Futures And Options What You Should Know Before You Trade

Commodity Futures Trading Commission

Federal Regulatory Agency
For Futures Trading

CFTC P-106A (01-97)

FUTURES AND OPTIONS --

WHAT YOU SHOULD KNOW BEFORE YOU TRADE

Trading commodity futures and options is not for everyone. It is a volatile, complex, and risky business. Before you invest any money in futures or options contracts, you should:

1. Consider your financial experience, goals, and financial resources and know how much you can afford to lose above and beyond your initial payment.

2. Understand commodity futures and option contracts and your obligations in entering into those contracts.

3. Understand your exposure to risk and other aspects of trading by thoroughly reviewing the risk disclosure documents your broker is required to give you.

4. Know who to contact if you have a problem or question.

The purpose of this brochure is to provide you with general information about trading commodity futures and options and to encourage you to ask more questions and gather more information before you open an account.

UNDERSTAND YOUR FINANCIAL GOALS AND RESOURCES

Who trades in commodity futures and options and why?

Most of the participants in the futures and options markets are commercial and institutional users of the commodities they trade. For example, a company or individual who holds an asset such as coffee, corn, soybeans, U.S. Treasury bonds, or a portfolio of stocks, wants the value of that asset to increase. That person also wants to limit, if possible, any loss in value. The company or individual may use the commodity markets to take an opposite position which can minimize the risk of financial loss from holding those assets when and if their price changes. This is called "hedging."

Other participants are speculators who hope to profit from changes in the price of the futures contract. A speculator buying a futures contract or call option, or selling a put option, hopes to profit from rising prices, while a speculator selling a futures contract or call option, or buying a put option, hopes to profit from declining prices. Because, unlike a hedger, a speculator does not own the underlying commodity, the components of the underlying index, or other product, losses in the futures market are not offset by gains in the cash market, and speculators can lose substantial amounts.

Individuals do participate in the market. An individual who owns or runs a business might participate as a hedger. Or, an individual with a substantial and diversified portfolio of investments might speculate using futures or options contracts. Individual investors should also have adequate resources to absorb the significant losses which can occur in futures and option trading.

Can futures and option trading meet my investment goals?

Futures trading is inherently complex and risky, and it is not appropriate for all investors. You should know how much you potentially can lose and honestly evaluate if you can afford to lose it in view of your financial resources and investment goals, and communicate this to your broker. If you decide you have the resources and the reasons to invest in futures, you should also determine the extent to which you plan to rely on advice from a broker versus making your own trading decisions. Then you should evaluate and compare the methods of trading before choosing the one you feel will best implement your goals. Finally, set some limits on the length of time you are willing to invest and the amount of loss you are willing to incur. Like other financial markets, futures are cyclical and gains may not be immediate. And remember that, because of the leveraged nature of futures, losses can be more than your original deposit.

Is there anything I should watch out for?

First, if it sounds too good to be true, it probably is. Promises of huge returns with limited risk are usually false. Be on the alert for anyone who downplays the importance of the disclosure statement; you should always receive one and always read it thoroughly before you open an account. Do your homework! Don't be pressured to "act now." Always ask questions. Beware when a salesperson tells you to borrow money to invest, and never agree to give money to someone you have never met. Watch out for guarantees of profit or boasts about past performance. Do not rely on claims of profits due to "predictable" seasonal or market cycles or claims based on the

impact of current news events.

There is fraud in every business and the futures industry is no exception, so you owe it to yourself to be careful. You may want to read Investment Swindles: How They Work and How to Avoid Them, a publication of the National Futures Association, or Swindlers are Calling, by the Alliance Against Fraud in Telemarketing, available from the CFTC or NFA.

Before you open an account, you should always check on the company's or individual's registration status by calling the National Futures Association (the private regulatory body that handles registration processing for the CFTC) at its toll-free number: 1-800-621-3570. If you live in Illinois, the NFA can be reached at 800-572-9400. The NFA's Information Center can also be contacted through the internet by sending an e-mail message to NFA's web site (http://www.nfa.futures.org). The NFA can also provide information on any disciplinary actions which have been brought against a registrant. Information on sanctions in effect against commodity professionals is also available on the CFTC's World Wide Web site (http://www.cftc.gov).

UNDERSTANDING COMMODITY FUTURES AND OPTION CONTRACTS AND YOUR CONTRACTUAL OBLIGATIONS

What are commodity futures and option contracts?

A futures contract is a legally binding agreement between two parties to buy or sell in the future, on a designated exchange, a specific quantity of a commodity at a specific price. The buyer and seller of a futures contract agree now on a price for a product to be delivered or paid for at a set time in the future, known as the "settlement date." Although actual delivery of the commodity can take place in fulfillment of the contract, most futures contracts are actually closed out or "offset" prior to delivery.

