unsecured receivable on the books of the servicer from the servicee was to be considered a non-allowable asset, which resulted in a direct capital charge to the firm. If the net cash balance of the servicee clients' accounts held at the servicer was a credit, the servicer had to segregate all securities. This means that unrelated client accounts of a serviced firm would have been netted against each other for the segregation calculation, instead of by each individual account.
8. If the net cash balance of the servicee's clients was a debit balance, the servicer might have desegregated those securities with loan value sufficient to finance the debit. This only applied to clients with debit balances.

To summarize, until the amendments to the Introducing Broker Rule were implemented in July 1997, the major problems were:

- Lack of CIPF coverage afforded to customers of non-SRO Dealer Members that contracted out certain services from SRO Dealer Members;
- The inability of the SRO to ensure that regulatory standards were maintained when non-SRO Dealer Members were serviced; and
- Client confusion and a lack of understanding as to which entity actually held their assets.

In July 1997, to accommodate the increased demand for flexibility in the Introducing Broker Rule, and to promote fair competition amongst Dealer Members, IIROC and other SROs amended IIROC Rule 35.

After doing an extensive study of the regulatory concerns and receiving input from interested service providers, new introducing broker/carrying broker rules were implemented in July 1997, with a six-month phase in period. These rules established a category of SRO membership that still allowed small securities firms to operate effectively with decreased capital and insurance requirements. However, because of the decreased requirements, introducing brokers were restricted in their activities, and arrangements with a carrying broker were subject to SRO approval and control.

The regulatory regime for introducing broker/carrying broker arrangements is contained in IIROC Rule 35, which sets out the limits and requirements of these arrangements.

The introducing broker/carrying broker arrangements are divided into four types of arrangements, which reflect a greater or lesser degree of service being provided by the carrying broker.

TYPE 1

Under a Type 1 arrangement, the carrying broker is responsible for clients introduced by the introducing broker. The carrying broker provides for margin requirements, funding of client accounts, security and free credit segregation, and handles all cash and security transactions on behalf of the introducing broker. The introducing and carrying brokers are jointly responsible for supervision and compliance. Disclosure of the arrangement is made to the client when an account is opened and is repeated continually on statements, trade confirmations, and correspondence.

To the extent that there are unsecured customer balances on the books of the carrying broker, the introducing broker must reclassify this amount of the comfort deposit lodged with the carrying broker as a non-allowable asset. This represents a contingent liability to the introducing broker for possible bad debt exposure and recovery by the carrying broker against the comfort deposit under the terms of the agreement.

TYPE 2

Under the Type 2 arrangement, the introducing broker has the ability to handle cash and securities and is solely responsible for supervision and compliance requirements. Disclosure of the arrangement can either be made when the account is opened and annually thereafter, or on a continuous basis as for Type 1 arrangements.

To the extent that there are unsecured customer balances carried on the books of the carrying broker, the introducing broker must reclassify this amount of the comfort deposit lodged with the carrying broker as a non-allowable asset. This represents a contingent liability to the introducing broker for possible bad debt exposure and recovery by the carrying broker against the comfort deposit under the terms of the agreement.

TYPE 3

Under a Type 3 arrangement, the introducing broker is responsible for reporting client account balances and providing for client margin. The introducing broker is also responsible for reporting concentrated security positions contained in the serviced client accounts.

The introducing broker is solely responsible for supervision and compliance and the arrangement is disclosed either when an account is opened and annually thereafter, or on a continuous basis.

The carrying broker provides for the segregation of securities, free credit segregation, and daily funding of client accounts. The carrying broker looks

after the daily funding requirements necessary to carry the client accounts and is responsible for ensuring that free credits for those accounts that are serviced are adequately segregated in accordance with the free credit segregation rules.

TYPE 4

Under the Type 4 arrangement, the introducing broker is responsible for the daily funding requirements necessary to carry the client accounts. As a result, the introducing broker must also take responsibility for free credit segregation relating to the client accounts carried. This is a modification of the Type 3 arrangement.

PRESCRIBED CONTRACTUAL AGREEMENTS

To assist firms in applying these rules, IIROC developed standard agreements for the four types of introducing/carrying arrangements. Commercial terms between two parties were permitted as appendices to the agreements, such as a negotiated fee schedule. Also, to avoid confusion in applying amended IIROC Rule 35 for existing back-office service arrangements already in place among Dealer Members, the IDA issued a Compliance Interpretation Bulletin C-111 dated March 4, 1997.

