



# Intelligent Trading

## Commodities, Forex, Futures and Options

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## FOCAL POINT CONCEPTS: Disclosure Documents and Due Diligence

By Mack Frankfurter, Chief Investment Strategist

Due diligence, a term which first came into use as a result of the Securities Act of 1933, is an investigative process by which financial and legal information is gathered, reviewed and appraised prior to making an investment. Astute investors understand that only after such a process can they make an informed determination to invest.

The first step in performing due diligence on CTAs is by acquiring and reviewing their disclosure document. While there are certain regulatory exemptions that allow exempt advisor to avoid producing a disclosure document (discussed at end of this article), registered CTAs are obligated to provide this document free of charge to investors.

Disclosure documents are a vital resource, but their construction is based on a regulatory template which unfortunately has a tendency to produce boilerplate results. For that reason, it is important to: (1) know how to extract the most pertinent data; and (2) leverage that data to ask questions and obtain additional information.

*Risk disclosure*—every CTA disclosure document is required by regulations to have a prescribed risk disclosure prominently displayed immediately after the cover page of the document. If the CTA trades foreign contracts, the risk disclosure will also include a statement as to the risks of trading futures outside of U.S. jurisdiction and authority.

*Table of contents*—this item must appear immediately after the risk disclosure statement. The remaining article outlines each of the required sections of the disclosure document and information which is required to be provided. It should be noted that these sections can be presented in any order as long as they are provided.

*Introduction*—this section must include name, form of organization, address and main telephone number of the business, as well as where the CTA's books and records will be kept and made available for inspection.

*Principals and business background*—the disclosure document must identify, by name, each controlling person who has an interest in the CTA. This information needs to include for the five years preceding the date of the document the business background of each individual who is involved in trading or operational decisions, or who supervises persons so engage. The more information disclosed the better.

This is just starting point to make further inquiries into the background of key staff. Ask additional questions! Background, experience and talent should be a key factor which drives a decision to invest in a CTA trading program.

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CME Euro FX Futures  
(Symbol: EC)

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*Trading program description*—every disclosure document is required to include a description of the CTA’s trading program(s), which should include the types of commodity interests and any restrictions or limitations on trading as established by the trading advisor. In many of the documents that we review, there is typically a generic description of fundamentals and/or technical trading.

The better documents go into some detail as to the trading strategies, but often there is a statement as to the proprietary nature of trading which limits such description. As with the business background information, this is a launching point for additional due diligence questions in regards to the CTA’s trading program(s) and strategies.

Even though it may not be included in this section, one of the key items that a disclosure document should cover is a discussion of the trading level, minimum account size, minimum trading level unit, and the type of funding which is required for the account to trade. Note that documents usually do not state margin-to-equity ratios, but this information can be obtained upon request. There are many subtleties as to how these various components work together, such as whether accrued profits or losses will alter the number of contracts traded. So be sure to ask a lot of questions in this area.

*Clearing arrangements*—if a CTA requires an investor to maintain their account at a certain FCM or IB, the CTA must disclose the name of that FCM or IB. In addition, related information with respect to clearing rates, give-up fees and any other fees should be disclosed if specific arrangements exist. Fee sharing arrangements should also be disclosed if the CTA shares management and incentive fees with introducers.

*Conflicts of interest*—the above section relates to conflicts of interest that may exist. While certain information is generic from one disclosure document to another, the key is to look for descriptions of any actual or potential conflicts of interest regarding any aspect of the trading program which may potentially interfere with the maintenance of a client’s account. Conflicts include, but are not limited to, any arrangement whereby the CTA or any principal of the CTA may benefit, directly or indirectly, with respect to per-trade compensation, or office space or other benefits from an FCM or IB.

*Litigation*—the CTA must disclose any material administrative, civil or criminal action, whether pending or concluded, within five years preceding the date of the document, against the CTA and all of its principals. If the client is required to maintain its account at a specific FCM or IB, then litigation about the FCM or IB must be disclosed too.

*Principal risk factors*—to round out the above few sections a discussion of the principal risk factors of the trading program also needs to be included. Again, information in this section tends to be generic and must cover risks such as volatility, leverage, liquidity and counterparty creditworthiness, as may be applicable to the trading program. All are important, but the key is to focus on risk factors beyond the generic factors.

*Fees*—a complete description of each fee which the CTA charges the client must also be included. There are many variations in how fees can be charged, but typically such fees involve a management fee as a percentage of assets under management, and an inventive fee as a percentage of new profits generated on the account.

Note that there can be many, many variations on a theme as to how CTAs charge fees. If there is any question, request the CTA to provide an example reconciliation as to how fees are calculated. Also note as to how fees are accrued and when they are charged.

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### *Focal Point Concepts* from page 2

*Required performance disclosures*—with the exception of proprietary trading results, CTAs must disclose the actual performance of all accounts directed by the CTA and by each of its trading principals. Trading principals are defined as any principal of the CTA who participates in making trading decisions for the CTA’s clients or who supervises or selects persons so engaged.

This is the section that most investors go directly to, which is understandable. Nowadays performance information is presented the form of a performance capsule, with certain statistical data highlighted such as worst peak-to-valley drawdown and number of accounts currently traded, as well as number accounts that have been closed profitably or not. In addition, a performance table is presented which shows monthly rate-of-returns and annual rate-of-returns for the most recent five calendar years.

