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Issues and Insights for Starting a CTA Business

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INTRODUCTION

Being a Commodity Trading Advisor (CTA) requires more than just a successful trading program. Too often, young CTAs fail by focusing entirely on trading returns while neglecting business and operational requirements that are necessary to become a viable, long-term enterprise. Others struggle because they have not adequately addressed issues that are of great importance to potential investors. In light of this, CME Group has created this guidance document, *Issues and Insights for Starting a CTA Business*, in order to help our clients grow and thrive.

This guide is not a comprehensive listing of everything a CTA needs to know, but it will help identify necessary items and often overlooked issues. It is organized into three sections: Business and Operations, Compliance, and Trading and Risk Management. Each section addresses various items and issues that all CTAs should consider to ensure that they start off on solid footing.

BUSINESS AND OPERATIONS

Business Plan

Your first step should be putting together a business plan. Creating a comprehensive business plan can help mitigate, or even eliminate, many of the pitfalls commonly experienced by emerging, growing and even established CTAs. It takes time and thought to create a solid business plan, but the clarity it provides is well worth the effort. The following is a small, high-level sample of a CTA's needs that you can use as a starting point for a business plan:

1. An organized, physical environment with ready access to information
2. Clearly defined responsibilities delegated to specified, appropriate personnel
3. Documented operational work flows and procedures for the following activities:

   a. Client services fulfillment (offering memorandums, communications, client relationship management – "CRM")

   b. Trade order management

   c. Portfolio accounting

   d. Risk management

   e. Investor and fund accounting and reporting

4. A documented compliance process that considers the following areas:

   a. Registration management

   b. Written supervisory procedures

   c. Business continuity, successor and disaster recovery plan

   d. Office of Foreign Assets Control (OFAC) compliance

   e. Supervision of personnel/branch offices

   f. Training of personnel

Capabilities Assessment

Next, you should create a list of requirements and compare it to available skills, resources and manpower. Critically evaluate your areas of advantage to decide what to build yourself and what to buy from service providers. Work down the list until you have identified all your needs, found solutions and put a plan in place to implement those solutions. It is important to consider the impact of growth or success on future needs and attempt to select systems/solutions that can easily expand to accommodate new product lines and functionality. The good news is that there are so many service providers, software programs and consultants available in today's marketplace that it is likely that one or more will offer the capabilities and tools required, while staying within a reasonable budget.

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Company Structure

There are a number of ways to put together a company, and you need to consider which company structure would be most suitable for you. Would it be best to take on a strategic partner or stay a sole proprietor? Should your firm be an LLC or corporation? These decisions will shape, among other things, your future revenue streams and liability levels, and should not be made lightly. It would be wise to obtain legal counsel and tax advice from firms that are well-versed in alternative investments prior to making this decision.

Prior to entering into a partnership, it makes sense to have clearly defined roles and responsibilities for each of the partners. This exercise will allow all parties to be clear on exactly what their responsibilities will be, cutting down on the possibility of future resentment over real or perceived inequality of efforts. It also helps to ensure that individual skill sets are used to their best advantage.

Start-Up Costs

It is generally a good idea to have at least enough operating capital to run your CTA for the first two years completely out of pocket. The first one or two million dollars you raise may be the most difficult, and it would not be unusual to find that initial investors will only accept incentive-based, fees-only terms, so it is best not to plan upon management fees being readily available. Adequate start-up capital will allow you to focus on establishing a track record and start raising capital to support company functions.

Your business plan will help determine just how much it will take to support your business for two years. Of course, if your business plan calls for expensive computers, office space and specialized staffing, expected two-year costs will be much higher than CTAs that start off working out of their homes with one or two employees skilled in multiple functions. When calculating your start-up costs, it is better to overstate your requirements than understate them.

When trying to attract institutional investors, substance counts far more than flash. You will get further by impressing them with your knowledge, professionalism and thoughtful approach to the development of your business and treatment of clients than you will by spending money on unnecessary window dressing. Of primary concern is that you know what you're doing and that you have the resources to accomplish it.

