

Market Information

## GUIDE TO BECOMING A COMMODITY TRADING ADVISOR

CFTA

**Guide to Becoming a CTA**  
**Dean E. Lundell**

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### Original panels moderated by: Ms. Patricia N. Gillman

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Mr. Greg Anderson	CTA and CPO	September 1993
Mr. Tom Basso	CTA	January 1993
Mr. Doug Bry	CTA	March 1994
Mr. David Cheval	CTA and CPO	May 1993
Ms. Laleen Doerrer	Money Raiser	January 1993
Ms. Audrey Gale	CTA Marketer/Administrator	September 1993
Ms. Patricia N. Gilman	Attorney	All Seminars
Ms. Malinda Goldsmith	CTA	March 1994
Mr. Yra Harris	Floor Trader and Former CTA	May 1993
Mr. Joe Krutsinger	FCM	January 1993
Mr. Michael Liccar	Accountant	May 1992
Mr. Edwin L. Miller	CTA and CPO	September 1993
Mr. Joe Nicholas	CTA Consultant	May 1993
Mr. Craig Pauly	CTA and CPO	May 1992
Mr. Jeff Quinto	FCM	March 1994
Mr. Thomas P. Schneider	CTA	December 1992

*"How to Survive Your First NFA Audit"*  
*MFA Journal, Appendix IV*

Although a number of years have passed since those first seminars, the pages still offer the reader valuable insights and useful advice on what it takes to become a successful CTA (Commodity Trading Advisor). It is our sincere hope that you will find value in the wisdom contained in these pages.

### **About the author**

The author, Dean Lundell, has been a Vice President at Merrill Lynch Capital Markets, a Principal of a regional investment bank and is, of course, a CTA. He is the author of *Sun Tzu's Art of War for Traders and Investors* (McGraw-Hill) and has written numerous publications for private audiences on interest rate derivatives and foreign exchange, corporate and investment banking and the fixed-income markets.

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**MARKET TRENDS FOR  
ALTERNATIVE INVESTMENTS**

CHAPTER





## Alternative Investments

Alternative investments can encompass a wide variety of investment vehicles, among which are certain fixed-income instruments, equity real estate, private equity, hedge funds, and of course managed futures.

The trend for institutional participation in alternative markets is clearly on the rise on a global basis, with the exception of Japan. Geographic areas that have seen the greatest expansion in allocations to this broad asset category are North America, continental Europe, the United Kingdom and Australia.

As of early 2004, allocations to alternative investments, including managed futures, comprise almost 14 percent of investment dollars in Australia, (although that is a relatively small market), 9.5 percent in Canada, 7.5 percent in the United States, 8 percent in continental Europe, and 7 percent in the United Kingdom, while Japan lags at only 0.6 percent.

There is a wide disparity among institutional investors in regard to the percentages of funds they have invested in alternative markets, particularly between pension funds and endowment funds and foundations. On a global basis, endowment funds and foundations are most involved in these markets, with roughly 20 percent of their assets in alternative investments, while pension funds lag this trend significantly.

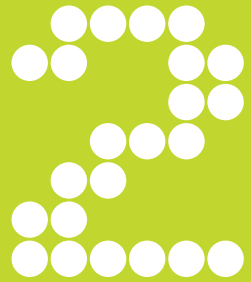
The growth in managed futures over the past 25 years has been truly exponential. According to The Barclay Group, which monitors assets under management, CTAs (Commodity Trading Advisors) were managing \$310 million in 1980. By 1990, that figure was \$10.5 billion; by 2000 it was \$37.9 billion and in 2003 it totaled \$86.5 billion. These figures are echoed in the substantial increases in trading volume on futures exchanges around the globe. Electronic trading has certainly played a major role in contributing to this extraordinary growth. There is no mistaking the trend. For more information, visit [www.barclaygrp.com](http://www.barclaygrp.com).

Even hedge funds, which have tended to eschew the institutional market because they were unwilling to reveal certain portfolio characteristics, are now participating extensively in managed futures. As a CTA, and therefore as an institutional investor, you will have a fiduciary responsibility to perform due diligence. You will not have to reveal everything, but you will have to be prepared to explain the value proposition of your trading program.

The principal reason institutional investors participate in the managed futures market is the non-correlation of futures returns to traditional equity and debt investments. Although futures provide an attractive vehicle for diversifying total portfolio risk, managing and monitoring futures takes a disproportional amount of resources on the part of investors. Therefore, one of the most effective ways a CTA can secure assets to manage from these investors is to make it easy—and worthwhile—for them to do just that.

THE BUSINESS OF BEING A CTA

CHAPTER



## **Business Plan and Structure**

Being a CTA and managing other people's money is a business and should be treated as such. You have to think about it as any new business venture. Take the time to write a comprehensive business plan. Take an inventory of your strengths, your weaknesses, resources and skills. It's important to be honest with yourself and with your potential clients. If there is a deficiency somewhere, find a way to address it.

Although working with a partner can certainly have its advantages, it would be very much worth your while to incorporate, rather than being a sole proprietor. Make sure you have in writing what is going to happen in the event something goes wrong. This is a business like any other and it makes sense to protect yourself and your business. Make sure you secure the services of an attorney.

There are no hard and fast rules concerning areas of responsibility in partnerships. In some instances, partners do not allocate those areas of responsibility; in others they do. Some partners compare and contrast their thoughts and opinions and arrive at a consensus before executing any trade. On the flip side, other firms will have dedicated principals that focus on a particular market sector or segment. Admittedly, this approach has the potential to lead to problems concerning unequal performance or asset allocation to various market segments.

## **Staffing**

As a new CTA, you may have a modest amount of assets under management. You may need an assistant, but you can hire people who do not necessarily have to be employees of the firm. You can also outsource certain aspects of your business to professionals such as legal or accounting firms.

For example, you may have accounts at several different Futures Commission Merchants (FCMs). Instead of placing all your individual orders with each FCM, you could select someone to do give-ups on your behalf.

The basic concept is do not attempt to do everything by yourself. If you are at all successful at raising money and trading the markets, you will very soon be much too busy with the markets.

Certainly, at a minimum, you are going to need people for clerical functions such as keeping track of your equity run, collecting fees and providing general operational functions, and that doesn't begin to address the problem of marketing yourself, which has become a professional function unto itself.

It would be very much worth your while to have an assistant or partner who can run the company, talk to clients and eventually help with trading. This will enable you to concentrate on trading, not talking with clients and assuming other administrative duties. A partner or assistant functioning as your “trading conscience” can be worthwhile if you are a discretionary trader. This should be someone that you know and trust and who knows how you trade. You need someone with the ability to ask, “What are you thinking?” This person can help keep you on track. Systems traders, however, generally, do not have this particular problem, since the system makes the trading decisions.

### **Growth Management**

How you are going to raise money will often dictate what you are going to need to set up your office. Are you going to have a single pool of funds or will you raise funds yourself from a variety of sources? Your administrative needs will also multiply if you decide to trade in the cash markets, such as foreign exchange, or perhaps trade in foreign markets. Participate in either of those markets and you will have to have someone on-call 24 hours a day.

You could experience growth in several ways, not just assets under management:

- The number of Futures Commission Merchants you are dealing with. An increase here may very well demonstrate the need for someone to process trades, report give-ups and check positions daily.
- Trading various cash markets in addition to the futures markets. You may find that you need to hire an experienced trader instead of going through the learning curve yourself.
- Trading 24-hour markets. If you choose to do this, you will need someone to monitor positions or at least be on-call.

Operating in these different markets will also result in additional costs. You will probably want to approach these growth areas slowly and take care to see that your trading is leading the growth. You do not want to be in the position of having your trading being driven by having to make enough money to cover your overhead.

In addition to being very efficient, one of the beauties of this business is that it is not labor intensive. Once you pass the \$5 million mark in equity, your costs should be covered fairly easily.

The type of firm you run and the number of clients you serve can often dictate your administrative needs. One firm may have \$50 million under management with ten clients, while another might have \$50 million under management, but have 1,000 clients. Obviously, the administrative needs of the second would far outpace the needs of the first, since you would need a staff or resources for compliance, accounting, marketing, trading, account administration, information systems, and research and development.

### **Office Equipment and Trading Systems**

A computerized trading system with live markets, as you know, is an absolute necessity. There are myriad systems on the market with levels of capability from rudimentary to the highly sophisticated. Most all of them will offer news and access to various levels of technical analysis. Multiple monitors are a matter of personal preference and budgetary constraints. Having a separate computer for accounting, client databases and other administrative functions is a necessity.

Another necessity is having back-up systems for your computers, telephone lines, data delivery systems, power grid and so forth. You cannot afford to be “down” regardless of the reason.

### **Start-Up Costs**

Anyone who allocates money on behalf of an institution is not going to care how much money you have spent in setting up your operation. The only thing that matters to them is that they believe you know what you’re doing and that you have the resources to accomplish it. Persian rugs and crystal chandeliers may impress a retail clientele, but not an institutional client.

Having the money to stay in business for the first couple of years is critical. The first one to two million dollars you raise will be the most difficult. Given that, you will want to have sufficient money to operate your firm for the first two years. Although it is a questionable policy to depend on incentive fees to cover your overhead, in the beginning you may not have a choice. You very well may be faced with a situation in which people will allocate capital to you on an incentive basis only, but not on a management fee basis.

How much is enough? That depends on the return you provide and the costs you incur. Admittedly, that is difficult to quantify. Ideally, you want to get to the \$10 million under management level as quickly as possible.

Do not fall into the trap of raising your overhead to the point where you can't concentrate on your trading. That will impact your focus and results.

The costs incurred in getting started as a CTA depends on what you do. If you have expensive computer capability, an office staff and office space along with marketing, accounting and legal expenses, \$250,000 to \$300,000 for the first year is reasonable. You can do it with less money if you work out of your home, do not attend industry conferences and just focus on trading and establishing a year-long track record.

Stephen Heilman, CME floor trader, CTA and president of Augustan Capital Management, LLC offers some realistic expectations.

"The first one to two million dollars you will raise will be the most difficult and some accounts will only offer you an incentive fee, not a management fee. You also may not be able to cover your expenses when you first start out," Heilman says.

### **Brokerage Firms and Commission Rates**

Establishing solid business relationships can play an integral roll in attracting serious money and your ultimate success. Your current brokerage relationship is an excellent place to start. Discuss how they can help you and conversely how you can help them. They may be able to help with introductions and marketing.

One school of thought is to do all of your business through one FCM, even using give-ups to that end. Admittedly, you need to be important to your FCM. You also have to recognize that another firm may offer to bring you a significant amount of money to manage, with the understanding that you clear through that firm. You have to remain flexible and adapt to the situation using your best business sense.

### **Commissions and Clients**

Commissions certainly play an important roll in your cost of doing business. As a CTA, you will no doubt enjoy substantial discounts on commissions. Some FCMs will use commissions as a loss leader in return for a share in the management and incentive fees. Others will add a certain amount in return for bringing you the funds to manage.

The commission rate that you agree to has a significant impact on your track record, particularly if you are trading a large number of contracts or are especially active. When you decide on how many and which FCMs to clear through, remember that it will impact your trading, your track record and your executions.

You also have to realize that timely information is also valuable to you. In the over-the-counter fixed-income and foreign exchange markets, some customers will sell the bid and buy the offer. Others will squeeze the dealer on every trade they make. Which customers do you think receive the best service? As a CTA, you have a fiduciary responsibility to watch out for your clients' best interests. Do you want to be the first phone call your FCM makes, or the last? Which is in your clients' best interest? Balancing the cost effectiveness of commissions weighed against the effectiveness of service received is a decision you will have to make.

### **Execution Services**

Slippage, the difference between the last sale and what your eventual execution is, is a major factor in your overall performance. As such, it will benefit you to find quality order fillers you want to deal with. You can use the services of an association, or you can hand pick your brokers. Because you are trading "upstairs" instead of on the floor, receiving quality executions will save you significant money in slippage. Find people who know what you are doing and what you are trying to accomplish.

You have three choices in deciding how you are going to execute a trade:  
You can:

- Go through an order desk at every FCM you clear through for every single trade
- Go directly to a broker who can give up trades to the various clearing FCMs
- Select a single FCM and have them give up trades to various clearing members.

The first choice is the least desirable, while the last is the best. If you choose the latter, you can select whomever you consider to be the best broker.

Explain to your clients how important it is for you to have some input in selecting your own brokers and going directly to them. Just a tick or two on every trade adds up over time. Money raisers will often want you to go through their order desks in order to reduce costs, but give-up fees are not that significant when compared to what it can cost you in time by making several phone calls to various desks.



## **Professional Services**

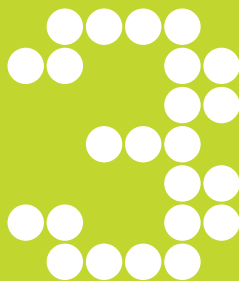
When you are just starting out as a CTA, disclosure documents and track record issues seem incredibly complex. It is worth your while to secure the services of an outside party to handle these tasks. You want an attorney who can help you write a complete and comprehensive disclosure document to protect you. It has to be very explicit in your agreements in all the areas where there could be confusion between the parties. Make absolutely sure you do what your disclosure says you're going to do.

