Introducing Broker/Carrying Broker Arrangements

This Notice has been prepared to describe the background to and provide details of IDA By-law No. 35 with respect to introducing broker/carrying broker arrangements. IDA By-law No. 35 was most recently amended with the issuance of Bulletin #XXXX on July XX, 2001 (the amendments themselves are effective September 1, 2001). This Notice replaces Compliance Interpretation Bulletin C-111, issued on March 4, 1997.

1. Why make changes to the existing By-law?

By-law No. 35 has been amended to provide clients of the introducing broker additional protection as well as to promote greater efficiency within the introducing broker/carrying arrangements. These amendments establish more appropriate boundaries and requirements for introducing broker/carrying broker arrangements and are part of the continuous response process to the changing needs of Members of the IDA and other SROs.

Because Type 1 and Type 2 introducing brokers rely on their carrying brokers to provide the capital necessary to support the customer base being carried and it is the carrying brokers that have the right and responsibility to monitor the ongoing solvency of the introducing brokers and their customers, it would be inappropriate for Type 1 and Type 2 introducing brokers to enter into multiple agreements or to fully service any part of their securities-related activities. Similarly, because Type 1 introducing brokers rely on their carrying brokers to carry out joint supervision and compliance roles, the amendments make it clear that Type 1 introducing brokers must clear all trades through their carrying broker.

By-law No. 35 establishes a category of SRO membership which allows small securities firms to operate effectively with decreased
capital and insurance requirements. Because of these decreased requirements, introducing brokers are restricted in their activities and their arrangements with carrying brokers are subject to SRO approval and control.

The amendments regarding Type 3 and Type 4 introducing brokers give the corresponding brokers the ability to specialize relationships based on lines of business. It enables the brokers to make the most efficient choices between providing full service to a line of business in-house or entering into an arrangement with the most appropriate carrying broker. This flexibility is only available to Type 3 and Type 4 introducing brokers in recognition of the differences in the abilities and responsibilities of different types of introducing brokers.

In response to the rapid changes in the markets and Member firms’ needs, the amendments also grant to the District Councils the discretion to exempt Members from the requirements of this By-law.

2. What are the relevant changes made to the introducing broker/carrying broker arrangements?

A matrix outlining the changes resulting from the recent amendments is enclosed Attachment #1. A second matrix outlining the resultant revised key characteristics of each of the four arrangements is enclosed as Attachment #2.

**Introducing Type 1 Arrangement**

In a Type 1 Arrangement the By-law is amended so that introducing Type 1 brokers are not permitted to fully service any part of their securities-related activities and are required to clear all trades through the carrying broker.

On the opening of a new account, a disclosure statement must be provided to the customer outlining the roles and responsibilities of the introducing and carrying brokers and a client acknowledgement of the disclosure must be obtained. Thereafter, disclosure of the arrangement must be made on an ongoing basis on all contracts, statements and correspondence. Sample opening and ongoing disclosures are available on request.

Account agreements such as margin agreements, guarantees and options and futures trading agreements must be three-party agreements between the customer, the introducing broker and the carrying broker.

**Introducing Type 2 Arrangement**

In a Type 2 Arrangement the By-law is amended so that Type 2 introducing brokers are also prohibited from fully servicing any part of their securities-related activities.

As in a Type 1 Arrangement, an acknowledgement of the disclosure must also be obtained from the client. With regard to ongoing disclosure, it may be done annually, in which case the introducing broker may elect not to have the logos of both introducing and carrying brokers on its confirmations, statements and similar correspondence.

As in a Type 1 Arrangement, account agreements such as margin agreements, guarantees and options and futures trading agreements must be three-party agreements between the customer, the introducing broker and the carrying broker.

**Introducing Type 3 Arrangement**

In a Type 3 Arrangement the recent amendments to By-law No. 35 expand the ability of Type 3 introducing brokers to enter into more than one introducing broker/carrying broker arrangement, provided a business case can be made for having additional arrangements. Type 3 introducing brokers may also fully service part of its securities-related activities.
When an account to be carried under a Type 3 introducing broker/carrying broker arrangement is opened, the arrangement must be disclosed to the customer. However, no acknowledgement of the disclosure is required.