For CTAs which accept notional funding, an investor who plans to partially fund an account should first interpolate the rate of return information by referencing a performance matrix table. This table will indicate the impact of additional leverage on account volatility, and illustrates the effect that different degrees of leverage can have on the actual rate of return.

Notional funding is just one example of the many nuances related to calculating composite performance data. In order to help investors understand these subtleties, Managed Account Research has written a piece titled, “Pitfalls in Performance Evaluation.” Feel free to contact us to obtain a copy and/or to discuss.

*Material and supplemental information*—investors need to be aware that nothing shall relieve a CTA from the obligation to disclose all material information to existing or prospective clients even if such information is not specifically required to be disclosed pursuant to regulatory rules. If any information, other than what is required by regulations, is provided, the information may not be misleading with required disclosures.

*Exceptions*—an exception to the disclosure document rule exists for CTAs who direct accounts of Qualified Eligible Persons (QEPs) as defined by Rule 4.7. In these situations, upon filing the required exemption notice, a disclosure document is not required to be provided to the QEPs. Also, traders who provide advice to 15 or fewer persons during the past 12 months and do not hold themselves out to the public as a CTA, are not required to provide disclosure documents.

## STATISTICAL INSIGHT: VAMI



VAMI stands for Value Added Monetary Index and is an industry standard method for calculating commodity trading advisors’ compounded rate of return. The VAMI method generally assumes an initial investment of \$1,000 (sometimes \$10,000 is used as a baseline amount) and shows how such an investment would have fared over a certain period of time. The VAMI is often presented in the form of a monthly performance chart.

In order to calculate annual rate-of-returns using VAMI, one must first calculate the value of \$1,000 investment as of the end of each sub-period or month based upon the monthly rate-of-returns computed in accordance with one of the above mentioned methods. The calculation would be as follows:

In the first month of the period:

$$\text{VAMI for month} = (1 + \text{ROR for month}) \times 1000$$

For all subsequent months:

$$\text{VAMI for month} = (1 + \text{ROR for month}) \times \text{VAMI for prior month}$$

Annual ROR would then be calculated as follows:

$$\text{Annual ROR} = (\text{year-end VAMI} - 1000) \text{ divided by } 1000$$

When calculating the annual rate-of-returns for subsequent years, the value of the initial investment should be reset to \$1,000 at the start of each year. VAMI columns are standard for 7 and 13 column performance tables.



## CONTRACT SPOTLIGHT: CME Euro FX Futures (Symbol: EC)

CME created FX futures, the first ever financial futures contracts, in 1972, under the leadership of Leo Melamed, CME Chairman Emeritus. This innovation capitalized on the U.S. abandonment of the Bretton Woods agreement, which had fixed world exchange rates to a gold standard after World War II. As a result, currency values were allowed to float, increasing the risk of doing business.

By creating another type of market in which futures could be traded, CME currency futures extended the reach of risk management beyond commodities. The concept of currency futures was revolutionary, gaining credibility through the endorsement of Nobel-prize-winning economist Milton Friedman. Today, CME offers FX futures and options contracts on 19 currencies, all of which trade electronically on the exchange's CME Globex platform. It is the largest regulated marketplace for FX trading.

CME Euro FX futures offer institutions, portfolio managers, corporations and private investors ways manage the risks associated with euro rate fluctuations. The main difference between FX spot prices and FX futures prices is that the futures prices reflect the interest rate differential of the respective countries, since the futures contracts cover time periods over which interest would be paid or earned.

A spot trade involves an exchange of one currency for another, where the exchange usually takes place two days following the initial transaction. In contrast, CME FX futures, in most cases, expire on a quarterly cycle, generally on set dates in March, June, September and December. In order to derive futures rates for these specific expirations, traders use a combination of spot plus or minus forward points to obtain the futures rate. Forward points simply represent the interest rate differential between two countries.

### Contract Specifications

<b>Trading Unit</b>	125,000 Euro	<b>Price Quotation</b>	1 point = \$.0001 per Euro = \$12.50 per contract
<b>Trading Hours (US Eastern Time)</b>	Floor trading: 7:20 a.m.-2:00 p.m. LTD(9:16 a.m.) central time. CME Globex platform Mon-Thurs 5:00 p.m.-4:00 p.m. Central time. Sun. and holidays 3:00 p.m.-4:00 p.m.  On holidays, CME FX products trading on the CME Globex electronic platform resume trading at 5:00 p.m. (CT) after a 12:00 noon (CT) trading halt.	<b>Trading Months</b>	Six months in the March Quarterly Cycle. Mar, Jun, Sep, Dec.  Persons acting pursuant to an expressed or implied agreement or understanding, and the positions of all accounts in which a person or persons have a proprietary or beneficial interest, shall be cumulated.
<b>Last Trading Day</b>	The second business day before third Wednesday. Delivery shall be made on the third Wednesday of the contract month. If that day is not a business day in the country of delivery or is a bank holiday in either Chicago or NYC, then delivery shall be made on the next day which is a business day.	<b>Deliverable Grades</b>	Not applicable.
<b>Settlement Type</b>	Physically Delivered	<b>More Information</b>	<a href="http://rulebook.cme.com/Rulebook/Chapters/pdffiles/261.pdf">http://rulebook.cme.com/Rulebook/Chapters/pdffiles/261.pdf</a>

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