Similarly, getting competent legal advice is the most important thing to do when you are just starting out. Make absolutely sure you are in compliance with all the rules and regulations. You want to be in compliance with the spirit of the law as well as the letter. The last thing you want is a problem or issue with the National Futures Association or any of the exchanges. Having good, sound legal advice is money well spent.

It is also in your best interest to have qualified accounting help. You will have to keep very detailed records of every account you manage on a daily basis. If you do that, your track record can be computed on that daily basis. It is fairly expensive to have your own accounting staff, so you can outsource this function as well. According to Stephen Heilman, "Outsourcing your accounting needs is some of the best money you can spend; it's well worth it."

CREATING YOUR TRADING PRODUCT

CHAPTER



## Overview

The strategy that you will pursue, and that will be carefully delineated in your disclosure document, will outline your consistent approach to how you trade. Your strategy is limited only by your imagination.

Charles Mizrahi, retired founder of Hampton Investors and a former floor trader would teach you to “differentiate yourself.”

“What makes you different?” Mizrahi would ask. “The hardest thing to do is sum up in one line what you do. You need something exciting. Find something unique, then sell the basics. The world does not need another trend following approach. Find a niche that you’re good at. Specialize in a market that is unique.”

William Taki reinforces that view.

“Your research and strategy is your product. It is increasingly important to be different, stable and sustainable,” Taki states. “Trend following is extremely competitive field, it may be better to focus on strategies which add stability to trend following.”

In a broad sense, there are two ways to approach your trading strategy: Choose a mechanical or systems method, or choose a discretionary strategy. Each has advantages and disadvantages.

Mechanical systems generate trading signals automatically, typically by computer with neural networks and/or genetic algorithms, and the trader follows those signals to the letter. Mechanical systems are, by definition, based on technical analysis. There are some users of these systems who will nevertheless employ a certain amount of discretion when deciding when to place the order that the system has generated.

Discretionary strategies are those in which traders use their judgment to place buy and sell orders. These traders typically follow market fundamentals, although many will overlay some degree of technical analysis to augment their basic decision.

Both types of strategies are often labeled “trend-following,” if the strategy is designed to follow market trends, be it short-, medium- or long-term positions.

The more markets you are involved in, the more computerized you will have to be. The CTA who follows eighty markets will have to be considerably more computerized than the CTA who follows ten to twenty. If you are going to use an element of discretion in your strategy, you will have to pare back the number of markets you trade. The more judgment you use, the fewer markets you will be able to trade. There are only so many hours in a day.

There are many different types of potential investors, such as pension funds, endowment funds and even retail investors. You cannot be all things to all people. Tailor your product to what you do best.

Institutional investors will typically choose a group of traders within an asset allocation. The individual traders within that group will often be negatively correlated with each other. Therefore, if you are a high-risk, high-return type of trader, that's fine. You will be matched against another trader who is particularly conservative. The entire group will then be offered to a particular investor.

People who raise capital expect to produce an above-average return for their clients. In that vein, they tend to look for longer track records for discretionary traders than they do for mechanical or systems traders. Discretionary traders are more difficult to place initially, but will attract more capital in the long run. Track records for discretionary traders are typically in the eighteen-month area, whereas mechanical traders are more in the six- to twelve-month area.

Money raisers find it easier to conclude that a new CTA's strategy is good if it is mechanical. To verify the strategy, they will run simulations using historical data and adjust it to compensate for contract differentiations when they roll over. They will also perform random measurements and probability distributions. The end game, of course, is to give them a confidence level in your strategy and methods.

## Mechanical Systems

Mechanical trading systems have been likened to automatic pilots for airplanes. You should endeavor to constantly refine your system until it works the way you want it to. When you reach that point, leave it alone, until or unless it doesn't work.

An Internet search of "mechanical trading systems" will yield hundreds, if not thousands, of results for commercially available systems, from well known names to others that you may not know. You will have to do your own homework to decide if any of these systems are appropriate for you.

The alternative is to design your own system. This will require that you have considerable computer programming skills. If you do not have the requisite computer skills, you can either hire someone to do that for you or outsource that function.

There are six key areas that you should consider when developing your system:

- Reasonable gain-to-volatility ratio
- Non-correlation with other investment vehicles
- Significant degree of market predictability
- Market liquidity
- Adaptability to changing market conditions
- Risk management strategies

As previously mentioned, funds that use multiple advisors often use an asset allocation model to select advisors who are not correlated with each other. If you modify your trading program, you should be aware that those changes could affect the fund mix and cause them to reallocate funds or change advisors.

There are three basic reasons for using a mechanical system. Mechanical systems enable you to substantially increase your diversification, reduce your overhead and make your life considerably easier. Although you may experience draw-downs and experience a losing string of trades, you will not be agonizing over them personally.

Your major task is to build and design your system. Once that is done, it is critical that you have the discipline to stick with it. It's important that you do not override the system's decisions.

Having that discipline can be extremely difficult. When money is involved, psychology can interfere with objectivity. Don't let it. The fundamental idea of the system in the first place is that it takes care of itself—if you let it.

When you develop your system, there are five items to be mindful of:

- Keep your first system simple, so that you and your potential clients can understand it. You should know the total number of winning and losing trades, the largest winners and losers as well as the average winning and losing trades, and the percentage of winning trades that came from long or short positions.
- Balance. Your system should have roughly an equal number of long and short trades that make about the same on both sides of the market.
- The system is not dependent on one or even a few large trades.
- Gain divided by drawdown should be in excess of an 8:1 ratio.
- Average trades should be larger than \$150 after commissions.

### **Discretionary Strategies**

A fundamental approach to the markets when combined with the assistance of technical analysis has become increasingly important. The majority of CTAs with the bulk of the money under management are systems traders. They are quite predictable and do well when the markets have defined trends.

CTAs who are fundamentalists fit very well into a mix that a Commodity Pool Operator (CPO) or capital raiser puts together for a pool that includes the various types of approaches to trading. Since there are a large number of fundamentalists, an approach that includes a discretionary element is valuable if you have that talent.

Discretionary strategies do have their down sides. The number of markets you trade is limited because you have to babysit the markets. In addition, your ego is at risk every day. The system didn't go wrong—you did.

Investors will want to see a certain level of objectivity in a discretionary trader. They will want to know how much risk you take, whether you have obeyed your own rules, and how disciplined you are. Some may even want to know your current psychological state.

### **Diversified Strategies**

How many markets you trade and to what extent are different for every trader. You have to decide what you're comfortable with, considering your skills and experience, resources and capital.

William Taki would suggest "taking a multi-strategy approach in order to be stable and efficient over the long term in this business."

The more markets you trade, the more time it takes. Once you have become accustomed to being a CTA, you might wish to add a couple of additional markets that you think are interesting. Do your research and testing and then add them as you see fit. The more computerized you are, the more markets you will be able to handle. If you know how to use them, computers can leverage your time.

The United States is obviously not the only country that has futures markets. Look at the British, continental European, Japanese, Asian and Australian markets. For example, if your forté is financial futures, there are interest rate, equity and foreign exchange futures markets around the globe. The same is true for agricultural markets. Applying the same strategies to other markets may open up new doors of success for you.

### **Single Sector Strategies**

Single sector traders, those traders who specialize in a specific market or groups of related markets, are going to experience both the positive and negative aspects of pursuing that strategy.

One of the negative dynamics of being a single sector trader is that you limit your client base because the majority of money raisers are apt to choose advisors that are diversified over those that are not. Another aspect is that single sector traders may have to wait for their chosen markets to make a move.

On the positive side of the equation, being a single sector trader will give you an identity within the industry and provide you with the opportunity to distinguish yourself and your expertise. The other positive aspect of being a single sector advisor is that there isn't as much competition when a potential client is looking for a discretionary trader in a particular market. There are many technical traders but comparatively few discretionary traders functioning as specialists in a given market.

## **Strategy Design and Testing**

Everyone has a certain psychological profile and their own set of strengths and weaknesses. When you develop your strategy and design your trading system or approach, be sure it matches who you are. Make sure it matches your style and personality. Find what works best for you and stick with it in good times and bad. Be disciplined.

William Taki recommends that you “differentiate your product by being different, stable and efficient over key periods of market risk.”

It is important to stay with an equity size that matches your style and strategy. Conversely, do not change your strategy to accommodate an increase in equity under management. Some CTAs have chosen to turn equity away rather than change their strategy. You cannot be everything to everybody.

Investors will place money with you based on what you say in your disclosure document. When drafting your disclosure document, state what you plan to do and what you are prepared to lose doing it. Investors understand the nature of this business and are prepared to live with it when they understand and can quantify the risks and potential rewards. Find clients that match your style and strategy and then stay disciplined to it.

You will have to apply historical data to any technical or systematic approach to the markets to see how the system would have performed in the past. Your goal is to identify ideas that not only worked with historical data, but that have an element of predictability so that they will hopefully work in the future.

The cardinal sin in developing a trading system is what is known as “curve-fitting”—designing a system that shows remarkably well when using historical data but that has little likelihood of performing well in real time or the future. You should expect that under actual conditions, your system will not perform as well in live markets as it does under hypothetical conditions, using historical data.



Regardless of what type of trader you are—technical, discretionary or intuitive—you, like everyone else, will go through a decision making process before you take a position in a market. Spend the time to write that process down. Then, you can run that decision process through a system generator software program. This is the fastest and most cost-effective way to find out if your strategy is a good one. It will give you an idea of what your track record, drawdowns and hypothetical return would look like. Keep in mind that these figures may or may not factor in slippage and commissions.

It is important when developing your strategy to include a macro view of portfolio management. Generally, when returns start to flatten out you may be trading too many markets or there is not enough leverage in those markets. People who raise capital on your behalf will employ randomness studies and probability distributions to determine trading strategy outcomes.

### **Slippage Control**

Slippage is the difference between the first price you receive on a trade and the last price at which you are ultimately filled; i.e., the difference between the price that triggers a buy or sell and the price at which you get filled. Slippage can be profitable, but usually isn't. It is a cost of doing business as a CTA.

Incumbent upon you as an asset manager is to use every tool or method at your disposal to keep slippage under control. Be mindful of the types of orders you place, when you place them, how you place them and the people that you place them with. Some CTAs hand-pick their floor brokers, selecting those that they feel will get them the best executions.

Getting out of a trade can be more difficult than getting in. The types of orders you place are entirely up to you, of course, depending on how willing you are to give up the edge. You can certainly use stop and limit orders, but how willing are you to miss a trade? Perhaps the market will come back to your level and perhaps it won't. You have to be the best judge of that. The bottom line is that slippage can be a significant cost of doing business and is more important than saving a few cents on commissions.

### **Institutional vs. Retail Investors**

You have to appreciate that when you are developing a trading system or method, you are creating a product. That product has to be marketable. From time to time, you may find yourself developing a particular program for an individual account. Testing your product using historical data will produce certain returns, volatility, drawdowns and so forth. Those parameters will either include or exclude certain investor groups, even within broad categories.

Individual retail investors are often those who know that this is a business better left to professionals. They have come to this realization either the easy way, or having tried it themselves and failed, the hard way. Should you choose to pursue this market, your administrative costs will be significant, simply because of the number of accounts you will have to have under management.

“Allocators love not losing,” say Charles Mizrahi. “They are attracted at first by the large returns, but then get more conservative. Some people love the returns, but can’t stomach the volatility. Professional allocators have a low tolerance for risk. Some are more concerned with not losing money than they are with making money because their concern is not getting fired.”

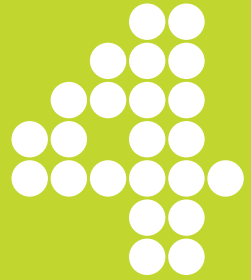
Although they initially will tolerate larger drawdowns in return for higher returns, retail accounts often prove to be more fickle and will withdraw funds after a relatively short period of drawdowns. They will think your system has malfunctioned, but will then get back in after you show improvement again and that you’re at the top of your equity curve.

The primary reason institutional accounts will invest with you is because of the non-correlation to traditional equity and debt investments. Even within this broad category, you will find wide divergences between types of accounts. For example, as a rule pension funds tend to be more risk averse than endowment or foundation funds. Therefore, certain risk/return profiles will appeal to certain groups of institutional investors.

Regardless of what type of client base you choose to pursue, there will come a point at which you will not be able to take on additional funds. You will reach a limit and your returns will start to diminish due to factors such as your system itself, leverage factors and market liquidity.

MARKETING YOUR CTA BUSINESS

CHAPTER



### **Track Record**

The best marketing tool at your disposal is your track record. Your best strategy is a plan to produce consistent returns. Sources of capital are going to use statistics that are based on monthly performance. It is even worthwhile to have your daily performance calculated. These statistics take on significance once you get beyond a few years. Money raisers and other sources of capital have to feel confident that you are capable of producing those returns on an on-going basis.

“Focus on research, trading and technology and let other professionals worry about the marketing and business development,” William Taki would advise. “That is, focus on your risk management and trading performance. Everything is in your track record. Have a three- to five-year time frame in mind.”

Should you have a short track record, you can explain to potential investors what you intend to do, with the purpose of giving them a certain comfort level with your program. Again, the bottom line is demonstrating performance and consistency.

“People who allocate assets are obviously more comfortable with a 15-year track record than they are with someone with one,” says Stephen Heilman. “The longer and more robust your track record is, the better.”