As in Type 1 and 2 Arrangements, account agreements such as margin agreements, guarantees and options and futures trading agreements must be three-party agreements between the customer, the introducing broker and the carrying broker.

**Introducing Type 4 Arrangement**

In a Type 4 Arrangement the recent amendments to By-law No. 35 expand the ability of Type 4 introducing brokers to enter into more than one introducing broker/carrying broker arrangement and also fully service part of their securities-related activities.

As in a Type 3 Arrangement, when an account to be carried under a Type 4 introducing broker/carrying broker arrangement is opened, the arrangement must be disclosed to the customer. However, no acknowledgement of the disclosure is required.

Unlike Type 1, 2 and 3 Arrangements, account agreements such as margin agreements, guarantees and options and futures trading agreements need not be three-party agreements between the customer, the introducing broker and the carrying broker. Rather, the introducing broker may execute these account related documents directly with its customer without the involvement of the carrying broker.

3. **What were the regulatory concerns leading to the recent amendments to By-law No. 35?**

Experience with the implementation of By-law No. 35 showed that interpretation and application of certain aspects of the By-law were necessary. Therefore, the amendments to By-law No. 35 have been made.

The principal issue dealt with in the recent amendments was multiple introducing/carrying arrangements. A number of Members had established multiple relationships, sometimes with the same carrying broker, to cover different kinds of accounts or lines of business. Others had indicated a desire to fully service parts of their business while having other parts carried.

In several cases regular trading accounts were carried under a Type 3 Arrangement, while RRSP accounts were carried under a Type 2 Arrangement out of a belief that a Type 2 Arrangement was necessary in order to come under the carrying broker’s trustee agreement. The Association has ascertained that Type 3 and 4 introducing brokers can make use of their carrier’s established trustee agreement to cover RRSP accounts.

The Association will continue to study the regulatory issues and amend By-law No. 35 as necessary.

4. **What will happen to the existing introducing broker /carrying broker arrangements as a result of the amendments?**

The amendments to By-law No. 35 are refinements to the operation of those arrangements introduced in 1997. These amendments have not altered the fundamental nature of the relationship between introducing and carrying brokers. As mentioned in the above question 3 and other sections, some clarification and additional rules have been formed to allow more efficient choices between introducing and carrying brokers. In a word, the amendments continue to restrict certain activities of Type 1 and Type 2 and expand Type 3 and Type 4 capacities.

A black-line copy of the most recent amendments to By-law No. 35 is enclosed as **Attachment #3**.

Any Member having current arrangements that contravene the amendments is
required to make the necessary changes as soon as possible.

5. What trading related functions in combination are considered to be an Introducing Broker/Carrying Broker Arrangement and therefore subject to the regulatory requirements of By-law No. 35?

Certain combinations of functions provided by one firm to another constitute an Introducing Broker/Carrying Broker Arrangement, whereas other combinations of functions do not. The following are six main trading related functions that are performed:

<table>
<thead>
<tr>
<th>Function #1</th>
<th>Function #2</th>
<th>Function #3</th>
<th>Function #4</th>
<th>Function #5</th>
<th>Function #6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trade</td>
<td>Trade</td>
<td>Custody of</td>
<td>Custody of</td>
<td>Bookkeeping</td>
<td>Financing</td>
</tr>
<tr>
<td>execution</td>
<td>settlement</td>
<td>cash</td>
<td>securities</td>
<td></td>
<td>of positions</td>
</tr>
</tbody>
</table>

Functions or combinations of functions that do not constitute an Introducing Broker/Carrying Broker Arrangement include:

Functions #1 and #2 This combination of functions is a “jitney” or “omnibus” arrangement and is not subject to the requirements of the Introducing Broker/Carrying Broker Arrangement rules, as set out in By-law No. 35.