SUMMARY OF SALIENT FEATURES

IDA Member Regulation Notice MR-096 dated August 31, 2001 superseded C-111 and further clarified the introducing/carrying broker rules that were codified into IIROC Rule.¹ The following is a summary of the current rules relating to the introducing/carrying broker requirements.

1. The minimum capital is \$75,000 for Type 1 arrangements and \$250,000 for all other types.
2. All introducing brokers must keep adequate books and records. The critical difference relates to which broker reports the balances of client accounts and which one provides for margin requirements. The carrying broker must report client account balances for introduced accounts of Types 1 and 2, while introducing brokers must report client account balances of their own introduced accounts under Type 3 and 4 arrangements.
3. Client margining is the responsibility of the introducing broker in Type 3 and 4 arrangements, while the carrying broker is responsible for the margining of client accounts introduced under Type 1 and 2 arrangements.
4. Although client accounts introduced under Type 1, 2, and 3 arrangements are financed and funded by the carrying broker, only Type 4 introducing brokers are responsible for the financing and funding of their introduced client accounts.
5. All comfort deposits must be segregated. This includes cash deposits, which must be kept in a separate bank account.

6. The carrying broker is responsible for segregation of client securities for clients of all types of introducing brokers.
7. The carrying broker is responsible for client free credit segregation, except in Type 4 arrangements.
8. Both introducing brokers and carrying brokers must provide the necessary insurance coverage. Introducing brokers of Types 1 to 4 must include the client net equity in calculating their insurance coverage.
9. Disclosure is a fundamental requirement of the introduction arrangements. Although Type 1 introducing brokers have an obligation to continuously disclose the introducing relationship on all correspondence with their clients, introducing brokers of all other categories have the option of making an annual disclosure. All introducing brokers must make the necessary disclosure when an account is opened.
10. Except for Type 1 arrangements, compliance supervision is the sole responsibility of the introducing broker. For Type 1 arrangements, compliance responsibility is shared between the introducing broker and the carrying broker.
11. With the exception of foreign subsidiaries and foreign affiliates, both introducing brokers and carrying brokers must be SRO Dealer Members.
12. Type 3 and Type 4 introducing brokers can have multiple introducing/carrying broker arrangements. The ability to use the services of more than one carrying broker will give introducing brokers access to the most appropriate level of service for a particular line of business. They already had this access for futures contracts and options, because many carrying brokers cannot offer services that include futures contracts and options. Multiple arrangements will be approved by SROs only where there is a separate product line and where the introducing broker can show that it has appropriate systems in place to monitor the Know Your Client rule and can report customer cash balances and securities positions on a combined basis.
13. Type 3 and Type 4 introducing brokers can fully service a line of business. This gives introducing brokers the ability to combine their own in-house specialization with other services from a carrying broker. The same considerations in granting approval of multiple carrying brokers to Type 3 and 4 introducing brokers will apply: the introducing broker will have to show that it has adequate monitoring systems in place and can report customer securities and cash positions on a combined basis.
14. Type 1 and Type 2 introducing brokers are prohibited from entering into more than one introducing arrangement and from fully servicing a certain product line or line of business.
15. Type 1 introducing brokers are required to clear all trades through the carrying broker. This allows the carrying broker to properly supervise the business of the introducing broker and gives the carrying broker

all of the information it needs to carry out joint supervision and compliance responsibilities under the Type 1 arrangements.

16. Type 1 and Type 2 introducing brokers are restricted to one arrangement (the only exception being the currently allowed arrangement for futures contracts and options). In addition, Type 1 and 2 introducing brokers are prohibited from fully servicing certain product lines or lines of business.

Summary items 12-16 reflect Rule 35 amendments and by the following summary of changes.