Institutional investors are interested in seeing that you can trade with serious money. Hypothetical results without any real-time, proprietary trading experience is going to inhibit your ability to attract large amounts of capital.

### **Raising Funds**

Marketing and public relations combined with a good trading product and track record could result in more money than you are capable of managing. Quite often you will see that CTAs with modest track records but good marketing and public relations will attract more money than CTAs with exceptional track records but little marketing or public relations.

There is no requirement that you must have a track record as a CTA. However, those with floor trading experience or perhaps upstairs trading experience at a member firm are in a better position to attract clients than those who do not have that experience.

The absence of a track record in real time will make it difficult to raise capital. One answer might be to build a track record prior to registering as a CTA. In this case, it is important that you trade your own money, as you would for potential clients, with your plan and strategy. For example, if you are a floor trader who spreads the front months and buys the bid and sells the offer, this is not going to work when trading upstairs for others. By its very nature, upstairs trading implies you take positions, not make a market.

If you choose to attract capital from friends, neighbors and relatives and put it into a single account, be careful that you do not fall under the requirements of being a commodity pool operator. That would require the proper registration with the National Futures Association (NFA).

One of the more difficult hurdles you will have to manage is getting the first one to two million dollars under management. In the beginning, you can expect to be trading managed accounts as opposed to institutional accounts and fund managers. Once you have established a decent track record with five to ten million dollars under management, trading managers and other institutions that make allocation decisions will see that you are credible. The next step will be trading a large amount of money over time to show that consistency of returns that is so important.

Another avenue for you is to approach member firms and other trading managers that have emerging trader programs. They can allocate a small amount of funds and then watch how you do. Be mindful of signing an exclusive agreement or otherwise giving someone else control over your business. If you sign an exclusive agreement, you are bound to that firm and no others.

### **Account Sizes**

The account size you want to solicit is directly related to how many markets you intend to trade and how much risk-to-equity you are willing to assume. Similarly, that risk-to-equity ratio is going to determine, to a large extent, the type of accounts you are going to solicit. Use the formula in the Risk Management chapter to determine the risk-per-trade as a percentage of equity for each market you intend to trade.

“Your goal should be obtainable returns with moderate risk,” recommends Charles Mizrahi. “Keep your risk and drawdowns small.”

One of the most important aspects of your trading product is diversification, the ability to trade several different markets. Small accounts limit your ability to do that. Small accounts also limit your ability to stay with a trade and may subsequently have negative consequences regarding margin requirements. As professionals, CTAs should never, ever have to deal with margin requirement problems.

### **Professional Money Raisers**

A professional money raiser is the liaison between you and your client. A money raiser who is a Commodity Pool Operator can serve two very basic needs:

- He or she can provide a source of capital and create an opportunity for you to develop a track record
- He or she can take responsibility for the pool's overall performance

Working with a commodity pool operator is a way to be introduced to significant capital early on in your business, without having to go through the time and effort of making direct contact with institutional clients.

Trading managers, or "managers of managers," are important, particularly if your trading program tends to be more volatile than others. They act as a buffer between you and the client. This insulation will leave you alone to concentrate on your trading, which is why you were hired in the first place.

Being a good trader is not synonymous with being good at sales. It can be difficult when your ego is involved and someone takes issue with something that you truly believe in. A manager of managers, however, will look at your system to see how it might fit with someone else's. When they do that, they reduce the overall volatility by blending various CTAs that have a negative correlation and thus produce a smoother return for the client.

There are various positives and negatives to letting a trading manager, or someone else, take a percentage of your fees in exchange for doing everything for you. Raising capital, establishing and running a back office, calculating your track record and assuming your marketing are just a few of the tasks that may or may not be worth your while to outsource.

People who typically avail themselves of these services do not want a partner and do not want to deal with mundane business problems or decisions. They just wish to focus on their trading.

Aligning yourself with a trading manager is a decision that only you can make. There is always going to be a cost involved in using someone else to raise capital. It may or may not be worth it for you to do it yourself. Certainly your fees will be higher, but by how much? Fees from money raisers come in two basic forms: They are either a part of the fee structure or they are in the commissions. In any event, you do not want to rely on just one source of capital as your avenue to large allocations.

Many CTAs do not have a problem with sources of capital earning their fees, as they support their business and perform many of the client relationship tasks. You should make sure however, that you understand all their fees upfront. It is in your best interest to know what the impact is to the ultimate client, before you accept an account. For a prosperous business, all the parties involved have to be successful: the Commodity Trading Advisor, the Commodity Pool Operator if that is the case and of course, the ultimate investor.

Flexibility is the watchword when it comes to structuring arrangements with parties that market for you. Do your best to ensure their incentives are based on the amount of capital they secure for you. You may want to make their compensation reliant on incentive fees. By focusing on the incentive portion of your fees, they can tell the client that they only make money if you do. Many CTAs use a declining time scale, as they do not wish to pay someone a fee years hence when they no longer have anything to do with their business.

One of the most cost effective ways to find people willing to raise capital on your behalf is to join the Managed Funds Association (MFA). Included in your welcome package will be a membership directory that provides the names, addresses and telephone numbers of money raisers. They may or may not define themselves as such, but look for commodity pool operators, brokers and managers of managers. Then forward your track record and disclosure document to them.

New CTAs should make a point of attending the various industry conferences. They are a great way to meet people. Find out who allocates assets and make contact with them. In the beginning, it's all about networking. After that, you can contact them and make appointments to see them in their offices when they have the time to do so. Discuss your program and strategy as well as your background. Much of the business in this industry is accomplished on that level. Even if you are a new CTA, some CPOs will make a small allocation based on nothing more than instinct and see how you do.

Quite often, Futures Commission Merchants are interested in establishing relationships for managed account programs with individual CTAs. Some have emerging trader programs. In addition, networking through your attorney and accountant can often be helpful.

Last, but certainly not least, is cold calling. Do not be afraid to contact people you don't know. If you're honest, polite and have a good presentation, it can make a difference. People will listen to what you have to say.

People who raise capital for you are going to look for certain criteria. Among these are your track record, the integrity of the data you used, what adjustments you might have made to the data and the level of sophistication and understanding you have of systematic management. Be ready to answer any questions the money raiser will have. Even a hypothetical program will have credibility if you do as well.

When putting your system together, make absolutely sure you know it thoroughly so you can answer any and all questions about it. Money raisers take a dim view of purchased systems, under the theory that if you can purchase it, anyone can. There are turnkey systems that come with any number of certain capabilities that do allow you to change parameters of indicators. Generally speaking, money raisers look for systems that are designed by the CTA.

Fundamental traders, by definition, need to have a track record of actual trading results. The people who will review your results do not like excuses. What they do appreciate are intelligent answers as to why you made or lost money.

In evaluating a discretionary system trader, quite often money raisers are more inclined to worry about drawdowns than they are about rates of return. There is still a concern about "gunslingers" out there.

People who raise capital admire CTAs who have discipline. Take the time to write down your philosophy, structure and discipline, even if you are a discretionary trader, and then stick with it.



## Client Relationships

The type of trading program or system that you design will in large part determine what type of clients will participate in it. Institutional clients, like you, have a fiduciary responsibility and allocate their assets accordingly. Therefore, from a marketing perspective, you have to consider how many investors and how much equity will support what you intend on offering. Conversely, at what point will too much equity detract from the returns you are trying to achieve? Regardless, assets allocated to alternative investments typically represent only a small portion of the investor's total portfolio.

Similarly, if you intend on marketing to a retail, or individual, clientele, you should take care to ensure that their investment with you represents that same small portion of their liquid assets. Typically, that portion should be no more than 10 percent total in managed futures and even that may be pushing the envelope. To be absolutely certain what portion of a client's assets you should manage, you should seek out qualified legal counsel.

In addition, you should know if your client can afford to lose all the money they place with you, both financially and mentally. Retail clients in particular will put money in and take money out at the worst possible times. You should also make it clear that whatever money is placed with you is there for an extended period of time. It should be a long-term commitment.

From time to time, you may find it necessary to engage in anti-marketing. Do not be afraid to turn down an account if you sense that the client isn't right for you. Make sure the potential client is aware of the downsides as well as the upsides. Make sure they have realistic expectations.

Our market place today is much more sophisticated, focused, conservative and institutional than it has ever been in years gone by. Therefore, the type of trading products that sell are more conservative than they have been in the past. In order to properly target a particular client base, you must find out what their interests and priorities are, what they will typically allocate and what type of CTAs they are have an interest in. Be familiar with what tools the trading manager uses when they evaluate you and your program. Look at yourself from their perspective and how to address their concerns in order to focus your marketing efforts and deliver what you have promised.

### **National Futures Association Rules**

After you have designed your trading program, you will want to then design promotional material to send to or leave with potential investors. The National Futures Association has very stringent rules on promotional material and communications with the public; particularly, Rule 2-29. Before you give anything to a potential investor, have it reviewed by competent legal counsel and the NFA. The last problem in the world you want is a regulatory one.

Rule 2-29 was designed by NFA members and has two basic functions. The first is to insure the highest ethical standards when you communicate with the public and the second is that no rule should stifle fair marketing. Some of Rule 2-29's provisions are general, while others are quite specific.

Communications with the public can take many forms. Sales or educational material, any form of advertising, phone solicitations, prepared sales "scripts," seminar or meeting presentations or invitations to attend them and newspapers, reports and circulars are all examples of communications with the public.

The following is paraphrased from the NFA Manual. Generally speaking, Rule 2-29 requires the following:

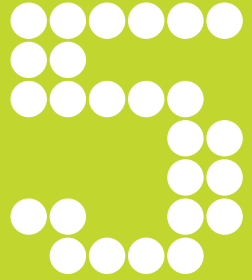
- Statements made in promotional material must be factually true and you must be able to document them
- Statements concerning profits must be accompanied by a statement about losses or potential losses, equally prominently
- Hypothetical results in the past must say they are hypothetical—in CAPITAL LETTERS
- Statements regarding past results must say that past results are not indicative of future results
- Rates of return must be calculated consistent with CFTC Regulation 4.21(a)(4)(ii)(F).
- Statements concerning past performance must be representative for all accounts over the same period of time
- Statements of opinion must be identified as such and have a reasonable basis in fact

- Members must have written procedures for reviewing and approving promotional material used by associates and employees
- Copies of promotional material and their approval must be readily accessible for three years after the date of last use
- Copies of promotional material must be on file with the NFA immediately after use if required by the Director of Compliance

Again, before you disseminate anything to the public, have your attorney and the NFA review it first.

THE MEASURES OF CTA SUCCESS

CHAPTER





## Attracting Investors

The reason investors will place money with you, in the first place, is that the returns on futures do not correlate with returns on traditional investments such as stocks and bonds. Implied in that reasoning is that they expect returns in any type of market. Those returns, of course, are commensurate with risk and volatility.

You will be evaluated on four basic criteria:

- Performance
- Consistency
- Volatility
- Drawdowns

Within each of these categories, there are any number of methods to measure performance.

## Performance and Consistency of Returns

Investors are considerably more conservative and sophisticated than they were years ago. As alternative investments have come into their own for serious asset allocations, the means have been developed to measure return, risk and potential returns, and drawdowns.

“The hedge fund and CTA business has matured to the point that we are now moving toward global standards and practices,” says William Taki.

“Sophisticated investors who build portfolios and manage risk are employing increasingly diversified portfolios. Sophisticated investors understand what drives strategy returns. It is more important than ever to understand how to manage change and adapt in such an environment.”

Many investors will look for a certain return beyond the “riskless rate of return.” You will have to ask your clients what they consider that to be. Many will recognize the standard three-month Treasury Bill, while others consider the thirty-year Treasury Bond as that rate, although the absence of new issuance may change that. In any case, make sure you know what your investors are using for a benchmark and how you will be measured.

High absolute returns are important, but with the caveat that they are achieved on a reasonable risk-adjusted basis. For larger institutional sources of funds to be interested in a high return trader, your track record is going to have to be commensurately longer. The reason is that they will want to see that you can recover from the larger inherent drawdowns. Again, consistency of returns is a major key to your success.

William Taki suggests the importance of "having a coherent process which you follow that explains how you are disciplined and consistent."

Monthly returns that a floor trader would consider boring will bring all the money you can handle, but only if you are consistent with those returns and show small drawdowns. You have to be able to show that you can produce consistent returns month after month.

### **Limiting Drawdowns**

Institutional investors in particular are more inclined to accept a smaller return if it is accompanied by similar smaller drawdowns. These investors and others who allocate assets will not become comfortable with you until they have seen those results produced consistently over an extended period of time.

Put yourself in the position of pension fund managers. They have a fiduciary responsibility to their plan participants and are accountable to their board of directors. Now take a look at your absolute peak-to-trough equity, net returns, drawdowns and consistency. The conclusions you might draw are no doubt similar to those of an individual making a decision to place equity with you.

### **Length of Track Record**

The length of your track record can be a somewhat nebulous subject. As we have already discussed, if you are a fundamental trader your track record most likely is going to be longer than if you are more systems oriented.

Years ago, two years of experience might have been acceptable. That window then moved to one year and perhaps even six months in some cases. Now, however, a realistic expectation is three years minimum to become an established CTA. Other experience does count though, including your tenure as a floor trader or other venue, such as trading cash markets "upstairs" at a member firm. People who allocate capital, from any number of sources, may also have "emerging trader" programs.