Functions #2, #3 and #4 This combination of functions is a custodial arrangement and is not subject to the requirements of the Introducing Broker/Carrying Broker Arrangement rules, as set out in By-law No. 35. Of course this arrangement is subject to other requirements set out in the IDA Rule Book relating to custody of customer cash and securities.

Functions #1, #2, and #5 This combination of functions is not subject to the requirements of By-law No. 35. The introducing broker/carrying broker requirements do not apply where cash and security custody is performed at a separate and assets are not commingled in any way with the service provider’s assets. This requires distinct segregation of securities by means of individual account FINS #s at the Canadian Depository for Securities Ltd. or other depository for securities of the servicee.

Function #5 The preparation of books and records is not subject to the requirements of By-law No. 35. This function is typically performed by a service bureau with the firm retaining the responsibility to comply the IDA Rule Book requirements for bookkeeping.

Combinations of functions that do constitute an Introducing Broker/Carrying Broker Arrangement include:

Functions #1 through #6 This combination of functions is subject to the introducing and carrying broker rules and is classified as either a Type 1, 2 or 3 Arrangement pursuant to By-law No. 35.

Functions #1 through #5 This combination of functions is subject to the introducing and carrying broker rules where financing of customer positions is performed by the introducer and is classified as a Type 4 Arrangement pursuant to By-law No. 35.

Functions #2 through #6 This combination of functions is subject to the introducing and carrying broker rules where trade execution is performed by the introducer and is classified as either a Type 2 or 3 Arrangement pursuant to By-law No. 35.

Functions #2 through #5 This combination of functions is subject to the introducing and carrying broker rules where trade execution and financing of customer positions is performed by the introducer and is classified as a Type 4 Arrangement pursuant to By-law No. 35.

6. Now that the MFDA has been recognized as a SRO, does this mean that MFDA
Member firms can now enter into introducing broker/carrying broker arrangements with Member firms of other SROs?

In addition to requiring that both the introducing broker and the carrying broker be members of a SRO, by-law sections 35.1(b) and 35.1(c) require both firms be members of a SRO that is a participating institution in the Canadian Investor Protection Fund. Currently, the only SROs that are participating institutions in the Canadian Investor Protection Fund are the Investment Dealers Association of Canada, The Toronto Stock Exchange, the Bourse de Montréal Inc. and the Canadian Venture Exchange. As a result, MFDA Member firms are not permitted at this time to into introducing broker/carrying broker arrangements with Member firms of other SROs.

7. Are there any exceptions set out in the new By-law?

The amended By-law allows the SROs to exempt a relationship between a member and an affiliate that is a Canadian financial institution from the introducing broker/carrying broker rules, provided certain conditions are met. The exclusion would allow an employee of a Canadian financial institution affiliate to handle securities clearance and settlement, maintain records and perform operational functions on the member’s behalf provided that the custodial functions are handled on a segregated basis in accordance with the segregation provisions set out in Regulation 2000.

In addition, an exemption is still available for arrangements where a Member carries accounts of its foreign affiliate. In order to obtain such an exemption, the member must:

(i) Provide the IDA with satisfactory evidence and details of the relationship;
(ii) Disclose the relationship and any limit on CIPF coverage for carried customers of the foreign affiliate to those customer on an annual basis;
(iii) Obtain approval of the arrangement from the requisite regulatory authority of the foreign jurisdiction;
(iv) Report a balance owing to or from its foreign affiliate on its financial reports;
(v) Segregate all securities in accordance with the segregation requirements set out in the by-laws and regulations; and
(vi) Include the foreign affiliate’s customer accounts in its asset measurement calculations for insurance purposes.

Finally, By-law No. 35 now allows a Member firm the ability to request its District Council to grant the exemption from the bylaw for a proposed relationship provided an acceptable business case can be made to justify the need for the relationship.

8. What other reference sources are there relating to Introducing Broker/Carrying Broker Arrangements?

IDA Bulletin XXXX, issued on August XX, 2001. This notice announced the implementation of the most recent changes to By-law No. 35.

