

WHAT TO CONSIDER WHEN CHOOSING A CARRYING BROKER



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This document is intended to provide information for firms to consider when selecting a Carrying Broker. This document may not necessarily be comprehensive for your business model.

Firms should refer to IDA By-Law 35, Bulletin #2883 and Member Regulation Notice 096 for further information on the Association's requirements with respect to introducing/carrying relationships. See www.ida.ca for further information on joining the IDA.

A. What is an Introducing/Carrying Relationship?

Subject to the Association's rules and regulations, introducing/carrying relationships between Member firms allow a firm (the "Introducing Broker" or "Introducer") to enter the industry and provide full service to their clients without bearing the large start-up and maintenance costs of operating a complete full-service back office. Instead, under agreement required by the IDA, the Introducer uses another firm's back office to clear and settle securities transactions (the "Carrier" or "Carrying Broker"). While introducing/carrying relationships have existed in the United States since the mid 1970's, the business in Canada began in earnest in the early 1990s. Carrying relationships are playing an increasingly important role for the independent dealer segment in Canada - over half of current IDA Members are Introducing Brokers.

There are 4 types of contractual relationships possible in an introducing/carrying relationship (Sample agreements and definitions are available on the IDA's website at www.ida.ca). The Introducer takes on increasingly more responsibility for capital and compliance moving from Type 1 to Type 4.

Type 2 or Type 3 relationships would typify the majority of arrangements that exist today. The major difference between a Type 2 and a Type 3 relationship relates to the capital responsibility for client accounts that are either under-margined or have overdue debits. In a Type 2 relationship, the Carrying Broker assumes initial capital responsibility for these accounts whereas in a Type 3 relationship the Introducing Broker accepts this responsibility. Perhaps the most significant difference that arises from this is the responsibility for adequate capital to cover concentrated security positions. As the concentration formula is based on a firm's Risk Adjusted Capital (RAC), an Introducing Broker must consider the implications of a Type 3 relationship from this perspective as well.

- The basic services provided by the Carrying Broker may include:
 - Execution, clearing, and settlement of trades (jitney services)
 - Segregation or custody of client funds and securities
 - Compliance and registration
 - Maintenance of books and records of client transactions
 - Financing of client positions
 - Preparation and distribution of client statements and trade confirmations
 - Financial and regulatory reporting

- In addition, many Carriers provide other value added services to augment their core offerings, such as:
 - Access to desktop technology
 - Access to preferential bulk buying power
 - Wealth management products
 - Retirement services
 - Banking products
 - Insurance products and services
 - Access to research and new issues
 - On-line access for retail clients

The Introducing Broker brings its securities business to the Carrying Broker for processing. Carrying Broker services may include receipt, custody and delivery of securities, for which it charges the Introducing Broker a fee. The Carrying Broker collects from the Introducer's clients the money due on the transactions effected by the Introducer, including commissions due to the Introducing Broker. The Carrying Broker is responsible for settlement of trades with the contra broker (the other side of the trade) on behalf of the Introducing Broker. In addition, the Carrying Broker may extend credit to the Introducing Broker's clients to enable them to purchase securities on margin.

In a typical Type 2 relationship, the Introducing Broker opens an account with its client, takes the client's order for the purchase or sale of securities and transmits the order to the Carrying Broker for execution, or the Introducing Broker executes the order and transmits the terms of the trade to the Carrying Broker for settlement. The Carrying Broker then completes the transaction by collecting either cash from the Introducing Broker's client if securities are being purchased or certificates from the Introducing Broker's client if securities are being sold. The Carrying Broker may lend the client any required amount if the purchase is being made on margin and, in effect, makes delivery of cash or certificates to the contra broker (for the other party to the transaction). Cash or certificates received by the Carrying Broker for the Introducing Broker's client are either held in the account or delivered to the client. The Carrying Broker sends the client a written confirmation containing the details of each transaction immediately after it is executed, as well as a periodic statement for the client's entire account.

The receiving, execution, clearing, settlement and delivery functions involved in the clearing process require the performance of a series of complex steps, many of which are accomplished through data processing systems. These steps include receipt, identification and delivery of funds and securities, internal financial controls, accounting functions, office services and custody of securities. Any mistakes in the clearing process could result in liability to the parties involved.

There is risk to the Carrying Broker that an Introducing Broker's client will fail to pay for securities in a cash account or meet the required margin requirements if the securities are purchased in a margin account.