"Have a business strategy that will sustain you for three years," suggests William Taki. "CTAs have to prove themselves with three years of experience and \$35 million in assets under management to be credible in the current environment."

## **Becoming Established**

Becoming “established” is very much a function of who you are, what kind of capital you might be able to attract and what kind of track record you have achieved. Under normal circumstances, three years might be a reasonable benchmark. Up to seven is not unusual. There are many exceptions to this rule, of course. It may only take you six months if you were a former proprietary trader at a member firm, or, conversely, it may take in excess of three years.

“Be in it for the long haul. Build your business like a house, one brick at a time,” counsels Charles Mizrahi. “View this as building a business, not as a trader looking for the next trade.”

That being the case, you should plan on three years before you will see a decent income from operations and should properly prepare for that.

As we have already discussed, becoming established is as much a function of marketing and public relations as it is achieving a good and consistent track record through your trading. It will pay to get to know people through the various industry associations.

## **Rates of Growth**

It is quite common for growth rates to start to accelerate somewhere after that three year time frame. That’s when people who allocate assets will take notice of you and come to certain conclusions about your trading program and how you might fit into their matrix of traders.

You will find that there are certain barriers or benchmarks in terms of assets under management. Obviously, the first million is the first one. That will show everyone that you are in the business. At ten million, you’ll have enough to hire a small staff, open up an office and make a living. At thirty million, people who raise capital will believe that you are a survivor and are in the business for the long term.

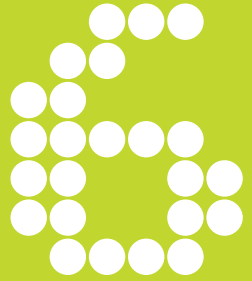
You may find that some investors will be reluctant to commit funds if it will substantially increase the total funds you have under management. Their major concern is that you will be unable to perform as you have in the past with the significant increase in funds. Experienced capital raisers know that one of the biggest pitfalls with new traders is that they are not always able to successfully absorb new capital. They know very well that there is a point of diminishing returns with any one trader.



Have a plan in place to manage your growth in a controlled manner, even if that means turning away money that would compromise your ability to manage it. There is a learning curve in managing more funds, more markets and more clients

RISK MANAGEMENT FOR CTAs

CHAPTER





### **Your Risk Profile**

Your risk management profile, or technique, is extremely important to anyone considering allocating capital to you. It is second only to the consistency of your rate of return.

In evaluating your risk profile, quantitative measures such as the Sharpe Ratio could be used. Very simply, that is your rate of return divided by the standard deviation. The closer to parity, or 1:1, that ratio is, the more conservative you appear to be.

### **Diversification**

By diversifying a managed futures portfolio, you introduce the portfolio management concept of a balanced portfolio. Clients are interested in how you are going to minimize their market exposure. You do that by diversifying your assets under management among various commodities. If you can master the skill to do that, it will not only improve the potential for enhanced returns, but will also reduce your standard deviation in the process. Not surprisingly, it will also improve your marketing capability.

“Diversify your product line, but within what you know,” Charles Mizrahi advises. “Stick to your knitting; don’t trade markets you don’t know.”

Diversifying into other markets is crucial to your success. Even if you are specialized in a particular market area – interest rates, for example—Chicago is not the only interest rate market in the world. Before venturing into foreign interest rate markets, however, be sure to back-test the data with your system and make sure the volume and open interest meet your criteria. Versatility and adaptability are critical to your success.

“Have experienced advisors and people within your organization that are objective and can monitor your strategy from a compliance and investors’ point of view,” William Taki advises., “Objective risk management is a good thing.”

### **Risk per Trade**

The amount of equity that you risk on any given trade will impact your risk profile. There is no magic number. It may be 1 percent or 2 percent, but on rare occasions you may find a CTA risking in excess of 5 percent. Risk too little and you forgo profit opportunity; risk too much and you will increase your vulnerability. You will have to find a balance where you and your investors feel comfortable. You will also find that many CTAs will have a limit on marker sectors and even a limit on the portfolio as a whole.

Remember to constantly evaluate your risk per trade and the number of contracts you are holding as the market moves along with your stops. By doing that, you create a controlled risk structure as a percentage of your equity at risk.

### **Position Sizes and Risk Exposure**

Determining your position sizes is very much a function of what type of trader you are. Are you a high return-high risk trader? Perhaps you choose to be a moderate return-low risk trader. In either case, you must do the math before knowing how many contracts to trade.

Consider the following formula for new positions, courtesy of Tom Basso:

- Determine the trade entry price from your trading system
- Determine the stop-loss price
- Convert the difference between the entry and stop-loss point into dollars per contract
- Determine the risk per trade as a percentage of equity
- Divide the risk per trade by risk per contract to determine the number of contracts to buy or sell for the position

For ongoing risk exposure:

- Determine the risk limit per existing trade as a percentage of equity
- Determine the risk per contract based on changes in price and stop-loss point
- Determine the allowable risk based on portfolio equity
- Determine the number of contracts to hold by dividing the allowable risk by the risk per contract

You can modify these formulas by allocations to a particular market based on any number of factors. By using formulas such as these, you keep your leverage constant, so that you trade as you have always done, regardless of the amount of equity you are managing.

### **Trading in Units**

Should you find yourself managing more than one account and the performance of each account must be identical, consider trading in units. Working in units will condense everything down to the least common denominator. For example, if you have two accounts, one for a million and the second for half a million, the smaller account would trade 50 percent of the larger. If your position formula dictates 10 contracts for the smaller account, it would be 20 for the larger. The unit size will fluctuate, so that every day you will know how many contracts should be in each account based on the equity in the account.

### **Kick-Out Levels**

One of the fundamental questions that anyone who allocates assets is going to ask is at what point do you liquidate everything?

This is an integral part of your risk profile and you will have to determine this in advance. Of course it is based on the portfolio's net asset value, but when or how often? This might be on a daily basis or monthly. Perhaps you will compute this on a rolling monthly average. You may want to factor in starting or current equity. Whatever method you use, have it spelled out prior to soliciting investors.

### **Volatility Measurement and Control**

We all know markets are dynamic, not static. Given that, it makes sense to build into your trading system the ability to adapt to changing levels of volatility. Being able to adapt to changing levels of volatility will help you align your portfolio to keep volatility levels proportional to the risk involved.

"Events can blow out your indicators," cautions Charles Mizrahi. "Being stopped out can also mean missing a great trade, and that's the great paradox."

During periods of high volatility you may have to increase your risk on that trade in order to stay with it. Having done that, perhaps you would also want to reduce the outright number of contracts you have in position to accommodate that volatility. During these periods of high volatility, you have to give the market some room to maneuver. You do not want to be constantly stopped-out or whip-sawed. "Your daily risk management process is a critical function," explains William Taki.

Volatility controls will help your clients maintain their composure during these times. You do not need to attract the attention of nervous clients during periods of high volatility.

Consider using the following volatility control formula, again courtesy of Tom Basso:

- Take the open, high, low and close of the last two trading days.
- Measure the market's true range of price movement over the last twenty-four hour trading period by measuring the difference between the higher of yesterday's close or today's high against and the lower of yesterday's close or today's low
- Convert the true range in ticks to dollars per contract to determine the average daily volatility
- Average these figures over a period of time, perhaps ten to twenty days, depending on your trading strategy
- Compute the number of contracts by first multiplying account equity by the percentage to which you wish to limit volatility—for example, 1 percent. Then divide this number by the volatility per contract above to determine the number of contracts to hold.
- Finally, compare this answer to the number of contracts you determined by the on-going risk exposure and use the smaller of the two.

### **Margin-to-Equity Ratio**

The concept of margin-to-equity has a direct correlation to rate of return, drawdowns, position sizes and the volatility of equity in your accounts. As a floor trader, perhaps you did not give this concept a great deal of credence, until the margin became a concern. Moving “upstairs” involves making a transition to where it is a major concern almost immediately.

Given the markets that you choose to trade, a margin-to-equity ratio of 15 percent may give you all the volatility you require. The math is simple if it does not, since you only need to increase that ratio to a level that does give you the required volatility. The opposite is true if you find that you have too much volatility.

Remember that exchanges are very competitive so that margin requirements may or may not reflect the actual volatility of the commodity. Therefore, use margin-to-equity as a guide rather than as an absolute rule. You should make your own interpretation of how much risk is inherent in any position you have or are contemplating. In addition to that, FCMs may require additional margin if they judge the volatility as excessive and certain institutional clients may have their own set of criteria.

### **Commission-to-Equity Ratio**

The commission-to-equity ratio is the percentage of total assets you generate in commissions on an annual basis. Many new CTAs are tempted to accept high commission rates early on in return for assets allocated to them. Although you are certainly free to do so, keep in mind that high commission rates will increase that ratio, hurt your fees and impact your track record negatively.

Conversely, the FCM can bring you much needed capital early on and may have clients willing to accept a new CTA. There is also quality of executions to be considered and as we've already discussed, do you want to be the first phone call or the last?

In the final analysis, only you can weigh the pros and cons and negotiate the best deal you can for the level of services rendered.

### **Stop Orders**

Stop orders are an integral part of controlling your risk. They are particularly useful for traders who have a difficult time pulling the trigger when the time comes to exit a trade. There are traders who are more willing to leave stop orders with their executing brokers, whether on day or open basis, and those who prefer to keep stop orders out of the pit. In either case, using stops is your protection.

There are any number of criteria you might use as to what price level you wish to be stopped out at. You might use historic support or resistance levels or perhaps base your stop-out level as a percentage of risk. You might move your stop levels closer or farther away from the current market based on a level of profit or loss. Whatever your method, have the discipline to stick to your plan. Have an exit strategy.



## Common Questions

In addition to various quantitative measures applied to your trading program, capital raisers are apt to ask other questions as well. The following is a representative list of questions that Baldwin CTA would want you to answer:

- Have you had any other trading programs during the past five years, under this name or others? What was the start date for each?
- How many systems are used to support your program?
- Are you always in the market, either long or short?
- What type of system do you use and to what extent? I.e., technical, fundamental, discretionary, trend-following, counter-trend, reaction or anticipatory, chart patterns, seasonal cycles, spreads, options, arbitrage and so forth?
- What is your estimate of the number of round-turn trades you make per year, per million dollars?
- What is your percentage estimate of winning trades versus losing trades?
- What is the average length of winning trades versus losing trades?
- What is the average gain on winning trades versus the average loss on losing trades?
- Who designed the underlying trading systems you use?
- Are you subject to any licensing agreements?
- How far back have you tested your systems?
- When did you last modify your system?
- How often do you evaluate and/or modify your system?
- Are there any limitations to your system?
- Does your system have a long or short bias?
- Do you inform clients of minor changes to your system, methodology or risk control?
- Do you anticipate making any further changes to your system?
- What are your contingency plans in the case of illness or death of key personnel?
- What circumstances would shut your system down and close all open positions?
- What is your method of re-entry into a market if you are stopped out?
- What type of research do you do on an ongoing basis?

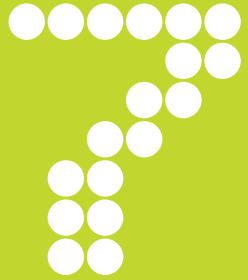
- Do you enter a market on strength or weakness for trend following trades?
- What markets are your principal focus?
- Do you intend on trading any cash,, currency cross-rate or options markets?
- What type of options strategies do you use?
- Do you trade foreign markets?
- Do you ever trade delivery month contracts?
- Do you trade spreads, either inter or intra-market?
- Do you trade different markets by the same rules?
- What is your allocation to various market sectors?
- How often do you change or review your asset allocation?
- What is your method for determining initial and ongoing exposure?
- Do you scale in or enter an entire position at once?
- Do you scale out or exit all at once?
- What type of markets does your system perform best and worst in?
- What are your risk management parameters?
- How do you manage volatility or changes in volatility?
- Do you ever purposely stay out of a market?
- How do you manage drawdowns and subsequent recovery?
- How do you manage dramatically winning or losing positions?
- What is the maximum capital you feel you can manage with your current system?
- How will equity growth affect your trading program?
- What is your fee structure?
- What separates you from everyone else?

This list is certainly not all-inclusive, but the basic concept is the more serious the money, the more in-depth your discussion with potential investors is going to be.



CTA PERFORMANCE RECORDS

CHAPTER





## Regulatory Requirements

The regulatory requirements of performance reporting required by the Commodity Futures Trading Commission (CFTC) and the National Futures Association are such that you are highly advised to seek out professional accounting and competent legal advice.

Please visit and review the CFTC and NFA Web sites at:

- [www.cftc.gov](http://www.cftc.gov)
- [www.nfa.futures.org](http://www.nfa.futures.org)

Your performance record is simply a financial statement that states the amount of equity you are managing, the various results of trading and the resulting ending equity, net performance and monthly rate of return. You are required to update your Disclosure Document every nine months unless there is a material change, and then as soon as possible thereafter.