Standards and Responsibilities	Type 1 Section 35.2	Type 2 Section 35.3	Type 3 Section 35.4	Type 4 Section 35.5
Must a written contract and approval be obtained to enter into introducing broker/carrying arrangement?	Yes Sec. 35.1(e)(i)	Yes Sec. 35.1(e)(i)	Yes Sec. 35.1(e)(i)	Yes Sec. 35.1(e)(i)
Can an Introducing Broker introduce customers to more than one Carrying Broker and fully service any part of its securities-related activities?	No, with the exception of an additional arrangement entered into exclusively for trading in futures and options Sec. 35.1(e)(ii) & (iii)	No, with the exception of an additional arrangement entered into exclusively for trading in futures and options Sec. 35.1(e)(ii) & (iii)	Yes, including the arrangement for trading in futures and options Sec. 35.1(e)(v)	Yes, including the arrangement for trading in futures and options Sec. 35.1(e)(v)
Can an introducing broker clear the trade settlements on its own?	No Sec. 35.1(e)(iv)	Yes Sec. 35.3	Yes Sec. 35.4	Yes Sec. 35.5
May a Dealer Member be exempted from the requirement of this Rule 35?	Yes, at the discretion of the District Council Sec. 35.1(h)	Yes, at the discretion of the District Council Sec. 35.1(h)	Yes, at the discretion of the District Council Sec. 35.1(h)	Yes, at the discretion of the District Council Sec. 35.1(h)
Is there any requirement for client acknowledgment at the opening of	Yes Sec. 35.2(k)	Yes Sec. 35.3(k)	No Sec. 35.4(k)	No Sec. 35.5(k)

Standards and Responsibilities	Type 1 Section 35.2	Type 2 Section 35.3	Type 3 Section 35.4	Type 4 Section 35.5
client accounts?				

ACTIVITY MATRIX FOR IDENTIFYING INTRODUCING/CARRYING BROKER TYPES

The simplest way to explain the application of the introducing/carrying rules is to identify the six major activities covered by contracted service arrangements. The type of activity or combination of activities that a Dealer Member contracts to a third party dictates whether the introducing/carrying broker rules apply. Please use this matrix and the activity combinations listed to identify and determine whether the introducing/carrying broker rules apply and for what type of introduction arrangement they apply.

Activity 1	Activity 2	Activity 3	Activity 4	Activity 5	Activity 6
Trade execution	Trade settlement	Custody of cash	Custody of securities	Bookkeeping	Financing of customer positions
Activities 1 and 2	This combination is a "jitney" or "omnibus" arrangement and is not subject to the requirements of IIROC Rule 35.				
Activities 2, 3, and 4	This combination of functions is a custodial arrangement and is not subject to the requirements of IIROC Rule 35. However, the arrangement is subject to other requirements set out in IIROC Rule Book relating to custody of customer monies and securities.				
Activity 5	The preparation of books and records is not subject to the requirements of IIROC Rule 35. This function is typically performed by a service bureau with the firm retaining the responsibility to comply with IIROC Rule Book for minimum books and records				
Activities 1, 2, and 5	This combination of functions is not subject to the requirements of IIROC Rule 35. The introducing / carrying broker requirements do not apply where cash and security custody is kept separate and not commingled in any way with the service provider's assets under administration. This requires distinct segregation of securities by means of individual account FINs at CDS or other depository for securities of the service.				
Activities subject to IIROC Rule 35					
Activities 1-5	This combination of functions is subject to the introducing / carrying broker rules where financing of customer positions is performed by the introducing broker and is classified as a Type				

	4 arrangement under IIROC Rule 35.
Activities 1-6	This combination of functions is subject to the introducing / carrying broker rules and is classified as either a Type 1, 2, or 3 arrangement under IIROC Rule 35.
Activities 2-5	This combination of functions is subject to the introducing / carrying broker rules where trade execution and financing of customer positions is performed by the introducing broker. This is classified as a Type 4 arrangement under IIROC Rule 35.
Activities 2-6	This combination of functions is subject to the introducing / carrying broker rules where trade execution is performed by the introducing broker. This is classified as either a Type 2 or 3 arrangement under IIROC Rule 35.

FREQUENTLY ASKED QUESTIONS (FAQs)

Structure

1. What contract services qualify under the introducing/carrying broker rules?

Answer: Arrangements that combine services related to books and records services and custody, contracted out to or from any third party, are subject to the introducing / carrying broker rules.

The execution and settlement of trades for or by a Dealer Member is considered as a "jitney" arrangement and is not itself subject to the introducing rules. In addition, securities held in custody by one Dealer Member for any other party under a written custodial agreement is not in itself subject to the introducing rules. It is the combination of the contracting of books and records, and custody of securities services that is subject to the introducing rules.

2. How are "books and records" defined under the introducing/carrying broker rules?

Answer: In the introducing/carrying broker rules, "books and records" are defined as the processing of servicee transactions through the servicer's own system of books and records, resulting in the commingling of monies and securities in the general ledger and stock record of the servicer.

EDP service providers that provide services related to books and records are not subject to the introducing rules, because they do not handle monies and securities.