While the Introducing Broker makes decisions as to which transactions may be made by their clients, Carrying Brokers reserve the right to reject a trade, should they so decide. Additionally, the Carrying Broker is financially responsible for the obligations of the Introducing Broker's clients and will look to the Introducing Broker for repayment of any loss in the event the Introducing Broker's client does not pay. As such, most Carrying Brokers will require a security deposit from their Introducing Brokers.

The financing of margin accounts is one of the primary services provided by a Carrying Broker. In a margin account, the Carrying Broker provides part of the balance of the purchase price as a loan secured by the securities purchased and/or other securities owned by the client. The Carrying Broker charges interest on the loan, and typically shares interest spread earned with the Introducing Broker. Loan amounts are regulated by the IDA although the Carrying Broker will usually impose more stringent in-house rules. Equity capital, secured bank borrowing and free credit balances in client's accounts provide the source of funds for the Carrying Broker to finance margin accounts.

An introducing/carrying agreement must be executed between the Introducing Broker and the Carrying Broker and the two firms must be member firms of either the IDA or the Bourse de Montréal Inc. As a result, MFDA firms may not be carried by IDA firms at this time. The introducing/carrying agreement requires SRO (either the IDA or the Bourse de Montréal Inc.) approval.

B. What a Carrying Broker Wants to Know about You

Before you approach Carrying Brokers to discuss a potential relationship, it is helpful to have a clear picture of your firm, or the firm you are building. Some of the items below might assist you to define your firm, both from your point of view and from a Carrier's point of view.

An important part of your due diligence in creating your new securities firm is to carefully assess and decide on your Carrying Broker. This due diligence is best performed through meeting with prospective Carriers and then developing a short list of potential partners from which to formally request a proposal.

As an Introducing Firm:

You should provide prospective Carriers a copy of your strategic/business plan, which is a summary overview of your entire business and, more particularly, those areas that will form your "correspondent business".

If you don't have a formal strategic/business plan, then you should consider developing one. This document is the foundation of every successful business and is an important step in documenting a logical and rational sense of direction for your firm. It also establishes some benchmarks by which progress towards the attainment of business goals is measured. A business plan (including 5 year pro-forma financial statements) also forms part of the IDA's membership application requirements.

Some key elements of a business plan include:

1. Define Core and Niche Business

This step is important as it documents the range of products and services to be offered, your business objectives and strategy, sources of revenue, your cost structure, etc.

2. Define Target Market

It is important to develop detailed information of targeted clients using demographic data such as gender, age, income level, education level, geographic location, urban/rural distribution, occupation, ethnicity, investment assets, etc. This will identify who your clients are and what you can offer them.

3. Identify Firm's Strategic Plans

Strategic planning relates to the overall direction or evolution of the firm. It is a process whereby key people in the firm can define or redefine the corporate mission, assess the current situation, decide what the business will look like 3 to 5 years out and map a course of action to bring the firm from where it is now to where the principals want it to be, recognizing its strengths, weaknesses, opportunities and competitive threats (sometimes referred to as a SWOT Analysis – strengths, weaknesses, opportunities, threats).

4. Consider Branding

In mature businesses like financial services, established firms have clearly defined market positions and images – a brand identity, if you will. Newly established competitors need to consider how they will differentiate themselves from their competitors, either through a name, term, symbol, design (or combinations of all of these) to stand apart from competitors and to provide something tangible to potential clients. A Carrying Broker needs to understand your branding plans and needs so that an assessment of your 'white label' requirements is possible.

5. Key Individuals

The management and organization portion of your business plan is crucial; many businesses and business plans fail because the proper talent was not assembled to manage the organization. A Carrying Broker will want to know that a potential new Introducer has the experience, business acumen and reputation to be a success in the new venture and the Carrier will use this information as part of its overall assessment of the Introducer's new business proposal.

6. Pro-forma Financial Statements

Start-up businesses, by definition, do not have a financial history. Instead, an Introducer's business plan is based on a realistic and comprehensive set of financial projections which reflect the new venture's anticipated financial performance. These statements should include (but are not limited to), a set of assumptions on which the financial projections are based, projected income/cash flow statements, balance sheet and break-even analyses that encompass a five-year vision of the new firm. As part of the development of these pro-formas, a Carrying Broker can assist you by providing information on their costs and/or specific industry costs.