You should compute your performance record on a monthly basis for several reasons:

- It is going to give a better indication about your month-to-month volatility
- Tracking services normally publish monthly rate-of-return figures
- Performance reports are subject to distortion if figured on a quarterly instead of a monthly basis, depending on the timing of additions and withdrawals and the effect of compounding

The thirteen-column CFTC format is the most complete report you will need. Typically, people who evaluate your performance will require this information. Included in this report is beginning equity, additions, withdrawals, gross realized profits and losses, the net change in unrealized profits and losses, interest income, brokerage commissions and other expenses, advisory fees, net performance, ending equity and the rate of return. Many CTAs also include a Value Added Monthly Index.

Note: Effective May 1, 2004, a new rule went into effect regarding Notional Funding. It requires CTAs to report performance on the entire funding commitment, not the notional portion, and to adjust prior performance to reflect that as well. Please consult with your professional accounting advisor and legal counsel regarding this new rule.

### **Proprietary Performance Record**

The CFTC requires that performance records from professional traders be presented on a “pro forma” or “as is” basis. In fact, the CFTC has taken serious issue with CTAs who compile performance records based solely on the results of their own trading. Their argument is as follows:

- Your own trading is not how you would trade for a client
- As an exchange member you enjoy reduced margin requirements
- You pay member rates rather than brokerage commissions
- You are not charging yourself management and incentive fees
- From a practical standpoint, people who raise capital for you or allocate assets to you will place less credence in your disclosure document if it is based solely on your own trading. Should you decide to include your own personal trading or proprietary track record, you have to observe two rules:
  - You cannot co-mingle your record with those of outside clients
  - You have to present equity, brokerage commissions and other fees, management fees and incentive fees on a pro forma basis. i.e., as if it were a customer account

### **Simulated or Hypothetical Reports**

Without real-time, actual trading results, you might put together a “simulated” or hypothetical performance record that would be an indication of your trading program or style. This type of performance record has the least amount of credibility with anyone reviewing your program. Simulated or hypothetical programs are comprised of actual trades, but rather are based on “paper trades” indicative of what you propose to do.

Should you choose to do this, the CFTC requires that you state, in CAPITAL letters, that this program is simulated or hypothetical. A couple of caveats are in order as well:

- Factor in slippage and round turn commission rates and note them in the footnotes.
- Account for contract rollovers because they can skew the results.
- Scrutinize your data carefully to make the results reasonably real.

Once you begin actual trading, it is a good practice to present both the hypothetical and the real performance records in your presentations to investors.

### Composite Performance Records

Composite performance records are a combined or aggregate report of all the accounts you manage. Therefore, any composite record has inherent distortions in it because each account may have differing cost structures and commission rates. This difference may be particularly acute if you have specialized accounts that focus on a particular market or markets.

Should you trade accounts differently from each other, for example if you have different programs, you should separate the performance tables for each account or program. Not only is this a good practice from a regulatory perspective, but from a marketing viewpoint as well. It works to your advantage to show separate tables instead of a composite.

### Rate of Return Calculations

The Division of Trading and Markets of the Commodity Futures Trading Commission has the responsibility for reviewing CTA Disclosure Documents and performance reporting. Many of their requirements are not identified in the Commodity Exchange Act, but rather are delineated via advisories and interpretations issued by the Division in “deficiency letters.”

The Commodity Futures Trading Commission and the National Futures Association propose and enact rule changes from time to time. It is very much in your best interest to secure professional accounting and legal advice.

The CFTC has defined four types of rate-of-return methods that you may use:

- **Time Weighted System:** In this system, you weigh the additions, withdrawals and beginning equity over the number of days in the month. It is a simple weighted average and a quick way of calculating the rate of return. The drawback is that it can be one of the most inaccurate approaches to calculating rate-of-return because it assumes that your performance was earned pro rata over the entire period in the average.
- **Average Daily Equity:** In this system, which is a variation of the Time Weighted System, the denominator is determined by adding the aggregate of net liquidating equity in all your accounts on a daily basis and then dividing by the number of days in the month. It is somewhat better than the Time Weighted System, in that it takes into account accumulated profits, but it is also, however, inaccurate for the same reason. It assumes performance is earned pro rata over the averages.



- **Only Accounts Traded:** This method shows the rate of return only for accounts that were open during the entire period and that had no additions or withdrawals. The reasoning behind this method is that it is more representative of the true rate of return. However, if your additions or withdrawals vary significantly from your beginning equity, you are not allowed to use this method. The problem with this method is that it does not include all the accounts you manage, only those with no equity changes during the month. It is however, preferable to the Time Weighted and Average Daily Equity methods.
- **Daily Compounded Equity:** This method is the most accurate of the four. It calculates your performance as if you closed out the books every day. It is the only approach that objectively includes all accounts and actually matches your daily performance against the equity available to you on a daily basis.

### **Establishing Your Performance Record**

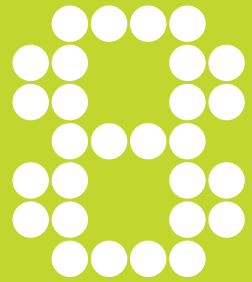
In the absence of a formal track record and assuming you are not going to use your own proprietary trading as one, you might want to establish a model account and trade it as though it were a customer account with your trading program. This type of account is one that prospective investors and capital raisers can review, and will lend much more credibility to your Disclosure Document than a simulated or hypothetical record because it will be in real time under actual market conditions.

When you establish this account, arrange with a Futures Commission Merchant to charge it an actual or representative retail commission rate. With outside documentation from your FCM, NFA auditors and potential investors will find it considerably easier to document your performance when they perform their due diligence.

Your model account should be similar to the size of the minimum account you would accept. Years ago, the tenure that investors looked for was approximately three years. In more recent times, that has decreased to eighteen months and perhaps less as demand for trading talent has increased.

You can also choose to fund this model account on a "notional" basis. Instead of establishing a \$100,000 account, you could establish a \$20,000 to \$40,000 notional account and trade it as though it were a \$100,000, including the number of contracts you would trade and all the appropriate fees. Please review the above caveat regarding notional funding of an account.

CHAPTER



## Fees

Like any enterprise, customers are going to draw a distinction between price and value. You, being the new merchant, want to charge enough to remain in business and competitive while also generating enough revenue, at least initially, to cover your overhead.

The Commodity Futures Trading Commission asks CTAs and CPOs to provide a figure in their disclosure document called the "Total Fee Load." This is the sum of all the various charges an account can expect to be charged. The idea is that the client knows, upfront, precisely what the trader must make before the client begins to make any money.

From a CTA's perspective, the first order of business is to stay in business. The best way to stay in business is to make money for your clients. Not surprisingly, clients are inclined to complain about management and incentive fees. To remain competitive, keep your fees in line, make sure your clients know that you earn those fees and establish your fee structure at the outset so there are no surprises.

## Compensation Components

There are four basic ways a CTA can be compensated:

- **Management Fee.** Payment based on a percentage of the equity under management
- **Incentive Fee.** Payment based on a percentage of net new trading profits
- **Commissions.** Payment based on the commissions generated
- **Percentage of Interest Income.** Payment based on a portion of interest income

In the last ten to fifteen years, compensation through commissions has diminished significantly, as it obviously represents an inherent conflict of interest. More often than not, fees are based on the management and incentive components. Fees based on commissions and interest income tend to drain the client. It would be worth your while to seek out professional help in structuring and spelling out exactly the form your compensation will take in your advisory agreement and Disclosure Document. If your wording is vague or ambiguous, you will open yourself up to a dispute at some point in time.

Incentive fees are based on an account's new, net high profits. "New" and "net" are, of course, the operative words. If you earn \$100,000 in profits on a \$1 million account, your fee is based on that figure. If you then lose \$50,000, you must earn that back, as well as any management fees previously billed before you may bill for further incentive fees. Make it clear to your clients that you are not being paid twice for the same profits. This is one way in which clients are protected.

How often you bill for your incentive fee is another point to be addressed. Traditionally, monthly or quarterly billing cycles were standard fare. More recently billing cycles have stretched out to six months and even annually.

Management fees can be a function of how new or established you are. For a new CTA, one creative way to handle the management fee aspect is by an advance against the incentive fee. This gives a new CTA the opportunity to partially cover overhead and not leave the impression that there is any urgency to trade aggressively in order to generate an incentive fee.

A new CTA may or may not want to consider a "zero deal." In other words, if someone is willing to give you start-up money in exchange for zero management fees, would accepting this "zero-deal" make the difference in getting a half-million dollar account or not? This is a business decision that only you can make.

Early on, it is likely that you may work for lower than average fees. From the clients' perspective, a new CTA is an unknown and they will want to be compensated for that risk in exchange for allocating funds to you. They also want to see if you can generate consistent returns. From the CTA's viewpoint, you would probably want to limit the time during which you are willing to accept a "zero deal."

You may also want to consider alternative fee arrangements based on a variety of factors, such as the size of the account, the overall cost structure of your operation and your relationship with the people or source of the capital.

You may be accustomed to thinking of trading gains or losses in terms of dollars. As a CTA, start to think in terms of percentages made or lost. Psychologically, it's better not to think in terms of money. Think in terms of how much you made or lost in terms of percentages.

Whether your cut-off period is monthly, quarterly, semi-annually or annually, it is a good policy to prepare your billings within thirty days after each period.

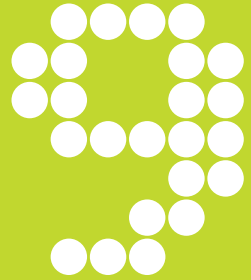
It is common for a CTA to have the authority to debit an account directly. Should you choose to do so, you will need your client's agreement and special documentation from your Futures Commission Merchant.

The subject of closed or closing accounts should be addressed. If an account is severing a relationship with you, you may find it difficult to collect any fees that you are due. Have your accountant make a reasonable estimate of the fees you have earned if you know an account will be closing imminently.

If you are managing money for a pool, it is a good policy to have the pool give you a detailed computation of fees, so that you can reconcile it with your own computations and records.

CTA REGISTRATION AND AUDITS

CHAPTER





## Registration Requirements

Technically, you do not have to be registered as a CTA if you are not actively informing people that you are accepting money to manage and if you have fifteen or fewer clients. However, how much credibility will you have if you do not register as a CTA?

The first step is to contact the National Futures Association and request the registration packet. If you choose to be registered as a sole proprietor, the fee, as of early 2004, is \$100 per year. If you are going to actively manage money, you will have to be an NFA member and pay a fee of \$500 as a sole proprietor. The registration process will take approximately three weeks if you are already registered as a floor broker or in some other registered capacity. People not currently in the business will of course have to successfully pass the Series III examination.

Registering as a corporation, of whatever type, takes longer and is more involved. The same \$100 fee applies, but the annual fee for a corporation is \$1000. Generally speaking, each principal of the company must submit the proper forms along with fingerprint cards, which cost \$70 each. The processing time can considerably longer because the FBI will run a fingerprint check.

## Disclosure Documents

In setting up your initial Disclosure Document, it is highly advisable to secure the services of an attorney. Should you choose to do it yourself, the Commodity Exchange Act outlines the content of a properly designed Disclosure Document. Again, there are certain risk disclosure statements, which must be used verbatim. Your Disclosure Document is your central piece of promotional material and should be formatted in accordance with CFTC Regulations and NFA compliance rules.

The interval between filing for registration as a CTA and receiving the NFA's approval is an opportune time to write your Disclosure Document if you haven't done so already. Your Disclosure Document must be on file with the Commodity Futures Trading Commission for twenty-one days before you can solicit clients as a CTA. You may not solicit a client without a Disclosure Document. Aside from language that is required, Disclosure Documents can range from quite simple to incredibly complex. It is in your best interest to seek out professional accounting and legal advice to make sure your filing is done correctly.



There are two NFA Rules concerning Disclosure Documents: For customers who, regardless of income and net worth requirements are not particularly financially sophisticated, you will need full disclosure. For Qualified Eligible Clients or Participants you can use Rule 4.7. This rule describes disclosure for investors who are well versed with the risk involved in futures trading; it also carries commensurately higher minimum income and net worth requirements. It is important that you and your legal advisor contact the National Futures Association for particulars regarding either of these types of Disclosure Documents.

The Commodity Futures Trading Commission requires that certain items be included in your Disclosure Document. Among the more salient are the following:

- Prescribed statements on risk and on losing money, which cannot be changed in any way. They must appear word for word.
- Your performance history in trading customer accounts for the last five complete years or for as long as you have been trading customer accounts for which you select the trade and place the order. This requirement does not cover trading for your own account.
- Description of your trading program. You do not have to outline discrete proprietary information; instead, you are to give investors a flavor of how you approach the market. While satisfying the CFTC, this is also an opportunity to market your unique approach since the Disclosure Document is your primary vehicle for advertising and marketing.
- Previous disciplinary or legal actions. The CFTC and NFA want to know of any action brought against you by clients or by the exchanges in the previous five years. You must also disclose whether you have been the subject of any large civil action or have filed for bankruptcy during this time. If the answer to any of these is "yes," you must provide details.
- Five year employment history
- Details of fees you plan to charge

It would be prudent for you to seek out professional accounting and legal counsel to help you prepare your Disclosure Documents.