Professional Services: Legal, Accounting, Compliance

Obtaining competent legal, accounting and compliance assistance is of the utmost importance.

You should retain legal counsel well-versed in the alternative investment industry. Among other things, knowledgeable counsel will create subscription documents, trading authorizations and offering/disclosure documents that will help protect the CTA from unnecessary liability. When choosing counsel, cost is not the only consideration. An attorney with a lower per-hour rate who is less knowledgeable may end up costing more in the long run by charging you for their learning curve. Make sure that the attorney you choose is easily accessible and will respond to requests promptly.

A well-known, highly qualified auditor may help boost investor confidence. Having a "no name" auditor is a red flag for potential clients conducting due diligence reviews and should be taken into account during the selection process.

It is important to have qualified accounting support. Keeping detailed records of every account you manage on a daily basis will allow you maximum flexibility when computing track records and providing clients with performance reports. It can be expensive to employ full-time accounting staff, so you should consider the cost/benefit of outsourcing this function to one of the many reputable back-office/administration firms available. Outside administrators are often viewed as an important control feature by investors.

As a start-up CTA hoping to attract institutional funds, you must pay serious attention to compliance. Ideally, compliance procedures should be as simple as possible and offer as much "how-to" information as possible in order to ensure that tasks are done correctly and that nothing is overlooked. Consider obtaining assistance from counsel or a qualified compliance consultant if you do not possess adequate knowledge to create a compliance program addressing the National Futures Association (NFA) and exchange requirements.

Staffing

It is unrealistic to think that one person can "do it all," particularly as a business grows. You do need to pay proper care and attention to trading in order to be a successful CTA. However, it takes more than trading to be a successful CTA. You must also develop an adequate staff.

More often than not, budget constraints are a big consideration when creating a staffing plan, so it is important to identify the areas of business in which you need help and then carefully consider the best, and most economical, way to obtain that assistance. Outsourcing has become commonplace for many areas of the business and can offer smaller firms access to highly qualified help at a lower price tag than hiring someone outright. To get the most out of your staffing dollars, look for persons who are already familiar with your trading methodology in order to cut down on training time. Try to hire individuals who have more than one skill set. Most starting CTAs do not have enough work to keep multiple individuals busy, so it makes sense whenever possible to hire people who can competently perform more than one function.

At a minimum, you will have to address back-office and operational functions such as account reconciliation and trade confirmation, fee calculation and billing. Administrative functions include making sure there is someone to answer the phones and respond to client requests during trading hours. You may also need someone to ensure you are in compliance with regulatory requirements and someone to market your CTA.

It may be in your best interest to have an assistant or partner who can run the company, talk to clients and at some point help with trading or at least placing orders, allowing you to concentrate on trading decisions. For discretionary traders, it is a good idea to have a knowledgeable person to act as a "trading conscience" who will question your thought processes and help keep trading in line with stated parameters. In all trading operations, you need to provide for adequate backup in the event of emergencies and planned outages such as vacations.

Growth Management

In assessing your staffing needs, consider the impact of the investment vehicles you offer, the instruments you trade and how you raise assets. A single pool with a full-service administrator would require less in-house staff than multiple pools and individually managed accounts. Will you market for yourself or employ third-party marketers? Participation in cash markets such as equity, debt or foreign exchange, cash or forwards may require that you have someone on call 24 hours a day.

Whenever possible, streamline your methodologies in order to cut down on work load. For example, instead of placing orders with several Futures Commission Merchants (FCMs), it may make sense to put give-up agreements in place so that you only have to place one order, thereby reducing both your workload and potential for error.

The type of firm you run and the number of clients you serve may dictate your administrative needs. One firm may have $50 million under management with 10 clients, while another might have $50 million under management with 500 clients. Obviously, the administrative needs of the second would far outpace the needs of the first. You would need additional staff or resources for compliance, accounting, marketing, trading, account administration and information systems.