7. Sources of Capital

A successful IDA Member, even in an introducing model, must have minimum capital to ensure its long-term success. The IDA has set minimum capital requirements for Introducing Brokers, based on the degree of autonomy (Type 1-4). More information is available on the IDA website, www.ida.ca. Notwithstanding the IDA requirements, realistic capital levels can be significantly higher. There are other capital requirements in the form of security deposits that may be imposed by your Carrying Broker that may exceed industry minimums. In addition, you will want to ensure that your new firm has adequate cash flow to start up and develop your new business.

With the above information in hand, or in development, you are now ready to have a discussion with a potential Carrying Broker.

Exchange of Information between Introducing Firm and Prospective Carrying Firm

As a first step in the discussion process, it is probably a good idea to secure a confidentiality agreement with the proposed Carrier(s). The use of a confidentiality agreement between the parties is an appropriate arrangement for the exchange of restricted and proprietary information and data. It is simply a legally-binding undertaking between the two parties that governs the transfer and disclosure of this information and includes, but is not limited to, information regarding methods of doing business, business structures and financial information. Confidential information does not include information already in the public domain.

By providing your prospective Carrying Broker with data on your current book(s) of business, you will be better able to determine the optimum mix of products/services and price-points that best suit your business model. For the purposes of a 'Request for Proposal', this exchange of information should include items such as:

1. Basic Description of the Arrangement Contemplated

A brief paragraph summarizing your business is helpful to prospective Carriers, including such information as:

- Business model - retail or institutional
- Proposed type of introducing/carrying broker arrangement
- Core services to be included - trading, compliance, financing, etc.

2. Number of Introducer's Salespeople/Projected Number of Salespeople

Number of registered salespeople (by regulatory jurisdiction) and projected number:

| Province | Currently Licensed | Projected Productivity | Projected to be Licensed | Projected Productivity |
|----------|--------------------|------------------------|--------------------------|------------------------|
| Ontario | | | | |
| Etc. | | | | |

3. Introducer’s Projected Trading and Clearing Volumes

The Carrying Broker’s cost structure, and hence its revenue model, is largely driven by trade volumes. Therefore, the Carrying Broker will be very interested in the number and type of trades you will transact through their organization. A ‘trade’ is usually defined as each trade confirmation generated for the client/average price account on agency transactions or each purchase or sale for inventory. Consider all trades, including cancels and corrects in your trade count.

Monthly Trade Volume

| Transaction Type | Average Monthly Volume | Projected Monthly Volume |
|--------------------|------------------------|--------------------------|
| CDN Equity | | |
| CDN Fixed Income | | |
| CDN Mutual Funds | | |
| CDN Options | | |
| CDN Other | | |
| US Equity | | |
| US Fixed Income | | |
| US Options | | |
| Non-North American | | |
| Total | | |

4. Introducer’s Projected Number of Accounts

Another important element of cost and pricing for a Carrying Broker is determined by the account type. A Carrying Broker will therefore want to know as many details as possible about your account base. An ‘account’ is usually defined as either an “entity” (individual, corporation, registered plan), but there may be multiple accounts per entity. It is important to be clear as to what you are including in your count.

| Account Type | | | |
|--------------|-------|-----------------------|--------------------|
| | Count | Total CDN \$ MV | Average Balance |
| CDN Cash | | | |
| CDN COD/DAP | | | |
| US COD/DAP | | | |
| CDN Margin | | | |
| US Margin | | | |
| RSP | | | |
| RIF | | | |
| RESP | | | |
| US Cash | | | |
| Inventory | | | |
| Total | | | |

5. Types of Accounts Introducer Intends to Offer

A Carrying Broker will also want to know the account types the Introducer intends to offer. To assist you develop your list, below are a list of possible account types (there may be others):

- RRSP
- RRIF
- RESP
- QSSP
- Margin
- Options
- Futures
- Managed
- Discretionary
- Cash & Trading
- Cash Management

| Account Type | Margin Debits | | Cash and Margin Credits | |
|--------------|---------------|-------------|-------------------------|-------------|
| | Count | Cash CDN \$ | Count | Cash CDN \$ |
| CDN Cash | | | | |
| US Cash | | | | |
| CDN Margin | | | | |
| US Margin | | | | |
| Registered | | | | |

6. Types of Business Introducer Intends to Engage in:

- Agency Trading
- Principal Trading
- On-line Trading
- Day Trading
- Corporate Finance*
- Mutual Funds
- Segregated Funds
- Pooled Funds
- Portfolio Management

- Foreign (Non-North American) Trading
- Syndicated Mortgages
- Private Placements*

*Generally, all corporate finance and private placement activities and obligations undertaken or incurred by Introducing Brokers are their sole and exclusive responsibility, including responsibility and liability for all capital to be provided for regulatory and other purposes in support of any corporate finance assignment, for all due diligence and related obligations, and for any liability incurred in respect of any corporate finance assignment.