## Record Keeping Requirements

National Futures Association Regulation 431 requires CTAs to maintain several types of records, including the following:

- Itemized daily record of each transaction that provides the pertinent execution details. Many CTAs use an equity-run computer system as a double check against the information they receive daily from their Futures Commission Merchants. You can use handwritten ledgers of your trades as you transact customer business, if you so choose.
- Daily and monthly confirmations from your FCMs. Consider filing these by customer rather than by trading day. More often than not, an NFA audit or due diligence person will be more interested in individual accounts. They will audit individual accounts and then compare them to your performance record.
- Name and address file of your clients, which should include:
  - Payment acknowledgement from your clients, stating they received your Disclosure Document and the date of that Disclosure Document.
  - All powers of attorney and discretionary trading authority documentation signed by the customers and FCMs.
  - Authorizations between you, your clients and the FCM enabling you to debit the customers' trading accounts for payment of your fee.
  - Advisory agreement, which spells out your responsibilities and those of your clients. This part also contains details of your fee structure and compensation.
- Books and records of all other transactions and business dealings involving futures or cash market commodity transactions between you and your client. This includes payment of fees similar to those you may directly debit from client trading accounts.
- Marketing information, such as:
  - Letters that you attach to disclosure documents
  - Publications or writings
  - Advertisements
  - Any other literature you distribute

Marketing information and literature must be maintained whether or not you obtained a client from those activities.

## **Being Audit Ready**

New CTAs can expect to have their place of business audited by the NFA within six to twelve months after their registration becomes effective and they begin managing money. After that, you can expect them approximately every twenty-four months; sooner if they happen to be in the neighborhood.

Be absolutely sure your back office is set up to the NFA's rules and guidelines. The rules are quite clear and defined but not terribly onerous. You must follow every rule and regulation and be audit ready, because you will not get very much advanced notice. It may even be worth your while to conduct mock audits annually just to be sure you're ready.

The NFA's compliance department will send you a CTA Self-Examination questionnaire, which will cover in detail the scope of the audit plan. This questionnaire, designed to help NFA members carry out their supervisory responsibilities, focuses on six major areas:

- General Information
- Disclosure Documents
- Records
- Customer Complaints and Advertising
- Fees and Block Order Allocation
- Performance Record Testing

## **General Information**

This first area will focus on general information about the firm, including any branch offices, the ownership and registration of the principals and Associated Persons (APs). This component of the audit will also examine compliance with NFA Bylaw 1101, which prohibits a registered NFA member from doing business with a non-member who is required to be registered or any suspended member. Do not do business with any non-members of the NFA who are required to be members.

**Records**

The focus of the records review is mainly concerned with customer account documentation. You should maintain separate account files with all the required documentation under CFTC Regulations.

Make sure all documentation is reviewed, signed, dated and the initial deposit is in the account prior to assigning any trades to an account. If you are not highly organized in this component of the audit, it can be particularly problematic. The assumption is that any disorganization is representative of other weak areas within your firm and can result in an expanded scope of the audit.

**Advertising, Communications and Customer Complaints**

This area deals with NFA Rule 2-29 and can be an area that is fraught with potential problems. You should have a compliance officer or other senior and knowledgeable person establish a written policy and procedure manual concerning sales practices. These practices should then be followed to the letter. NFA Rule 2-29 deals specifically with Communications with the Public and Promotional Material and can be the root of many future customer complaints.

The NFA's promotional department can review your material prior to use. Needless to say, this is highly recommended. It will limit future questions or problems. Your advertising and promotional material must be absolutely factual in any representations it makes, always keeping the customer in mind. Any and all numbers must be fully supported and all statements of performance must include mandatory disclaimers, such as: "Past results are not necessarily indicative of future results" and "The risk of loss in trading commodities can be substantial. You should therefore carefully consider whether such trading is suitable for you in light of your financial condition and investment objectives." Marketing your firm properly is particularly important, as it is an area that can affect your business for years to come.

### **Fees and Order Allocation**

Your CTA business should have designated written policies for calculating fees and block order allocation. Your audit will make certain that your practices match your procedures. The policies and procedures for calculating fees should be consistent with the description you give in your Disclosure Document and customer agreements.

Allocation of contracts and split fills should be in a systematic and non-preferential method. In addition, your carrying broker, or executing broker for give-ups, should have the breakdown with your account numbers and the quantity of contracts that are allocated to each account. A good practice is to have your executing broker set up a standard allocation of quantity per account with a systematic, non-preferential high-to-low or low-to-high price allocation. For large orders with multiple give-ups and accounts, this can be an absolute necessity. As you can see, it is very much in your best interest to develop a strong relationship with your executing and carrying brokers. They can provide a tremendous service for your CTA business and can help you save you time, money and headaches.

### **Performance Record Testing**

Lastly, your performance record must be reviewed very carefully. All performance figures in your promotional material must be fully documented and supported. The NFA will routinely check advertisements, marketing brochures and so forth, to determine if you are in complete compliance with NFA Rule 2-29.

Should you choose to do your performance accounting yourself, you should be thoroughly acquainted with the appropriate CFTC regulations. There are many highly qualified outside firms to do this task for you, but whoever does the calculations, the CTA is ultimately responsible for their accuracy.

### **Manuals and Documentation**

The Disclosure Document is the foundation for any CTA's business. It must be an accurate representation of the firm, its principals, a description of the trading approach, past performance results and any other information an investor needs to know in order to make an informed decision whether to place with you to manage or not. You should have a clearly defined and written policies and procedures manual that is accessible to any and all employees and that details the day-to-day operations of the firm.

In addition to your Disclosure Document and your Policies and Procedures Manual, you should have a Compliance Manual that defines what is needed for customer account documentation, customer complaints and so forth. For customer complaints, set up files for all written verbal complaints received by your firm, and include the resolution of each of those complaints. If your firm is active in soliciting investors, it is necessary have a Sales Practices Manual for Associated Persons to review.

The self-examination questionnaire's intent is to interpret and implement NFA's Compliance Rule 2-9, which requires a member firm to diligently supervise the conduct of their commodity futures business by the firm's employees and agents. You must complete this questionnaire annually, sign it and attest to the adequacy of the firm's procedures by an appropriate supervisor.

Once again, it is highly recommended, particularly for a new CTA, that you retain the services of an accounting professional and competent legal counsel. Remember, the ultimate responsibility for accuracy of performance reporting is the CTA's.

### **Exit Interview**

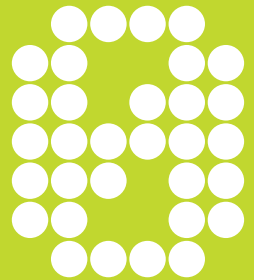
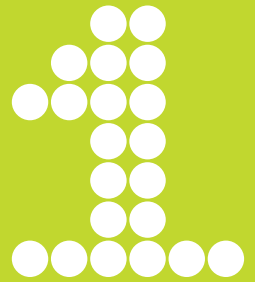
In the exit interview, the NFA auditors will make recommendations on how to improve your firm's policies and procedures. They will explain any deficiencies found, ask how you intend on complying with those deficiencies, and note your response in their report. They can also offer insight on NFA Rules and CFTC Regulations that you may be unclear about.

The NFA auditors' reports will describe any deficiencies they have found, and you will be asked to prepare a written response indicating the corrective actions that will be taken.

NFA Rules and CFTC Regulations are designed to protect the public by providing standardized procedures and policies for members of our industry. The NFA's auditors are qualified and willing to answer any and all questions you may have, and they are also willing to help you work through any problems you might have. Your NFA audit is a vehicle to help improve your firm's procedures and it can actually help you achieve that.

FROM FLOOR TRADER TO CTA

CHAPTER





## The Transition from the Floor to Upstairs

Your primary advantage as a floor trader is that you are an exchange member. This is your territory. You have survived and prospered through all kinds of markets; bull markets and bear, fast markets and slow markets. You have lived through market conditions most people can't begin to imagine. You know how these markets work and how orders are placed and the procedure of order flow. You have a strong knowledge base and can build on that.

To people who raise capital, floor traders are more of a known quantity than others who are not. One of the skills that you know all too well is good money management technique. One cannot exist on the floor and be successful if you are not a good money manager. There are numerous examples of traders who moved upstairs without a money management plan and the results were inevitable. The market ate them alive.

"Trading on the floor has nothing to do with trading 'upstairs,'" warns Charles Mizrahi, a former floor trader and CTA.

Your trading plan or methodology should be crystal clear when you start managing other people's money. It is acceptable to test out ideas on your own in real time, under actual market conditions, as long as you don't do it with clients' money. Remember, you have a fiduciary responsibility to your clients.

"Floor traders are emotionally attached to the floor," says Stephen Heilman. "When you trade upstairs, you have to figure out your game plan and then stick to it."

Moving upstairs requires a different mentality from the mentality of trading on the floor. The aggregate track record of floor traders who have moved upstairs is, frankly, mixed. Some of the industry's biggest successes as well as some of its largest failures, are floor traders who have moved upstairs. As a consequence, some investors are skeptical about former floor traders who have become CTAs.

After moving upstairs, the odds are fairly good that you are going to feel isolated. You'll miss the action of the pits and more importantly, you'll miss the sensory input of sight and sound. The upside is that after a while, many traders develop almost a sixth sense about how a market "feels." Ask anyone who trades bonds or foreign exchange upstairs for a member firm or large bank. It will take a while, but it will come.

Some investors will be skeptical because they will question how much of your success was attributable to being on the floor, seeing and hearing the action and being able to respond or take advantage of that. In addition, they might also question how much of your success accounted from obscure or arcane spread trades that you could not possibly duplicate at higher levels of equity. In establishing your track record, have your commodities accountant take those types of trades out.

"It's difficult for allocators to comprehend the market instincts and savvy you have developed on the floor and it is difficult to convey to them," says Charles Mizrahi, who can well appreciate the predicament.

### **The Skills You Have and the Skills You Will Need**

Many floor traders have a "do-it-yourself" mentality. This is quite understandable given your sense of self-reliance. As an upstairs trader, however, this can be a liability. Your job is to focus on the markets, your trading and your clients' well being. Let someone else handle the clerical duties and marketing support. Stay focused on what you do best—trading.

When trading on the floor, you became very used to dealing in short time frames. Trading upstairs will require that you have a considerably longer time frame, so that commissions, slippage, exchange fees and so forth will detract from your performance.

On the floor, you became very used to hearing, seeing and reacting to market forces. When trading upstairs, you will have to trade with much more of a strategic vision. A good analogy would be the cash bond market. Historically, some primary dealers have been position traders while others have chosen the distribution and market-making model. In the cash bond market, there are no exchange fees or commissions, and everything is traded on a net basis. CTAs trading upstairs do not have that luxury. Commissions and exchange fees are a very real cost of doing business. Therefore, by definition, a CTA is position trading as opposed to market making.

You will also have to change your thinking from transaction-oriented to strategically focused. The more strategic your thinking becomes, the easier it will be to trade from position and your transaction costs will diminish dramatically.

Part of that strategic thinking model requires having a thorough understanding of the cash markets, particularly over-the-counter derivatives that are competing with futures contracts.

For example, shifts in the yield curve, even on long-dated maturities, can cause hedge accounts to engage in interest rate swaps which may impact Eurodollar futures or Forward Rate Agreements in the OTC market. Changes in the interest rate differential, or basis, in corporate bonds may cause increased interest on a proportional basis in Treasury Note futures, as will dramatic changes in principal prepayments on Mortgage-Backed securities. Major changes in sector allocation in equities may cause increased buying or selling in those related futures contracts. It is certainly no secret that foreign exchange rates can cause both domestic and non-United States accounts to reallocate assets with resulting implications in the futures markets.

The more strategic your thinking becomes, the more effective and successful you will be.

“How have you provided value to someone’s portfolio? How have you provided true diversification?” William Taki says to ask yourself,

#### **Requirements for Floor Brokers**

A common question is, “Can I continue to trade for my own account while I develop myself as a Commodity Trading Advisor?” The answer is “Yes...**but.**”

If your sole desire is to manage a few accounts on the side while you continue to trade on the floor, you most likely will not have to do anything. However, the Commodity Exchange Act says that as a floor broker you can give advice to customers as long as what you are doing is solely incidental to your activities as a floor broker.

If this is what you’d like to do, you cannot start calling yourself a CTA. You are prohibited from telling people in any organized manner that you are in the business to manage their money. This means, no speeches, no advertising or promotional activities, not even business cards—nothing.

The fundamental problem in trading your own account while registered as a CTA is the inherent risk of conflict of interest. CTAs are fiduciaries, and your first duty is to put your clients’ best interests before your own.

There are two basic commandments that you must observe:

- You will not trade ahead of a customer order
- You will not take a position for your own account at the same time that you take an opposite position for a customer account

In other words, no front running and no crossing of orders.

The easiest way to approach trading for your own account while acting as a CTA is to trade your account in parallel with your customer account. Should you wish to have a test account where you try out new ideas in real time, you can do that as long as you are aware that it will probably trigger NFA audits every second year and they will look at your proprietary account information.

The best advice is to seek out competent legal counsel.

When you are preparing your first track record, you should ask yourself some questions. Are you proposing to do for clients what you have done for yourself? This may or may not be realistic.

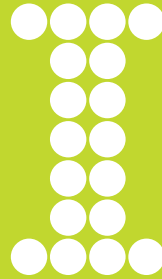
Initially, it is very common for new CTAs to generate a great number of short-term trades and a high volume of commissions. As you progress, you will find that the frequency of your trading slows down.