Dealer Members may provide services related to books and records to any third party or vice versa, provided that the system of books and records distinguishes one company from another, thereby creating a "self-balancing" general ledger and stock record. This means that all trading activity must flow through an EDP accounting system that

independently records money balances on the general ledger for each company. In addition, custody of the assets of the servicee must be separately identifiable in a physical location or maintained in a separate CDS or other depository account.

Jitney or Omnibus Arrangements

3. How are "jitney" or "omnibus" business relationships affected by the introducing/carrying broker rules?

Answer: Under "jitney" arrangements, any domestic or foreign broker can contract out trade execution and settlement. This most often occurs where a SRO or non-SRO domestic broker or foreign broker without access to a Canadian stock exchange or debt market contracts the trading desk and clearing services of an SRO Dealer Member. In order to track the trades, the Dealer Member will set up one account referred to as an "omnibus account" for the serviced broker. The words "jitney" and "omnibus" are sometimes used interchangeably to describe this arrangement.

The purpose of the omnibus account is to record all trading activity on behalf of the serviced broker. In most circumstances, the account is set up as a cash on delivery (COD) or delivered against payment (DAP) account, in which trades are settled each day and securities are received against payment or delivered against payment. However, custody may sometimes form part of the agreed-upon arrangement, in which the Dealer Member also acts as custodian for the securities.

Jitney and omnibus arrangements are not restricted to Dealer Members and do not fall under the introducing/carrying broker rules, because the Dealer Member does not provide customer record-keeping services. Because the owners of accounts carrying out trades executed through an omnibus account are not known to the Dealer Member, there is no customer accounting implications. The serviced broker is responsible for maintaining its own customer records.

In an omnibus arrangement, the clients of the serviced broker are not disclosed to the Dealer Member. As a result, the Dealer Member has no customer liability from a business conduct compliance perspective, including account documentation. In addition, CIPF provides no customer protection to trades operated through an omnibus account.

4. How are investment counselor business relationships affected by the introducing/ carrying broker rules?

Answer: Investment counselors represent a separate form of registration with each of the Canadian provincial securities commissions. On that basis, Know Your Client rules, such as account documentation and the suitability of trades, apply to investment counselors, just as they do to Dealer Members.

Investment counselors may contract the services of Dealer Member to execute trades and settle trades on behalf of their clients. They may

also contract Dealer Member to carry out record-keeping functions, such as trade confirmations and customer statements, including custody.

CIPF protection is provided to each Canadian customer of a domestic investment counselor when the customer's account is individually set up on the books of the Dealer Member, similar to a branch range of accounts. These accounts are maintained separately and are not netted for purposes of any margin calculation.

Provided that compliance and customer protection is afforded to customers of investment counselors, there is no need to subject these arrangements to the introducing/carrying broker framework.

5. What are the implications for conducting fully disclosed commodities futures business with U.S. commodity brokers?

Answer: A small number of Dealer Members are members of U.S. commodity exchanges and maintain their own commodity futures record-keeping systems, because of the specialized nature of the transactions. Most firms have arrangements with a U.S. commodity broker to provide execution and settlement and record-keeping services in "omnibus" arrangements.

To simplify record keeping, some firms have set up arrangements with U.S. commodity brokers whereby the customer is set up on the accounts of the U.S. broker. This simplifies record-keeping functions, such as margin maintenance and segregation of securities. Some Dealer Members mirror or match all customer trading activity on their own systems, so that they can issue confirmations, statements, and other notices. However, most firms rely on the record-keeping functions of the U.S. commodity broker.

The SRO requires Dealer Members to advance inventories only to meet margin calls and to retain custody of client securities to segregate or de-segregate the appropriate amount of securities to cover each client's margin requirements. The Canadian firm must also be responsible for safeguarding its own clients' assets, as its clients are eligible for CIPF coverage.

It is also a condition under these arrangements that clients receive contracts and statements from the Canadian firm and that the Canadian firm must keep the books and records in accordance with the SRO rules that apply in Canada. This would be achieved by a daily electronic transmission of the trading blotter, open contract positions, margin report, net equity run, and other information from the U.S. broker.

6. Can IIROC Dealer Members and MFDA members enter into introducing/carrying broker arrangements, or joint service or omnibus arrangements?

Answer: These structures are not permitted at this time.

Introducing/carrying arrangements between IIROC and MFDA firms are not

permitted under IIROC Rule 35.1(b), by virtue of the fact that the MFDA is not a participating member of the CIPF.