7. Special Situations

There may be some unique attributes of your business that you want to discuss with your potential Carrying Broker as process and service offerings can vary from Carrier to Carrier. Without restricting the potential topics, some typical issues that may warrant discussion include:

- Client name accounts
- Non-resident accounts
- Trading directly with counterparties
- Insurance services
- Small business accounts
- Futures

8. Level of Introducer's Intended Autonomy from Carrier:

- a) Does the Introducer intend to manage accounting, risk and financial regulatory reporting?
- b) Does the Introducer intend to have internal systems that will analyze returns/ provide analysis for sales management?
- c) Does the Introducer intend to be able to manage cash (cheques/deposits) at its offices? (This is particularly important where the Introducing and Carrying brokers are in different cities/provinces.)

C. What You Want to Know About Your Prospective Carrying Broker

When comparing the services offered by various Carrying Brokers, it is important to make a disciplined and organized comparison of the issues under discussion. Pricing and delivery models vary significantly by Carrier, with many permutations and combinations being offered. You should ask a lot of questions and systematically define the range of products and services to build an intrinsic profile of your Carrying Broker. These 'nuts and bolts' details can be integrated into your business plan through the request for proposal process and will provide you with quantifiable and comparable data to help you make your selection.

Because of the unique fiduciary responsibilities inherent in the financial services industry, your choice of Carrying Broker should also be, in part, determined by an evaluation of certain of your Carrying Broker's characteristics – such issues as industry reputation, financial strength, knowledge, experience, service assurances, flexibility, responsiveness and commitment to the business. These items are generally qualitative measures in nature.

In addition, listed below are some other matters and issues that our experience tells us you should discuss with your potential Carrying Broker before making a decision:

1. Carrying Firm's Credit Policies and Operating Procedures

Every Carrier has different policies for the risks in the securities business, so a discussion about your particular business model and client base is imperative and is important due diligence for each party.

2. Ability of Carrying Firm to Assist Introducers with Certain Aspects of the Membership Process

Your Carrying Broker may be able to assist you with such things as:

- Procedures manuals
- Internal control policy statements
- Registration
- Business plans
- Shareholder agreements
- Transition management
- Space and technology consulting
- Business continuity plans
- Sample account opening documents, trade confirmations, statements, etc.

3. Carrier's Systems

There are a wide range of system offerings available from Carrying Brokers, and the technology can be a major differentiator of services. The advisor front-end interface has to work for your business model and particular circumstances. The availability of, and the Carrier's willingness to develop and support, data-interfaces with proprietary technology is an important consideration. If it's important for your clients to have on-line access to their accounts than you need to ensure your Carrier can support this feature.

You should understand the cost structure and alternatives available through prospective Carriers.

4. Carrier's Business Continuity Plan

Business Continuity Plans (BCPs) and/or Disaster Recovery Plans (DRPs) are essential elements of any firm's business plan, as well as a regulatory requirement. **While every Introducing Broker is responsible for their own BCP/DRP**, a Carrying Broker can assist with certain components of your plan. Some elements to consider when evaluating a BCP or DRP from a Carrier are:

- Trading and settlement
- Accounting and payroll services
- Office support services
- Research products
- IT recovery strategies
- Telecom infrastructure

Trading and settlement issues are generally the most important and significant items of any BCP. Your Carrier's BCP should specifically address equity and fixed income trading through re-routing to alternate sites or to back-up systems.

In terms of IT recovery strategies and applications, DRPs should cover all major critical applications and provide for a level of information back-up that covers client transaction history and the retention of daily trades and book keeping information.

5. Carrier's Pricing Schedule

i) Cost per Trade

The cost per trade is the de-facto standard for basic provision of clearing services. However, the definition of a trade and the rate per trade varies widely among Carriers. Ensure you are comparing pricing among Carriers on a similar basis – usually defined by market. Carriers will also typically separate the clearing function from market execution charges.

ii) Costs for Different Types of Accounts?