**Standard Industry Agreements for each of the four types of introducing broker carrying broker arrangements are available as follows:**

Type 1 Introducing Broker
Type 2 Introducing Broker
Type 3 Introducing Broker
Type 4 Introducing Broker
Please Distribute To All Interested Parties In Your Firm

<table>
<thead>
<tr>
<th>Standards and Responsibilities</th>
<th>Type 1</th>
<th>Type 2</th>
<th>Type 3</th>
<th>Type 4</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Section 35.2</td>
<td>Section 35.2</td>
<td>Section 35.4</td>
<td>Section 35.5</td>
</tr>
<tr>
<td>1. Must a written contract and approval be obtained to enter into introducing broker / carrying arrangement</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td></td>
<td>Sec. 35.1(e)(i)</td>
<td>Sec. 35.1(e)(i)</td>
<td>Sec. 35.1(e)(i)</td>
<td>Sec. 35.1(e)(i)</td>
</tr>
<tr>
<td>2. Can an Introducing Broker introduce customers to more than one Carrying Broker and fully service any part of its securities-related activities?</td>
<td>No, with the exception of an additional arrangement entered into exclusively for trading in futures and options</td>
<td>No, with the exception of an additional arrangement entered into exclusively for trading in futures and options</td>
<td>Yes, including the arrangement for trading in futures and options</td>
<td>Yes, including the arrangement for trading in futures and options</td>
</tr>
<tr>
<td></td>
<td>Sec. 35.1(e)(ii) &amp; (iii)</td>
<td>Sec. 35.1(e)(ii) &amp; (iii)</td>
<td>Sec. 35.1(e)(v)</td>
<td>Sec. 35.1(e)(v)</td>
</tr>
<tr>
<td>3. Can an introducing broker clear the trade settlements on its own?</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td></td>
<td>Sec. 35.1(e)(v)</td>
<td>Sec. 35.3</td>
<td>Sec. 35.4</td>
<td>Sec. 35.5</td>
</tr>
<tr>
<td>4. May a Member be exempted from the requirement of this By-law 35?</td>
<td>Yes, at the discretion of the District Council</td>
<td>Yes, at the discretion of the District Council</td>
<td>Yes, at the discretion of the District Council</td>
<td>Yes, at the discretion of the District Council</td>
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<td></td>
<td>Sec. 35.1(h)</td>
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</tr>
<tr>
<td>5. Is there any requirement for client acknowledgment at the opening of client accounts?</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td></td>
<td>Sec. 35.2(k)</td>
<td>Sec. 35.3(k)</td>
<td>Sec. 35.4(k)</td>
<td>Sec. 35.5(k)</td>
</tr>
</tbody>
</table>

Legend:

Amended Section

Amendments to By-Law No. 35 (Attachment #2)
<table>
<thead>
<tr>
<th>Standards and Responsibilities</th>
<th>Type 1</th>
<th>Type 2</th>
<th>Type 3</th>
<th>Type 4</th>
</tr>
</thead>
<tbody>
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<td></td>
<td>Section 35.2</td>
<td>Section 35.2</td>
<td>Section 35.4</td>
<td>Section 35.5</td>
</tr>
<tr>
<td>1. Must Introducing and Carrying Brokers both be SRO Members?</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td></td>
<td>Sec. 35.1(b) &amp; (c)</td>
<td>Sec. 35.1(b) &amp; (c)</td>
<td>Sec. 35.1(b) &amp; (c)</td>
<td>Sec. 35.1(b) &amp; (c)</td>
</tr>
<tr>
<td>2. Can an employee of an affiliated Canadian financial institution handle securities clearance, settlement and record keeping on behalf of the Member?</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td></td>
<td>Sec. 35.1(d)</td>
<td>Sec. 35.1(d)</td>
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<td>3. Must a written contract and approval be obtained to enter into introducing broker/carrying arrangement</td>
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<td></td>
<td>Sec. 35.1(e)(ii) &amp; (iii)</td>
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<td>Sec. 35.1(e)(v)</td>
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</tr>
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<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td></td>
<td>Sec. 35.1(e) (v)</td>
<td>Sec. 35.3</td>
<td>Sec. 35.4</td>
<td>Sec. 35.5</td>
</tr>
</tbody>
</table>
6. May a Member be exempted from the requirement of this By-law 35?
   Yes, at the discretion of the District Council
   Sec. 35.1(h)