Marketing

There are a number of ways to go about raising capital and you should make your decision only after carefully considering the pros and cons of each. Here are a few options:

Enter into a seed capital arrangement with an established firm. This option may allow a starting CTA quick access to capital in order to establish a track record while benefiting from an established entities' infrastructure. It is important to be cognizant of any ownership, control or profit limitations this type of relationship may put on your business going forward. Similar types of arrangements are sometimes available through emerging trader programs sponsored by an FCM/member firm.

Enter into a third-party marketing agreement. A well respected third-party marketer may be able to market your firm effectively while allowing you to focus on trading and building your track record. Third-party marketers generally receive a percentage of fees generated by accounts they bring in. This will reduce your income, but not your ownership. You should also clearly define the terms of your third-party marketing agreement, which should cover topics such as severability for failure to perform, circumstances when a third-party marketer will not be entitled to a portion of fees, the duration of the agreement and exclusivity. CTAs using third-party marketers should not assume that they have delegated all of their marketing responsibilities, since many potential investors will insist on meeting the person who "pulls the trigger" before investing.

Do your own marketing. Some people have both the contacts and the talent to market their firm effectively, but it may not be an appropriate use of time to market your firm if it detracts from trading focus and track record development. Be brutally honest when considering your strengths and weaknesses. If you are not positive that you will be able to effectively articulate your strategy, inspire confidence and impress potential investors with your professionalism and competency, you should seek assistance from someone who can. A good first impression is a must. Keep in mind, however, that the third-party will need to be registered with the NFA.

There are a number of ways to go about raising capital and any decision should be made only after carefully considering the pros and cons of each.

COMPLIANCE

Registration Requirements

To avoid confusion, it is a good idea to visit the NFA Web site at www.nfa.futures.org and carefully review the Registration section for guidelines on CTA and Commodity Pool Operator (CPO) registration prior to accepting client assets. You are not required to register as a CTA until you hold yourself out to the public as a CTA and/or have 15 or more clients. However, you may wish to do so before passing this threshold since it may be easier to raise assets as a registered entity. Should you wish to combine or "pool" investor assets, you would be required to register immediately as a CPO.

The NFA Web site provides detailed information on the registration process, including fees, exam requirements and timelines. Registrants and potential registrants may contact the NFA via their information line (800 621 3570) or via e-mail (information@nfa.futures.org) should they have questions that are not readily answered by the Web site.

A number of exemptions are currently available to CTAs and CPOs from the NFA that offer relief from reporting requirements at varying levels based upon certain requirements being met. Chief among these requirements is the financial qualification of the clients. In some cases, CTAs and CPOs may decide to limit their clients to a certain type, such as Qualified Eligible Participant (QEP) to maximize relief and thereby lessen workload and administrative cost burden. To avoid potentially harmful errors or misunderstandings, seek guidance from the NFA, counsel or a compliance consultant to gain a complete understanding of the requirements for obtaining applicable exemptions, as well as the relief they afford.

Disclosure Documents

The Compliance section of the NFA Web site gives guidance on issues pertaining to CTAs and CPOs. *Disclosure Documents: A Guide for CPOs and CTAs* is available for download and discusses the requirements CPOs and CTAs must meet, presents a break-even analysis and sample performance table and describes the review and approval process used by NFA's Disclosure Document Review Team. CTAs may not solicit without a disclosure document. Although you may draft your own disclosure document, it is better to enlist the help of counsel in order to ensure that all required disclosures are made. Remember that a well-written disclosure document not only informs clients and potential clients of material facts and risk factors, it may also limit CTA liability by virtue of having disclosed those factors.

Performance Reporting

Performance records must be calculated in accordance with CFTC rules. For information on proper calculation methodology, download the *Sample Performance Calculation* from the Compliance section of the NFA Web site. You may also seek guidance from qualified accounting/audit firms or administrators. Remember that the CTA is always responsible for the accuracy of its performance record, even if it utilizes an outside party to do the calculations.