IDA MR Notice 296 (dated June 11, 2004) clarifies the current position concerning joint service and omnibus arrangements between MFDA and IIROC firms. Further clarification of the issues surrounding these arrangements may be found in OSC Staff Notice 31-712 "Mutual Fund Dealers Business Arrangements" and the related Issues Paper.

Under joint service arrangements, a mutual fund dealer and an investment dealer jointly service a client who maintains an account at the investment dealer. The client may hold only mutual fund securities or a wide range of securities in the account. The following regulatory concerns have been identified:

- Division of responsibility to the client for advice and trade suitability is unclear.
- Responsibility for supervising the mutual fund dealer salesperson and any other personnel dealing with the client is unclear.
- There are potential gaps in liability to the client.
- The client may be misled to believe that his/her mutual fund salesperson is proficient to deal in other types of securities.
- The mutual fund dealer salesperson is acting on behalf of both the mutual fund dealer and the investment dealer.

If clients' assets are non-mutual fund securities, some mutual fund dealers have chosen to maintain an omnibus account at an investment dealer to hold the non-mutual fund securities. As the omnibus account holder, the mutual fund dealer is required to confirm or reject settlements of clients' orders in the non-mutual fund securities. The following regulatory concerns have been identified:

- Clients' securities held in an omnibus account at an investment dealer are not covered by any investor protection fund.
- The nature of this type of arrangement places the primary responsibility for the clients' investments on the mutual fund dealer. Many clients would reasonably expect to receive advice on their entire investment portfolio. It also provides the mutual fund dealer with access to, and control over, the non-mutual fund securities of clients. Client expectations, along with access and control, increase the pressure for the mutual fund dealer and its salespersons to act beyond the scope of their registration.
- The mutual fund dealer may be trading in non-mutual fund securities by acting in furtherance of such trades within the meaning of the Securities Act (Ontario).

Foreign Affiliates

7. Does a foreign affiliate have to enter into a written introduction

agreement?

Answer: Yes, IIROC requires foreign affiliates to sign an introduction agreement, although it might be modified to suit the situation and to meet foreign regulatory requirements.

8. Can an introducing broker deal with more than one carrying broker?

Answer: IIROC Rule 35 limits the introducing brokers to dealing with one carrying broker only, except for futures business, which may be carried through another carrying broker. This only applies to Type 1 and 2 arrangements.

Customers

9. Can introducing brokers deal with clients directly?

Answer: Although all introducing brokers can take orders from clients, Type I introducing brokers are not allowed to handle client assets. Introducing brokers, particularly Types 1 and 2 should conduct all their client business through a carrying broker. They should not be reporting any client balances in their regulatory financial filings.

10. Can an introducing broker execute a client trade through a different carrying broker, if the first carrying broker refuses to do the trade?

Answer: Yes, for Types 3 and 4 only.

11. Can an introducing broker do principal trading through a broker other than the carrying broker?

Answer: Yes in the case of introducing brokers Types 2, 3, and 4. Type 1 introducing brokers must introduce all their business through a carrying broker. That is the reason for the reduced minimum capital requirement.

12. What customer credit policies should an Introducing Broker have in place?

Answer: Credit risk management is important for all Dealer Members, including Introducing brokers. Carrying brokers contractually impose their credit risk policies on client accounts introduced to them. It is incumbent on Introducers to protect against customer bad debts and the resulting liens on their comfort deposit with the Carrying broker and to apply those and/or higher credit risk policies for their customers.

For further details, see IIROC Notice 09-0171 dated June 11, 2009 - Best Practices for Credit Risk Management.

RRSPs

13. Is subcontracting the RRSP trustee arrangement permissible under an introducing/carrying broker arrangement?

Answer: For all types of introducing brokers, the RRSP accounts are reported on the books and records of the carrying broker, using its existing trustee relationship.

For Types 3 and 4 introducing brokers, the introducing broker must report RRSP client balances on its records. The introducing broker has an increased responsibility to ensure that such accounts are properly administered by the carrying broker. As a minimum, the carrying broker must maintain a separate trust account in the name of the introducing broker, or maintain a system of records that can identify, for each customer account of the introducing broker, monies that have been transferred and are held on deposit at the trustee.

14. Do introducing brokers of RRSP accounts for Types 3 and 4 have to report the client balances with the trustee separately?

Answer: Yes. The carrying broker will have to make available the necessary details to the introducing broker, regardless of whether the introducing broker uses its own trustee or that of the carrying broker.