7. What is the minimum capital requirement of the Introducing Broker for the purposes of calculating Risk Adjusted Capital?
   $75,000
   Sec. 35.2(a)
   $250,000
   Sec. 35.3(a)
   $250,000
   Sec. 35.4(a)
   $250,000
   Sec. 35.5(a)

8. Who provides for margin arising from Customer Accounts Carried?
   Carrying Broker
   Sec. 35.2(b)(i)

9. Who provides for margin arising from OTC Security Fails?
   Carrying Broker
   Sec. 35.2(b)(i)

10. Who provides for margin arising from Introducing Broker Principal Positions?
    Introducing Broker
    Sec. 35.2(b)(ii)

11. To what extent may the Carrying Broker offset against the required margin on the Customer Accounts Carried against the Introducing Broker Comfort Deposit? May offset against the loan value of Comfort Deposit to the extent of excess Risk Adjusted Capital
    May offset against the loan value of Comfort Deposit to the extent of excess Risk Adjusted Capital
    May offset against the loan value of Comfort Deposit to the extent of excess Risk Adjusted Capital
    Sec. 35.4(c)
    Sec. 35.3(c)

12. Who reports Customer Account Carried?
    Carrying Broker
    Sec. 35.2(d)
    Introducing Broker
    Sec. 35.4(d)
    Introducing Broker
    Sec. 35.5(d)
<table>
<thead>
<tr>
<th>Question</th>
<th>Carrying Broker Sec. 35.2(e)</th>
<th>Carrying Broker Sec. 35.3(e)</th>
<th>Carrying Broker Sec. 35.4(e)</th>
<th>Introducing Broker Sec. 35.5(e)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Who effectively funds Customer Accounts Carried?</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Does Carrying Broker segregate the Introducing Broker Comfort Deposit?</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>In the case of cash, is a separate bank account maintained?</td>
<td>Sec. 35.2(f)</td>
<td>Sec. 35.3(f)</td>
<td>Sec. 35.4(f)</td>
<td>Sec. 35.5(f)</td>
</tr>
<tr>
<td>Who includes in their Concentration Calculation the securities used for collateral purposes of Customer Accounts Carried?</td>
<td></td>
<td>Sec. 35.2(g)</td>
<td>Sec. 35.3(g)</td>
<td>Sec. 35.4(g)</td>
</tr>
<tr>
<td>Who takes responsibility for Segregation of Securities held in Customer Accounts Carried?</td>
<td></td>
<td>Sec. 35.2(h)</td>
<td>Sec. 35.3(h)</td>
<td>Sec. 35.4(h)</td>
</tr>
<tr>
<td>Who takes responsibility for Free Credit Segregation as it relates to Customer Accounts Carried?</td>
<td></td>
<td>Sec. 35.2(i)</td>
<td>Sec. 35.3(i)</td>
<td>Sec. 35.4(i)</td>
</tr>
<tr>
<td>What is the required Minimum Insurance Protection for $200,000</td>
<td>$500,000</td>
<td>$500,000</td>
<td>$500,000</td>
<td>$500,000</td>
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</tr>
</tbody>
</table>
19. Who assumes responsibility for F.I.B. Clause (A) Covering Fidelity Insurance?