Promotional Material

Before creating any marketing/promotional materials, download NFA Compliance Rule 2-29 from the NFA Web site and review it carefully. Compliance Rule 2-29 sets forth guidelines for what you may and may not say in your communications with the public. It is a good idea to have the NFA review your promotional materials prior to use. NFA's promotional material review program is free to NFA members and will help you ensure that your materials are compliant without adding to legal or compliance fees. Forward promotional materials that you wish to be reviewed to art@nfa.futures.org. NFA will review the documents and respond with approval/comments within 14 days of receipt. Should you need a faster turnaround, counsel or a qualified compliance consultant would most likely respond more quickly, but at a cost.

Remember that any claims made in promotional material, be they performance-related or otherwise, must be supported. Make sure that backup materials are maintained along with the promotional material so that it will be readily available when auditors arrive.

Recordkeeping

Proper recordkeeping is imperative. CFTC Regulations – Part 4, Section 4.23 and 4.33 Recordkeeping – set forth what records CTAs and CPOs need to have and how long they are to be maintained. You may download the document from the Compliance section of the NFA Web site. Many CTAs get into trouble because, although they are maintaining some documentation appropriately, they are missing certain pieces. This is particularly common in record keeping requirements surrounding trading. Review Section 4.33 carefully and make sure that all required items exist and are being maintained appropriately.

NFA Bylaw 1101

As a CTA you should be aware of NFA bylaw 1101. This bylaw prohibits NFA members from doing business with any individual or entity who should be, but is not, registered with the NFA (including suspended members). The most common Bylaw 1101 infraction occurs when a CTA accepts a client that appears to have pooled funds, but is not registered as a CPO. For example, if the investor is a partnership, that partnership may have to be registered with the NFA as a CPO. If it is not, you need to determine why it is exempt from NFA registration and maintain documentation in the client file.

Order Allocation

Your methodology for allocating block orders and split fills should be systematic and non-preferential. The procedure should be documented and adhered to consistently. If allocations are done by brokers, it is best to have the broker sign off on the procedure to prove they are aware of and will comply with the CTA's stated methodology.

Client Complaints

Every CTA should have written procedures for handling client complaints that includes an up-to-date customer complaint file. The procedures should detail steps to be taken in investigating and remediating client complaints. If the complaint is valid, steps should be taken to fix the problem. If the complaint is not valid, the process you follow and the documentation you keep will form the framework for your defense should the complaint be escalated to regulators. Without the ability to demonstrate that due care and effort was put into remediating the situation, regulators would be unlikely to side with the CTA.

Compliance Manual

It is a good idea to write out all of your compliance-related policies and procedures and keep them in a Compliance Manual. In addition to the topics previously listed, you should include all other items identified when reviewing the referenced guidance documents that are pertinent to your CTA business. Counsel, auditors and/or compliance consultants may assist you in creating your compliance manual or ensuring that the manual you create is adequate. Potential investors may ask for a copy of your compliance manual and evidence that you are following it.

General Compliance

Once a year, NFA registrants are required to complete a Self-Examination Checklist. The items set forth in the checklist represent the foundation of an NFA examination. Therefore, it is important that the CTA continue to work on any deficiencies identified when completing the checklist. The Self-Examination Checklist for FCMs, IBs, CPOs and CTAs is available for download from the Compliance section of the NFA Web site.

The Compliance section of the NFA Web site also offers guidance documents on, among other things, monitoring margin risk exposure, forex transactions, security futures products, and electronic trading and order routing systems. CTAs should review all available pertinent guidance.

It is a good idea to write out all of your compliance-related policies and procedures and keep them in a Compliance Manual.

Description of Trading Program

Lacking a substantial actual performance record, investors will rely heavily upon the trading methodology description set forth in the CTAs disclosure document and marketing materials. As such, it is imperative that any description given accurately reflects the trading activities of the CTA. Any deviation from stated methodology could be catastrophic for the CTA, resulting in losses of potential and existing clients, as well as creating potential liability for losses incurred by existing clients.

Many CTA trading programs fall into broad stylistic categories, e.g., trend-following, high frequency trading or fundamental value. But while there are similarities across CTAs, most managers believe they have developed unique features that give them an “edge” in the marketplace. The challenge comes from providing enough information about the trading program to satisfy the questions of potential investors without giving away their competitive advantage. In today’s world of high market volatility and a basic distrust for opaque managers, young CTAs may need to offer more information about their process than was expected just a few years ago.