Balance Sheet

15. What is the balance sheet impact between Types 1-4?

Answer: For all introduction types of arrangements (Types 1 to 4), it is the brokerage accounting system (EDP system of books and records) of the Carrying broker - as a stand-alone legal entity - where the customer records of Introducing brokers are located.

For introduction arrangement types 1 and 2, the customer account balances are all recorded on the balance sheet of the Carrying broker.

For introduction arrangement types 3 and 4, the customer account balances are reported on a "gross basis" on the balance sheet of the Introducing broker and on a "netted basis" on the balance sheet of the Carrying Broker.

Banking/Financing

16. Can the carrying broker be the "banker" for introducing brokers?

Answer: For Types 1-3, banking functions may be delegated to the carrying broker without capital penalty.

17. Can an introducing broker enter into security-lending activities?

Answer: For Type 1 and 2 introducing brokers, the carrying broker carries the customers' accounts and finances purchases and short sales. For Type 3 introducing brokers, this function is contracted to the carrying broker. The difference between a Type 3 and 4 introducing broker is that a Type 4 introducing broker net settles all trades with its carrying broker daily and arranges for its own financing.

18. Can a carrying broker arrange and manage the call loan activities to help fund client debits for Type 4 introducing brokers?

Answer: Yes, as long as this arrangement is documented and it is understood that these balances are the responsibility of the Type 4 introducing broker.

19. Does the carrying broker have to collateralize funds left with the carrying broker by the introducing broker?

Answer: No.

Inventory

20. Who is responsible for the principal trading activity of an Introducing broker?

Answer: All introducers are responsible for the regulatory accounting, reporting and margining of proprietary trading on their financial statements.

Except for type 4 introduction arrangements, the carrying broker contractually assumes responsibility for the funding of the introducer's principal trading activity.

21. Who is responsible to conduct monthly independent price verification for Introducer's inventory positions held in assigned inventory accounts by the Carrying broker?

Answer: For all types of introducing brokers, it is the responsibility of the introducer to report inventory holdings on its balance sheet at market value. This means that the introducing broker is held accountable for inventory valuations and mark to market for realized and unrealized profit and loss calculations. This requires the introducing broker to perform its own independent price verification of inventory holdings at least monthly. For further details, see IIROC Rule 2600 - Internal Control Policy Statement 7 - Pricing.

22. Who is responsible for the use of inventory accounts assigned by a Carrying broker for the Introducer to accumulate customer trades for average price ticketing?

Answer: An Introducing broker may be assigned the use of accounts from the inventory sub-ledger of its carrying broker for the purposes of accumulating customer trade order for average ticket pricing. The responsibility for this trading activity depends on whether the customer trade is "all or none" contingent order. If it is a contingent order, then the Introducer assumes the reporting and margin provision for the trades executed in the inventory account until the customer order is completed and ticketed to the customer account for settlement.

In the case of non-contingent customer orders, the customer liability begins on the date of the first trade regardless of the time required to fill the order and process a trade ticket. The Carrying broker must be notified of non-contingent customer trades conducted in average price inventory accounts in order to provide margin for the partial fills that are past normal settlement.

As the carrying broker for Types 1-3 arrangements is exposed to funding the inventory and client trading activity, the carrying broker must have in place appropriate risk management controls over credit, security concentration and funding to monitor and manage these risk exposures.

Deposits/Offsets/Margin

23. Does the introducing broker's deposit qualify as allowable assets?

Answer: Yes, provided that the carrying broker does not depend on them. Any deposits used by the carrying broker as offsets for client margin requirements must be reclassified by the introducing broker as non-allowable assets.

24. While introducing brokers' cash deposits are recorded on line 12 of the CGAAP based Statement A or line 11 of the IFRS based Statement A of Form 1, where is other trading/commission receivable from the carrying broker reported?

Answer: All receivables, including the cash comfort deposits, must be recorded on line 12 of the CGAAP based Statement A or line 11 of the IFRS based Statement A by the introducing brokers.

25. What offset(s) are permitted by the carrying broker using the comfort deposit of the introducing broker?

Answer: The carrying broker may offset the margin required on client accounts against the comfort deposits of the introducing brokers to the extent of the loan value of such deposits. For Types 1 and 2 introducing brokers, the offset must not exceed the risk-adjusted capital of the introducing broker. There must be a formal process of notification of such offsets, so that there is no duplication in the use of capital. Any portion of the introducing broker's comfort deposit that is used to reduce the carrying broker's margin requirement is to be classified as a non-allowable asset.