Both Introducing and Carrying Broker
Sec. 35.2(j)(ii)

20. Who reports Balances for Customer Accounts Carried for F.I.B. Clauses (B)(C)(D) on Schedule 10?

Balances for Customer Accounts Carried included in Client Net Equity and Total Asset calculations of Carrying Broker
Sec. 35.3(j)(iii)

Both Introducing and Carrying Broker
Sec. 35.4(j)(iii)

Both Introducing and Carrying Broker
Sec. 35.5(j)(iii)

21. Who is responsible for Registered Mail Insurance Requirement?

Both Introducing and Carrying Broker
Sec. 35.2(j)(iv)

Both Introducing and Carrying Broker
Sec. 35.3(j)(iv)

Both Introducing and Carrying Broker
Sec. 35.4(j)(iv)

Both Introducing and Carrying Broker
Sec. 35.5(j)(iv)

22. Is a disclosure statement required upon Account Opening?

Yes
Sec. 35.2(k)

Yes
Sec. 35.3(k)

Yes
Sec. 35.4(k)

Yes
Sec. 35.5(k)

23. Is there any requirement for client acknowledgment at the opening of client accounts?

Yes
Sec. 35.2(k)

Yes
Sec. 35.3(k)

No
Sec. 35.4(k)

No
Sec. 35.5(k)

24. Is there any requirement for

Optional; Yes if annual

Optional; Yes if annual

Optional; Yes if annual

Optional; Yes if annual
<table>
<thead>
<tr>
<th>Section</th>
<th>Requirement</th>
</tr>
</thead>
<tbody>
<tr>
<td>35.2(l)</td>
<td>Disclosure requirement for logos and roles on Contracts / Statements?</td>
</tr>
</tbody>
</table>

If the requirement for disclosure is not performed, refer to:

- **35.3(l)**
- **35.4(l)**
- **35.5(l)**

25. Is there a requirement for disclosure of logos and roles on all Correspondence?

<table>
<thead>
<tr>
<th>Section</th>
<th>Requirement</th>
</tr>
</thead>
<tbody>
<tr>
<td>35.2(l)</td>
<td>Yes</td>
</tr>
</tbody>
</table>

Optional; Yes if annual disclosure requirement (See 27 below) is not performed

- **35.3(l)**
- **35.4(l)**
- **35.5(l)**

26. Who must be a party to all Margin/Guarantee Documentation?

<table>
<thead>
<tr>
<th>Section</th>
<th>Requirement</th>
</tr>
</thead>
<tbody>
<tr>
<td>35.2(l)</td>
<td>Both Introducing and Carrying Broker</td>
</tr>
</tbody>
</table>

- **35.3(l)**
- **35.4(l)**

Introducing Broker only provided that the Introducing Broker provides the Carrying Broker (as part of the Type 4 Agreement) with the ability to act to protect its interest in the securities of the Customer Accounts Carried should the Introducing Broker become insolvent

- **35.5(l)**

27. Is there an optional Annual Information Disclosure requirement?

<table>
<thead>
<tr>
<th>Section</th>
<th>Requirement</th>
</tr>
</thead>
<tbody>
<tr>
<td>35.2(l)</td>
<td>No; disclosure requirements for contracts, statements and correspondence (See 24 and 25 above) are not performed</td>
</tr>
</tbody>
</table>

Yes, if disclosure requirements for contracts, statements and correspondence (See 24 and 25 above) are not performed

- **35.3(m)**
- **35.4(m)**
- **35.5(m)**
28. Is the introduced customer also considered a customer of the Introducing Broker for regulatory purposes?
   Yes
   Sec. 35.2(m)
   Yes  Sec. 35.3(n)
   Yes  Sec. 35.4(n)
   Yes  Sec. 35.5(n)

29. Who is responsible for Supervision and Compliance?
   Both Introducing and Carrying Broker
   Sec. 35.2(n)

30. Can the Introducing Broker facilitate Cash Transactions?
   Yes – through Carrying Broker account with Carrying Broker authorization
   Sec. 35.2(q)
   Yes – through either parties' account
   Sec. 35.3(p)
   Yes – through either parties' account
   Sec. 35.4(p)
   Yes – through either parties' account
   Sec. 35.5(p)

31. Who reports Introducing Broker principal positions?
   Introducing Broker
   Sec. 35.2(p)
   Introducing Broker
   Sec. 35.3(q)
   Introducing Broker
   Sec. 35.4(q)
   Introducing Broker
   Sec. 35.5(q)

32. Are there any exceptions given for an arrangement between a Member and a Foreign Affiliate