Carriers may also charge their services based on the type of account being serviced – ensure you are including all account types you will require in your discussions.

Specific pricing will vary considerably depending upon a number of variables, as determined by your requirements as stated in your business plan.

iii) Out of Pocket Expenses

The Introducing Broker is generally responsible for certain out of pocket expenses. These costs are not related to core trading, settlement or custodial services and may include such items as:

- Printing of statements
- Year end tax processing charges
- Third party printing charges if used
- Internet access and trading (if offered)
- Integrated portfolio management systems
- Data and other quote service charges
- Postage for Introducing Broker statements and confirms
- GST costs are usually passed on or charged where applicable
- Fees (and financing costs) associated with the transfer of accounts

It is important to understand what is included/excluded when comparing offerings from various Carriers.

iv) Client Service Charges (Miscellaneous fees)

Generally, these charges are provided at flow-through cost to the Introducing Broker, but some revenue opportunities exist for the Introducer. Carriers will reserve the right to adjust miscellaneous fees, with appropriate notice, as circumstances dictate.

- Registered Plan Administration charges
- Security registration (special rush)
- CCPC Holdings in RRSP
- Security registration (not including third party charges)
- Account transfers
- Partial transfers
- Wire transfers
- NSF cheque
- Stop payment
- Full deregistrations
- Partial deregistrations
- Certified cheques
- Ineligible fund custody (per security)
- Unscheduled RRIF withdrawal
- Failed transactions

6. Transition Assistance

The transition from your current administrative situation to a Carrying Broker arrangement may have some significant financial and operational implications for your firm. Your Carrier may assist you with the bulk transfer of your accounts, if possible. However, transition planning is not just about the transfer of your accounts. You should also understand the training program offered by your Carrier candidate – every investment dealer operates differently and your operations staff and sales staff need to get up to speed with your new back office as quickly and efficiently as possible.

7. Accounting, Payroll & Regulatory Reporting Services

Accounting and payroll matters are often problematic issues for an Introducer, given the extensive administrative and support structure necessary for their ongoing maintenance. Using the services of your Carrying Broker for these functions can free up resources better focused on revenue generation. A specific service agreement can allow the Carrying Broker to ensure that all necessary information required by the IDA such as General Ledgers, Financial Statements, Commission Summary Reports and Monthly Financial Reports is submitted on a monthly basis, as well as other periodic reporting such as Risk Adjusted Capital Calculations (weekly), CIPF assessment (quarterly) and Joint Regulatory Financial Questionnaire and Report (annually). It must be noted that the integrity of the financial statements and financial information is always the responsibility of the Introducing Broker.

8. Marketing and Sales Support

Promoting and marketing your new business is vital to its long-term success. In any start-up situation, these items are often overlooked in the development of a business plan and your prospective Carrying Broker may be able to assist you in the development of marketing plans and provide counsel in their execution.

9. Research and New Issue Services

These services may be included or offered “a la carte” from your Carrier.

10. Pricing of Fixed Income Products - Inventory and Pricing

The ability to source and transact fixed income transactions may be an important component of your business model. Ensure you compare breadth and pricing of the prospective Carriers’ fixed income inventories.

11. Managed Accounts, Fee Based Accounts, and WRAP Products

Your Carrier should provide information to you on as to ability to offer fee based accounts and access to managed products.

12. Service Model and Service Level Agreements (SLA)

Inquire as to your Carrier's service delivery model. This should include a documented SLA for those areas important to you as well as formal feedback mechanisms and a defined escalation processes.

13. Physical Tour of the Plant

Ask for a tour of your potential Carrier's operations and make your own assessment of their readiness to take on your business.

14. Ask for references!

Your Carrier should provide references from their current Introducing Brokers, with similar business models. Consider asking for a reference from an Introducer who has left the Carrying Broker.

NEXT STEPS:

For additional information on becoming an IDA Member, please access the IDA website at:
http://www.ida.ca/Membership/BecomMemb_en.asp

A list of potential Carrying Brokers is available on the IDA website at:
http://www.ida.ca/Membership/MembServices_en.asp



The Investment Dealers Association of Canada is the national self-regulatory organization and representative of the securities industry. The Association's mission is to protect investors and enhance the efficiency and competitiveness of the Canadian capital markets.

Also available on the Internet at <http://www.ida.ca>
Ce rapport est aussi disponible en français sur demande.

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