TRADING AND RISK MANAGEMENT

Style Drift

The language in your documents will likely be written broadly enough to offer you some legal protection should your actual trading deviate somewhat from your advertised style. There is, however, no protection from damage to your business if you trade contrary to what your investors expected when they signed up. Objections to style drift are more likely to arise if the program loses money, but savvy investors will see red flags even from winning trades if they come from a style, intensity or frequency of trading that is at odds with their expectations. If you discover that your program's original style is not working or that additional models need to be added to the program, you should communicate proactively with clients to avoid misunderstandings about style drift.

Transparency

Transparency is a delicate issue between a manager and investor. Some investors insist on separately managed accounts not only to achieve complete transparency, but also to have ultimate control over the account. Many other investors are satisfied being in a pooled vehicle. CTAs who are not overly concerned about outsiders analyzing their trading in order to "reverse-engineer" their process, may provide complete transparency. More often, all customers receive periodic snapshots of positions with an agreement that investors may check on the portfolio whenever they desire. Open communication with investors is in many ways more important than mechanical transparency.

Performance Attribution

Young CTAs should be completely candid about sources of current and historical returns. Potential investors have all seen short historical records that have outsized statistical returns generated by one or two lucky trades. You should be willing and able to describe all the contributors to your returns: What were the winning and losing trades? What were the weights of trades? How much of the risk capital was being used? By providing accurate performance attribution in both good and bad trading periods, you enhance the knowledge of the investor and manage future expectations.

Position Limits

Position limits have diminished in importance for many markets in recent years, though they are still prominent in most physical commodities markets. Given high market volatility, regulators and lawmakers may push for expanding position limits into areas where they are currently lightly used. The major risk to young CTAs is unintentionally exceeding allowable position limits. To minimize this problem, be aware of the current applicable position limits and, wherever possible, build controls into your trading system/process to restrict trading before position limits are breached. Contact exchanges for information on position limits applicable to contracts traded.

Identification of Risks

Young CTAs without a lengthy track record to prove they have adequate trading skill and business ability are at a decided disadvantage versus established CTAs. To inspire confidence, take the time to create a comprehensive list of risks associated with your trading methodology and develop procedures for controlling those risks. Demonstrating a clear understanding of and attention to the risks will increase investor confidence in the CTA's desire and ability to act in the client's best interest. To many investors new to CTA programs, futures may feel inherently riskier than the more familiar stocks and bonds. Try to establish and demonstrate controls in your trading process that minimize the chance that there will be any trading beyond the risk limits you have set for your program.

For allocators, risk management is of the utmost importance. Without acceptable risk measures, even the best performing trading programs will be of limited interest. It is a good idea to proactively identify and address the myriad of risks associated with conducting your CTA business prior to engaging in marketing efforts. Establishing clear guidelines and processes as well as forethought about potential obstacles will increase confidence in the CTA's ability to protect investor interests. Following are some, but not all, of the areas of risk that you should be aware of and address.

1. Trading inconsistent with stated trading programs (violations of internal concentration limits, stop-loss rules, and so on)
2. Unauthorized or otherwise fraudulent trading
3. Trade confirmation and reconciliation
4. Fairness of trade allocations across accounts
5. Trade error resolution (less important in electronic markets, but still an issue)
6. Custody of excess cash collateral and authorization to move that cash
7. The investment of excess cash collateral should be consistent with low risk objectives (many losses in 2007 and 2008 came from inappropriate investment of excess cash)

Ideally the risk management function should be able to act independently from the trading function, but for small/young CTAs, this is not always practical. Without independent risk management, CTAs must be able to demonstrate that there are enough independent controls in place to convince investors that the chance for losses due to extraordinary causes is minimized.

Try to establish and demonstrate controls in your trading process.

Issues & Insights for Starting a CTA Business was written by Kate Dressel, President of Strategic Compliance Solutions, LLC, with contributions made by Dean E. Lundell, Greenwhich Associates and Carol Kaufman, Alternatives TLC.

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