To the extent that there are unsecured customer balances carried on the books of the carrying broker, the introducing broker must reclassify this amount of the comfort deposit lodged with the carrying broker as a non-allowable asset. This represents a contingent liability on the comfort deposit by the carrying broker under the terms of the agreement.

26. Does the introducing broker require a custodial agreement with the carrying broker for the comfort deposit?

Answer: No, the introducing agreement is sufficient documentation.

27. Does the carrying broker have to segregate the introducing broker's fund deposits?

Answer: Yes. Just as security deposits have to be segregated, introducing broker's fund deposits must also be segregated in a separate bank account.

Segregation/Concentration

28. Which entity is responsible for client free credit segregation?

Answer: For types 1-3 arrangements, the Carrying broker retains the use of customer free credit balances on deposit. This includes meeting its funding obligations with other customer indebtedness. As such, it is the Carrying broker that is responsible to compute customer free credit segregation requirements for such introduction arrangements including its own customer free credit balances on an aggregated basis.

For type 4 arrangements, because the Introducing broker net settles its trading obligations with the Carrying broker, the introducing broker retains the right to use free credit balances and must accordingly compute its free credit segregation computations and comply with any resulting free credit segregation requirements.

29. Who is responsible for monitoring and providing capital for securities concentrations?

Answer: For Type 1 or 2 arrangements, the carrying broker is responsible for carrying the accounts of the introducing broker and providing any regulatory margin necessary for these accounts on its books. As the regulatory risk to loss resides with the carrying broker, it must also aggregate security positions of the introducing broker accounts it carries.

For Type 3 or 4 arrangements, the regulatory risk to client loss resides with the introducing broker, and the introducing broker must obtain concentration reports from the carrying broker to enable it to determine possible concentration exposure. If any concentration charge applies, the introducing broker must provide it in its capital position calculation.

30. Is the introducing broker responsible to ensure that client securities are properly segregated?

Answer: Introduction arrangements represent the contractual outsourcing of regulatory back-office functions from the Introducing Broker to the Carrying Broker. IIROC rules require that fully paid and excess margin securities be held in a segregated securities location and disclosed on customer month-end statements. As securities registrant, the Introducing broker has a fiduciary duty to its customers to ensure that regulatory obligations contracted out to any third party are met.

Segregation of client securities is the responsibility of the carrying broker, as stipulated in IIROC Rule 35. For the introducer to meet its fiduciary responsibility to clients for services contracted out to third parties, it should monitor the segregation disclosures on customer statement by reviewing a sample of customer statements each month-end for possible segregation deficiencies and documenting the resolution for the discrepancies identified.

31. Does the SIRFF regulatory financial filing program accommodate Type 3 introduced clients in the calculation of free credit balances by the carrying broker?

Answer: Yes. Statement D (Free Credit Segregation) accommodates Type 3 introducing brokers' free credit balances. Type 4 introducing brokers are responsible for their free credit segregation, and not the carrying broker.

Documentation

32. Can a standard introducing agreement be modified by the contracting parties?

Answer: While the standard agreements must not be modified, provisions may be added to the agreements by way of schedules or appendices, provided that they do not override the standard provisions.

33. Can a full service broker that introduces part of its business through a carrying broker (Type 3 or 4 arrangements) issue consolidated monthly statements?

Answer: This is permitted, provided there are proper internal controls in place at the introducing broker to generate complete and accurate statements.

Audit

34. What is the purpose for an Introducing broker to obtain an annual audit opinion on the adequacy of operational controls of a Carrying broker?

Answer: All Dealer Members continue to have regulatory obligations in respect to outsourcing arrangements in reference to National Instrument (NI) 31-103 and Part 11 - Internal controls and systems of the Companion Policy. In particular, the Introducing broker must conduct ongoing reviews of the quality of outsourced services. Aside from conducting its own review of the operations of the carrying broker, an annual audit opinion helps fulfill this regulatory requirement.

For auditors of the Introducing broker, Canadian Auditing Standards require that specified audit procedures be performed for reliance on the financial and operational functions outsourced to a third party service provider. The audit procedures may consist of the auditor of the Introducing broker conducting its own review and testing on the adequacy of internal controls of the service provider or alternatively relying on an independent audit opinion report on the adequacy of the internal controls of the service provider.

An annual CICA Section 5970 (or CSAE 3416 if after December 15, 2011) audit opinion furnished by the external auditors of the Carrying broker fulfils both a regulatory requirement of the Introducing broker as a securities registrant and meets the audit standards for reliance of the auditor of the Introducing broker on financial and operational functions that have been outsourced to third parties.