Are you a position trader or a market maker? If you are a position trader and have developed a strategy over the years that you think will readily transfer to customer accounts, you are probably ready to proceed. Conversely, if you think you can spread the front months and then buy the bid and sell the offer, forget it. It isn't going to happen as a CTA. Don't confuse being an exchange member and upstairs market-maker with managing customer money. You have to put together real numbers with reproducible results.

Should you expect to achieve those reproducible results as your assets under management get progressively larger? Probably not. Like anything else, there comes a point of diminishing returns. Take care to manage your equity growth so you can maintain the consistency of returns.

It might be worth the effort to set up a model account and then trade that account as you would a client account. Keep meticulous records and have a commodities accountant format the results for you. You can begin to show it whenever you feel it is the proper time.

APPENDIX



**New Position Risk**

1. Determine trade entry price via trading system.
2. Determine stop-loss price.
3. Convert the price difference between the entry point and the stop-loss point into dollars per contract.

{Example: Buy gold at \$400 per oz., with stop at \$390, (trailing with a 10-day moving average of closing prices). Account size: \$200,000.}

$$(400 - 390) \times \$100/\text{point} = \$1,000 \text{ risk per contract}$$

4. Determine risk per trade as a percent of equity.  
 **$\$200,000 \times 1\% = \$2,000 \text{ per trade}$**
5. Divide risk per trade by risk per contract to determine number of contracts to buy for the position.  
 **$\$2,000 \text{ risk per trade} : \$1,000 \text{ risk per contract} = 2 \text{ contracts}$**

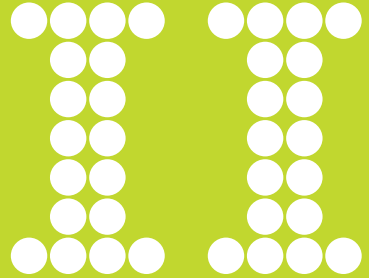
**Ongoing Risk Exposure**

1. Determine risk limit per existing trade as a percent of equity, e.g., 2.5%.
2. Determine risk per contract based on changes in price and stop-loss point.  
 **$(450 - 405) \times \$100/\text{point} = \$4,500$**
3. Determine allowable risk based on portfolio equity.  
 **$(\$210,000 \times 2.5\% = \$5,250)$**
4. Determine number of contracts to hold by dividing allowable risk by risk per contract.  
 **$\$5,250 \div \$4,500 = 1.167 \text{ (rounded down to 1)}$**

To make this relatively simple risk management system a bit more complicated, you could get into fancy allocations among a variety of markets or into controlling total portfolio risks. Personally, I think that is like squeezing the last drop out of the sponge.

MEASURING FUTURES VOLATILITY

APPENDIX



### Daily Volatility

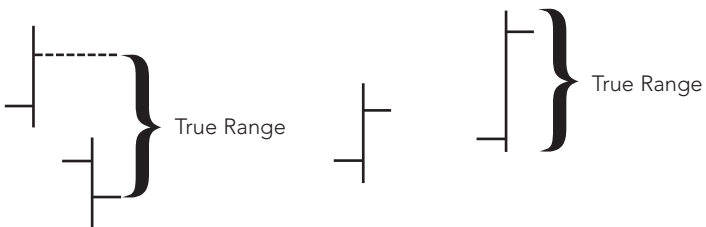
1. Take the open, high, low and closing prices of the last two trading days.
2. Determine the market's "true range" of price movement over the last 24-hour trading period by measuring the difference between the higher of yesterday's close or today's high vs. the lower of yesterday's close or today's low.
3. Convert "true range" in tick to dollars per contract to determine average daily volatility.

**\$3 average true range X \$100 per point = \$300 average volatility per contract**

4. Average these figures over several days, perhaps 10 or 20, depending on your trading strategy.
5. Calculate contracts by first multiplying account equity by the percent you wish to limit volatility to (say 1%). Then divide this number by the volatility per contract above to determine the contracts to hold.

**(\$2000,000 x 1%) : \$300 = 6.67 contracts (rounded down to 6)**

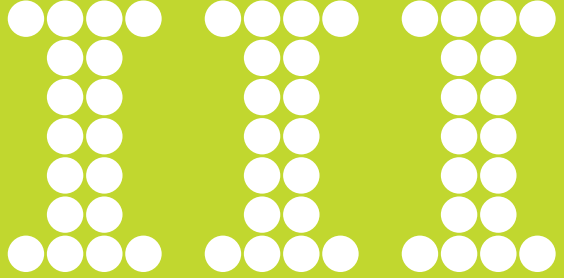
6. Compare this answer to the number of contracts as determined by the ongoing risk exposure (Appendix I) and take the smaller of the two.





SAMPLE PERFORMANCE RECORD

APPENDIX



Appendix III Sample Performance Record

Mo.	Beginning Equity	Additions	Withdrawals	Gross Realized Profit (Loss)	Brokerage Commissions, & Misc. Expenses	Net Realized Profit (Loss)
	(1)	(2)	(3)	(4)	(5)	(6)
20XX						
Mon.\$		\$11,821,000		\$503,980	\$89,762	\$414,218
Mon.	12,158,550	792,000		247,737	73,057	174,680
Mon.	13,050,531	100,000		333,320	61,999	271,321
Mon.	13,365,618	2,262,413		114,146	85,632	28,514
Mon.	15,583,809		4,369,973	(146,593)	45,688	(192,281)
Mon.	11,065,934		233,000	(154,720)	42,216	(196,936)
Mon.	10,447,634	2,004,315	907,546	45,757	55,033	(9,276)
Mon.	11,789,214			409,432	43,094	366,338
Mon.	12,058,540		50,654	301,786	41,965	259,821
20XX						
Mon. \$	12,236,307	\$96,383		\$41,446	\$48,554	(\$7,108)
Mon.	12,277,560	15,290,000		384,136	91,627	292,509
Mon.	28,411,733	500,000		779,365	159,801	619,564
Mon.	28,719,627	793,451		794,138	96,617	697,521
Mon.	29,834,193	400,000		1,058,841	106,744	952,097
Mon.	31,114,241	100,000		1,481,726	180,424	1,301,302
Mon.	32,243,277	1,265,116	32,000	778,472	111,683	666,789

**XYZ Corp.**

**Performance Record – XYZ International, Ltd.**

**(Unaudited)**

Inc. (Dec.) in Unrealized Profit (Loss)	Interest Income	Trading Advisor's Fees	Net Performance	Monthly Ending Equity	Rate of Return	Index
(7)	(8)	(9)	(10)	(11)	(12)	(13)
\$36,146	\$32,027	\$144,841	\$337,550	\$12,158,550	2.9%	1,029
(37,833)	37,693	74,559	99,981	13,050,531	0.8%	1,036
13,991	38,268	108,493	215,087	13,365,618	1.6%	1,053
(63,749)	41,277	50,264	(44,222)	15,583,809	-0.3%	1,050
51,445	42,703	49,769	(147,902)	11,065,934	-0.9%	1,040
(186,619)	32,120	33,865	(385,300)	10,447,634	-3.5%	1,004
278,203	26,789	50,906	244,810	11,789,214	2.0%	1,024
(67,168)	27,585	57,429	269,326	12,058,540	2.3%	1,047
45,895	31,288	108,583	228,421	12,236,307	1.9%	1,067

**(14) 20XX (9-Month) Compounded Rate of Return 6.7%**

(\$38,997)	\$30,181	\$39,206	(\$55,130)	\$12,277,560	-0.4%	1,062
840,352	47,896	336,584	844,173	28,411,733	3.1%	1,095
(830,344)	69,379	50,705	(192,106)	28,719,627	-0.7%	1,088
(242,864)	65,711	199,253	321,115	29,834,193	1.1%	1,100
218,700	71,996	362,745	880,048	31,114,241	2.9%	1,132
61,198	76,682	410,146	1,029,036	32,243,277	3.3%	1,169
1,554,128	74,855	594,783	1,700,989	35,177,382	5.1%	1,228

**(14) 20XX (7-Month) Compounded Rate of Return 15.1%**

**PAST RESULTS ARE NOT NECESSARILY INDICATIVE OF FUTURE RESULTS.**

The accompanying notes are an integral part of this performance record.

### Notes to Performance Table

A summary of the significant accounting policies which have been followed in preparing the accompanying performance table is set forth below:

- 1 Beginning Equity equals the ending equity from the previous month, if applicable, and includes the sum of all cash, accrued interest income, accrued brokerage commissions and miscellaneous expenses and the current market value of all open commodity positions.
- 2 Additions are the amounts, other than through sources of income, added during the period.
- 3 Withdrawals are the amounts, other than through sources of expense, withdrawn during the period.
- 4 Gross Realized Profit (Loss) is the gross realized gain/(loss) on closed futures contracts during the month. It is not reduced by Brokerage Commissions and Miscellaneous Expenses.
- 5 Brokerage Commissions and Miscellaneous Expenses are recognized on an accrual basis and represent the commissions charged per side by the futures commission merchant plus charges by certain exchanges and self-regulatory organizations and other changes to the account.
- 6 Net Realized Profit (Loss) represents the sum of Gross Realized Profit (Loss) less Brokerage Commissions and Miscellaneous Expenses. (See notes 4 and 5.)
- 7 Increase (Decrease) in Unrealized Profit (Loss) represents the total increase (decrease) from the preceding month in open commodity positions. Unrealized gains (losses) on futures contracts are calculated at the end of each month based on contract sizes and the differences between the commodity futures contract closing price and the price at which the contract was initially purchased or sold.
- 8 Interest Income is recognized on an accrual basis and represents interest earned on U.S. Government obligations, if any, held as margin in the trading account, and/or interest earned, if any, on equity balances at the futures commission merchant.
- 9 Trading Advisor's Fees are recognized on an accrual basis. Trading Advisor's Fees include a monthly management fee based on one-third of 1% of the net asset value of the client's accounts at the end of each calendar month (4% per annum) and a quarterly incentive fee equal to 22% of the net profits as described in the underlying advisory agreement. Negative incentive fees occur in those periods when trading losses have reduced incentive fees which had been previously accrued, but are not yet payable.

- 10 Net Performance equals Net Realized Profit (Loss) plus Change in Unrealized Profit (Loss) plus Interest Income less Trading Advisor's Fees.
- 11 Ending Equity equals the sum of Beginning Equity plus Additions minus Withdrawals plus Net Performance.
- 12 Monthly Rate of Return is determined using the "Time-Weighting" method. It is determined by dividing Net Performance for a month by the weighted average of Beginning Equity plus Additions less Withdrawals. The weighted average is computed by dividing the sum of each respective daily Beginning Equity plus Additions less Withdrawals balance, before reinvested profits or losses occurring during the month, by the number of days in the month.

Monthly Rate of Return may not be an accurate indicator of performance since it assumes that Net Performance is realized on a pro-rata basis over the daily weighted average of Beginning Equity plus Additions less Withdrawals during the month. In addition, Monthly Rate of Return is computed on a composite basis and does not measure the variances in actual rates of return experienced by each individual account, if any, during the period.

- 13 Index is included for informational purposes only and represents the estimated compounded monthly value of each hypothetical \$1,000 investment assumed to have been made as of the beginning of the period presented. Index is calculated as 1 plus the Monthly Rate of Return times the prior month's Index. Index may not be an accurate indicator of performance since it assumes a continuous investment with no subsequent additions, withdrawals or distributions of accumulated profits.

- 14 Compounded Rate of Return is listed below the final Monthly Rate of Return for each calendar period presented. It represents the compounded rate of return for each year or portion of the year presented. It is computed by applying successively the respective Monthly Rate of Return for each month beginning with the first month of that calendar period.

Compounded Rate of Return may not be an accurate indicator of performance since it assumes a continuous investment throughout the period.

HOW TO SURVIVE YOUR FIRST NFA AUDIT

APPENDIX



### How To Survive Your First NFA Audit\*

It's 9:00 am Monday morning and all is quiet. Markets are open and my weekly calendar is beginning to fill up with business meetings and appointments. The silence is broken by a knock at the door and in walk three conservatively dressed business people, salespersons, I presume. As I mentally make a list of all my recent office purchases, I know I do not need a new Xerox picture-perfect, triple-collating copy machine! My presumption is incorrect; they are auditors with the NFA and are here to conduct a "routine" audit.

It may be routine for them, but it is my first audit and just the mention of the word AUDIT sends chills down my spine. The last time I heard the word it was preceded by the letters IRS! I led them to a small conference room, where they could set up their materials to review my firm's documentation. The NFA auditor-in-charge of this audit sat down with me to explain the procedure she would be following and the information and documentation which they needed. Because I was a newly registered CTA, I had expected to be audited within six months of registering, and I had filled out the "CTA Self-examination" questionnaire just a few weeks after receiving it.

My first recommendation for surviving an NFA audit is to complete the CTA Self-examination questionnaire. This document, which I received from the NFA Compliance Department, covers in detail the scope of the NFA audit plan. It is designed to help NFA members carry out their supervisory responsibilities and it focuses on six major components.

\* First published in *MFA Journal*, December 1992.

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Thomas P. Schneider, chief trader at Chang Crowell, graduated from the University of Notre Dame in 1983 with a B.B.A. in Finance, and in 1994 will graduate from the University of Texas at Austin with an M.B.A. Mr. Schneider was employed by the National Futures Association as a compliance auditor from June 1983 until December 1984. From 1985 through 1993, Mr. Schneider was head trader and a principal of ELM Financial, Inc.

### **General Information**

The first area focuses on general information on the firm including branch offices, ownership and registration of principals and APs. This area also examines NFA Bylaw 1101, which, in essence, prohibits registered NFA members from doing business with any non-member of NFA who is required to be registered, or any suspended member.

A very meaningful survival tip is not to do business with nonmembers of NFA who are required to be members. If the organizational structure resembles any of the NFA registration categories, you should make an inquiry as to why they are not required to be a NFA member. You can always call the NFA Compliance Department for verification at 1-800-621-3570 (out-of- state) or 1-800-572-9400 (inside Illinois).

### **Disclosure Document**

Disclosure Document review has recently been assumed by the CFTC. Upon setting up your initial document it is highly advisable to work with an attorney. If the costs seem to be prohibitive, the Commodity Exchange Act outlines the content of a properly designed disclosure document. Within the document, there are certain risk disclosure statements which must be used verbatim. Your disclosure document is a central piece of promotional material for your firm, and should be formatted in accordance with CFTC Regulation 4.31 and NFA Compliance Rule 2-13.

### **Records**

Records review deals mainly with customer account documentation. The firm should maintain separate customer account files with all required documentation under CFTC Regulation 4.32. The person responsible for this area should be very familiar with organizing customer account files. A survival tip here is to make sure all documentation is reviewed, signed, dated, and the initial deposit is in the account prior to assigning any trades to an account. The Records component of an audit review is a potential nightmare if a CTA is not organized, and may be a reflection of other weak areas within the firm, which could result in a broadened scope of the audit.



### **Customer Complaints and Advertising**

This is a virtual minefield of potential problems. The CTA's marketing and sales practices should be followed in accordance with a policy and procedure manual designed by a compliance officer or equally knowledgeable employee of the firm. This deals specifically with NFA Rule 2-29 "Communications with the Public and Promotional Material," and can be the cause of many future customer complaints. NFA's promotional department currently is able to review promotional material prior to use, thereby limiting the questionable advertising promotions used by some CTAs. In order for a CTA to survive in the business, the firm must represent itself factually and with the customer in mind. All numbers need to be fully supported and all statements of performance need to include disclaimers such as "Past results are not necessarily indicative of future results" and "The risk of loss in trading commodities can be substantial. You should therefore carefully consider whether such trading is suitable for you in light of your financial condition and investment objectives." This decision of how to properly market your firm is vitally important and may affect your business for years to come.

### **Fees and Block Order Allocation**

The section for auditing of fees and block orders allocation should be in accordance with designated written policies and procedures of the CTA. The policies and procedures for calculating fees should be consistent with the description in the disclosure document and customer agreements. Allocation of contracts and split fills should be in a systematic and non-preferential manner. In addition, at the time an order is placed, the carrying broker (or executing broker for give-up trades) should have the breakdown with the account numbers and quantity of contracts allocated to each account.

A tip here is to set up with your executing broker a standard allocation of quantity per account with a systematic non-preferential high-to-low or low-to-high price allocation. This is an absolute necessity for large orders with multiple give-ups and accounts. With an allocation procedure already in place, you can call an executing broker and place an order to buy 250 contracts of US T-bonds at market, standard breakdown, and the executing broker knows the entire breakdown at the time the order is placed. The key here is to develop a strong relationship with your executing and carrying brokers, since they provide a tremendous service for the CTA and may save you time, money and headaches.

### **Performance Record Testing**

This is the final component of the six major areas of the CTA Self-examination questionnaire. This is an area where the CTA's performance record must be reviewed carefully. Most promotional material contains numerical figures that need to be fully supported. An NFA audit will commonly check recent advertisements, marketing brochures, etc., to determine if the CTAs in complete compliance with NFA Rule 2-29. If a CTA chooses to do performance accounting himself, which is common, the CTA needs to be familiar with CFTC Regulation 4.21 (a)(4)(ii)(A) through (F). There are many highly qualified outside firms and individuals who also do an excellent job compiling performance records for CTAs. However, whoever compiles the performance record for the CTA, the CTA is ultimately responsible for its accuracy and support.

A CTA's foundation is the disclosure document. This must be an accurate representation of the firm, its principals, description of trading approach, past performance results and other information an investor needs to evaluate in order to make an informed decision whether to have you manage their money or not. A CTA should have a policies and procedures manual, clearly accessible to all employees, detailing day-to-day operations of the firm.

### **Other Manuals and Documentation**

In addition, a compliance manual should be set up outlined what is needed for customer account documentation, customer complaints, etc. For customer complaints, a file should be set up with all written complaints and memos for verbal complaints received by the firm, including resolution of these complaints. If a CTA is active in sales solicitation, a sales practices manual is necessary for APs to review. It is highly recommended that a new CTA have an accountant, possibly even part time, to handle performance accounting for the firm. It is essential, however, that the principals know how to calculate performance results since they are ultimately responsible for the performance record.

The CTA Self-examination questionnaire is intended to interpret and implement NFA's Compliance Rule 2-9, which requires an NFA member firm to diligently supervise the conduct of their commodity futures business by the firm's employees and agents. The questionnaires must be completed annually, at which time they must be signed, and the adequacy of the firm's procedures attested to, by an appropriate supervisor.

### **The Exit Interview**

After sitting through an exit interview with the three NFA auditors on Wednesday afternoon, I appreciated the recommendations they made on improving my firm's policies and procedures. They explained the deficiencies found, asked how I was going to comply to correct the deficiencies, and noted by response in their report. In addition, they provided more insight on several NFA Rules and CFTC regulations about which I was uncertain.

Upon returning to their offices in Chicago or New York, the auditors will prepare an Audit Report which will contain deficiencies, if any were found, during the examination. If there were deficiencies, the CTA may be asked to prepare a written response to the Audit Report indicating corrective actions to be taken by the CTA. Throughout the process, I found out how a CTA survives his first NFA audit. You must remember that the audit is a way to improve your firm's procedures and can be a benefit rather than a nuisance. NFA auditors are qualified and willing to answer any question or work through any problems you may have. NFA Rules and CFTC Regulations are designed to protect the public, and to provide standardized procedures and policies for members of the industry. The goal of the NFA auditors is to examine the books and records of your firm to make sure you are in compliance with rules and regulations of the industry.

Now that you have survived your first NFA audit, you can concentrate on trading once again!

GLOSSARY/INDEX/RESOURCES

**GLOSSARY**

**account equity:** The monetary value of a futures trading account if all open positions were offset at current market prices.

**asset allocator:** One who makes decisions regarding how much of available equity will be allotted to a trader. Commodity pool operators and trading managers are the major asset allocators in the United States. See money raiser.

**clearing member:** An entity that is a member of an exchange's clearing organization. Clearing members have the ultimate responsibility for the financial commitments of customers who clear futures transactions through them.

**Commodity Futures Trading Commission (CFTC):** The U.S. federal regulatory agency of the futures industry, established in 1974.

**commodity pool:** An enterprise, usually in the form of a limited partnership, in which funds contributed by number of investors are combined for purposes of trading futures or options on futures.

**commodity pool operator (CPO):** An individual or organization, registered with the CFTC and NFA, that operates or solicits funds for a commodity pool.

**commodity trading advisor (CTA):** An individual or organization that is paid to directly or indirectly advise others on the buying and selling of futures or options on futures. Must be registered with the CFTC and NFA.

**commission-to-equity ratio:** Percentage of total assets under management that a commodity trading advisor generates in commissions on an annual basis.

**composite performance:** The trading returns generated from an aggregate of all accounts under management.

**disclosure document:** The document that CTAs and CPOs must supply when soliciting customers. It typically contains: disclosure statements; actual performance records; the CTA's business background and trading methodology; and advisory agreement papers.

**discretionary account:** See managed account.

**discretionary strategy:** A trading approach in which the trader uses judgment to generate buy and sell signals.

**drawdown:** The peak-to-trough measurement in both time and money of an account's losing period.

**due diligence:** The process in which an asset allocator investigates the trading and business of a commodity trading advisor.

**emerging trader:** A CTA with a short track record and typically less than \$1 million under management.

**futures commission merchant (FCM):** A brokerage firm registered with the CFTC and NFA to (1) solicit or accept orders to buy or sell futures or options on futures contracts, and (2) accept money or other assets from customers to support such orders.

**give-up:** A trade that is executed by one brokerage firm and cleared by another firm.

**hypothetical:** A performance record of simulated trades.

**introducing broker (IB):** An individual or firm registered with the CFTC and NFA that solicits and accepts trading orders from customers, but is prohibited from accepting money from customers.

**incentive fee:** A performance-based fee paid as a percentage of an account's net new trading profits.

**interbank:** The over-the-counter market for currency trading among international banks and dealers.

**managed account:** An arrangement by which the owner of an account gives written power of attorney to a CTA to buy and sell without prior approval of the account owner. Also called discretionary account.

**Managed Futures Association (MFA):** An organization for those interested in supporting the managed futures industry.

**management fee:** A fee set as a percentage of assets under management.

**manager of managers:** See trading manager.

**margin-to-equity ratio:** Percentage of assets under management that are used for performance bond purposes.

**mechanical strategy:** A trading approach in which buy and sell signals are generated by a previously designed system.

**model account:** An account established for the explicit purpose of developing a track record of actual trades based on the strategy, commissions and fees a trader intends to use in managing accounts.

**money raiser:** An individual or organization (typically a CPO, trading manager or IB) that solicits accounts on behalf of a CTA. See asset allocator.

**National Futures Association (NFA):** The futures industry's self-regulatory organization that handles registration of futures commission merchants, introducing brokers, CTAs, CPOs, and associated persons of these entities.

**net asset value (NAV):** The value of each unit of participation in a commodity pool or fund. The NAV typically calculates assets minus liabilities plus or minus the value of open positions when marked-to-the market, divided by the number of units.

**net equity:** An account's ledger balance plus open trade equity.

**net new profits:** Trading profits above the previous highest profit mark.

**net performance:** Change in net asset value exclusive of additions, withdrawals and redemptions.

**notional funds:** Funds that a client has committed to trading under the management of a CTA, but that are not physically on deposit in the client's trading account.

**only accounts traded (OAT):** A rate-of-return computation based only on accounts that were open throughout the period and had no additions or withdrawals.

**peak-to-trough:** The drawdown measurement made from the account's all-time equity high to a significant equity low. The measurement typically is made on a month-end basis and includes open and closed trades.

**performance bond:** The amount of money or collateral deposited by a customer with a broker, or by a broker with a clearing organization, for the purpose of insuring the broker or clearing organization against loss on open futures or options contracts. Also known in the futures industry as margin.

**pro forma:** A performance record presented of proprietary trading results on an "as is" basis.

**rate of return:** A performance measurement that tracks a trader's annual profits as a percent of assets under management.

**Sharpe Ratio:** A measure of risk-adjusted rate of return. It generally is calculated as [(average rate of return) minus (risk-free rate of return)] divided by (standard deviation of monthly returns). A relatively high Sharpe Ratio usually is indicative of good performance.

**Sterling Ratio:** A measure of historical risk and reward. It is calculated as (average annual rate of return for the last three calendar years) divided by [(average of maximum annual drawdown in each of those three years) plus (10 percentage points)].

**single sector:** A specific market or groups of related markets in which a CTA specializes.

**slippage:** 1. The price difference between the first and last execution needed to fill a trading order. 2. The difference between the price at which a trader wants to execute an order and the price at which the order was actually executed.

**standard deviation:** A statistical measure of a portfolio's performance risk.

**total fee load:** The sum of a managed account's various fees, expressed as a percentage of beginning equity.

**track record:** The entire performance history of a CTA.

**trading manager:** An individual or organization that allocates assets to CTAs and manages the allocations on behalf of investors. Generally registered as a CTA and CPO with the CFTC and/or as a registered investment adviser with the Securities and Exchange Commission.

**trading strategy:** The consistent approach to trading employed by a CTA.

**trading system:** A system that generates buy and sell signals for a mechanical trading strategy.

**trend-following:** A trading strategy designed to capture profits generated in short-, intermediate- or long-term price trends.

**Turtles:** Nickname for a group of traders trained in the mid-1980s by Chicago trading legend Richard Dennis.

**unit:** The number of contracts per market that the smallest account under management is allocated for each buy or sell transaction.

**value added monthly index (VAMI):** Compounded performance of a hypothetical \$1,000 investment.

**zero deal:** A payment arrangement, typically for new CTAs, in which the CTA receives no ("0") management fees and works only for an incentive fee.



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## RESOURCES

### **CME Education Department**

Both classroom and online courses are offered that may be of interest to CTAs. Please check the CME web site at [www.cme.com](http://www.cme.com)

### **Commodity Futures Trading Commission**

Three Lafayette Centre  
1155 21st Street, NW  
Washington, D.C. 20581  
Tel: 202-418-5000  
Numerous e-mail addresses  
[www.cftc.gov](http://www.cftc.gov)

### **National Futures Association**

200 W. Madison Street  
Suite 1600  
Chicago, Illinois 60606-3447  
Tel: 312-781-1300

120 Broadway  
Suite 1125  
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### **NFA Information Center**

Tel: 312-781-1410 or 800-621-3570  
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### **Futures Industry Association**

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### **Managed Funds Association**

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### **European Managed Futures Association**

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