35. What are the audit procedures for testing segregation for introducing brokers?

Answer: For purposes of the special audit procedures regarding the segregation of securities, IIROC determined that in the course of a year-end audit of any introducing broker, as defined in IIROC Rule 35, auditors are not required to perform these special compliance procedures for segregation or to report on findings.

This regulatory position is based on the fact that the carrying broker is a Dealer Member and is also subject to an audit, which includes special compliance procedures as they relate to the segregation of client fully paid and excess margin securities. This testing includes the securities of the accounts of the introducing broker.

36. What is the audit requirement for Type 3 and 4 introducing broker customer and inventory security positions held by the carrying broker?

Answer: All Type 3 and 4 introducing brokers should receive a breakdown of all security positions held on behalf of their customers and firm by the carrying broker. This "security listing" report breaks down for each security the quantity of securities held for each customer and firm positions under the "custodial control" of the carrying broker and reports the amount held in segregation.

For Type 3 and 4 introducing brokers, the planning of the audit engagement requires that arrangements be made with the carrying broker and its EDP service provider to ensure all applicable customer accounts of the introducing broker are produced for audit confirmation at year end.

The purpose of the circularization is to confirm both the completeness and accuracy of customer records and the security positions of the introducing broker. Auditors must verify with the carrying broker the source of the security listing report and verify completeness by cross-checking the security positions listed on the report to the security position reported on customer month-end statements.

37. What are the audit procedures for Types 1 to 4 introducing brokers?

Answer: The following chart provides guidance on the audit responsibilities for introducing brokers in relation to their carrying brokers.

Applicability of IIROC Rule 300 Audit Procedures b/w Introducing Types 1-4

Audit Procedures	Type 1 Introducing Broker	Type 2 Introducing Broker	Type 3 Introducing Broker	Type 4 Introducing Broker
Special report on segregation*	Not applicable	Not applicable	Not required	Not required
Special report on insurance*	Required	Required	Required	Required
Securities concentration	Required for inventory positions only	Required for inventory positions only	Required	Required
Free credit segregation	Not applicable	Not applicable	Required for free credit balances held directly	Required
Obtain and issue customer month-end statements for audit confirmations	Not applicable	Not applicable	Required	Required
Confirm Partner, Director, Officer accounts	Required	Required	Required	Required
Confirm RRSP monies held at trustee of carrying broker	Not applicable	Not applicable	Required	Required
Confirm securities held by carrying broker	Required for inventory positions only	Required for inventory positions only	Required	Required
Confirm securities accumulated in average price accounts	Required for inventory positions only	Required for inventory positions only	Required	Required
Confirm comfort deposit amount	Required	Required	Required	Required
Confirm amount of comfort deposit used by carrying broker for margin offset	Required to reclassify to non-allowable asset (must not reduce RAC of introducing broker to below zero)	Required to reclassify to non-allowable asset (must not reduce RAC of introducing broker to below zero)	Required	Required in the event of failed trades
Confirm receivables / payables with carrying broker	Required	Required	Required	Required
Test unhedged FX margin	Required for balances reported on its own financial statements	Required for balances reported on its own financial statements	Required for balances reported on its own financial statements	Required for balances reported on own financial statements

*Under the CGAAP-based Form 1, there are two separate special compliance reports - one for insurance and the other for segregation. Under the IFRS-based Form 1, these two special compliance reports have been combined as one.

REFERENCES

- IIROC Rule 35
- IIROC Rules Notice - Guidance Notice - 09-0171, Best Practices for Credit Risk Management, June 11, 2009
- IDA Bulletin 2357 "Introducing/Carrying Broker Arrangements", March 4, 1997
- IDA Bulletin 2883 "Introducing/Carrying Broker Arrangements", August 31, 2001
- IDA Compliance Interpretation Bulletin C-111, "Introducing/Carrying Broker Arrangements", March 4, 1997
- MR Notice 096 "Introducing/carrying Broker Arrangements", August 31, 2001
- MR Notice 0296 "Joint Service and Omnibus Arrangements between IDA and MFDA Members", June 11, 2004
- IDA Bulletin #3353 "Guidelines - What to Consider When Choosing a Carrying Broker", November 12, 2004
- MR0319 "Update to Joint Service and Omnibus Arrangements between IDA and MFDA Members", November 30, 2004

Note

- ¹ See IDA Bulletin 2883 dated August 31, 2001.