An option on a commodity futures contract is a legally binding agreement between two parties which gives the buyer, who pays a market determined price known as a "premium," the right (but not the obligation), within a specific time period, to exercise his option. Exercise of the option will result in the person being deemed to have entered into a futures contract at a specified price known as the "strike price." In some cases, an option may confer the right to buy or sell the underlying asset directly, and these options are known as options on the physical asset.

How do I go about trading futures or option contracts?

In the United States, futures contracts and options on futures contracts must be executed on or subject to the rules of a commodity exchange. But you, as an individual, cannot trade directly on an exchange. A person or firm must trade on your behalf. People and firms who trade on your behalf as a customer generally must be registered with the Commodity Futures Trading Commission.

There are two general categories of accounts through which you may trade.

Individual Account. In an individual account, trading is done only for you. An individual account

may be a "non-discretionary" account, which means that the broker may not execute any transactions without your prior approval. In a "discretionary" individual account, you give permission for the firm carrying your account or some third party to make trading decisions on your behalf.

You may open an individual account with a registered Futures Commission Merchant or through an Introducing Broker. An Introducing Broker may accept your orders and transmit them for execution to a Futures Commission Merchant with whom he has a relationship. An Introducing Broker is not permitted, however, to accept any funds from you. You deposit funds directly with a Futures Commission Merchant. In an individual discretionary account, you grant power-of-attorney to a Futures Commission Merchant, an Introducing Broker, one of their Associated Persons, or a Commodity Trading Advisor to make trading decisions on your behalf.

Commodity Pool. You may also trade commodities through a "commodity pool." In a commodity pool, you are purchasing shares or interests in the pool, and trades are executed for the pool, rather than for the individuals who have interests in the pool. Pool participants share ratably in gains or losses.

What are my contractual obligations?

Individual Account. When you enter into a futures or option contract through an individual account, you are required to make a payment referred to as a "margin payment" or "performance bond." This payment is small relative to the value of your market position, providing you with the ability to "leverage" your funds. Because trading commodity futures and option contracts is leveraged, small changes in price, which occur frequently, can result in large gains or losses in a short period of time.

Each day, your broker will calculate the current value of futures and option contracts held in your account. If the equity in your account has declined in value to the "maintenance margin level" (approximately 75% of the amount required to enter into the trades originally), you are required to provide more margin money to restore the initial margin level (this is called a "margin call"). This eliminates the needs to make repeated margin calls when daily price changes are relatively small.

If you fail to meet a margin call within a reasonable period of time, which could be as little as one hour, your brokerage firm may close out your positions to reduce your margin deficiency. If your position is liquidated at a loss, you would continue to be liable for that loss. You can, therefore, lose substantially more than your original margin deposit.

Commodity Pool. In a commodity pool, you have purchased a share or interest in the pool, and it is the pool itself which must make the performance bond payments and margin calls described above. Your contractual obligations as a participant in the pool, including your liability for any losses to the pool, must be described in the pool's disclosure document.

What is the role of the CFTC in protecting investors?

The Commodity Futures Trading Commission, or CFTC, was created by Congress in 1974 to regulate commodity futures and option markets in the United States and, in particular, to protect market participants against manipulation, abusive trade practices, and fraud. The CFTC requires

that all persons handling the public's commodity trading accounts and funds be registered with the CFTC. The CFTC also requires that before any individual or firm with whom you intend to open an account provide you with a risk disclosure statement which provides certain information specified by the CFTC.

UNDERSTAND YOUR EXPOSURE TO RISK AND OTHER ASPECTS OF TRADING

What is a risk disclosure document?

Because trading in futures and options is appropriate only for certain businesses and individuals, the CFTC requires that a broker provide you with a document which describes the risks involved in entering into futures and option contracts. The document provides you with an opportunity to carefully consider whether futures and options are appropriate for you in light of your experience, objectives, financial resources and other circumstances. The broker must receive a signed and dated acknowledgment from you that you have received a disclosure document before he or she can accept any funds, securities, or property from you. Accounts opened through different types of commodity professionals require different types of risk disclosure documents.

Futures Commission Merchants and Introducing Brokers. A Futures Commission Merchant or Introducing Broker must provide you with a disclosure statement which informs you of the risks inherent in trading futures contracts and/or options on futures contracts, as well as the effect that leverage may have on potential losses or gains. The disclosure statement must also inform you that trading futures in foreign markets carries particular risks because of fluctuations in the currency exchange rate and differences in regulatory protection.

Commodity Pools. The disclosure document for a commodity pool must include more extensive information, including the following:

Principal risk factors

The extent of your potential liability

The percentage return necessary for you to break even

Fees and expenses

Material litigation during the last five years against the pool's operator, manager, trading advisors, principals, the pool's futures commission merchants and introducing brokers

Actual or potential conflicts of interest of the pool's operator, manager or advisors

Past performance information

Information about the trader or company and its principals

The business background of the pool's operator, manager, and advisors

The volatility of the market

Limits on your ability to withdraw funds

Management, advisory, and brokerage fees

Whether foreign futures and option transactions are involved

The investment program of the pool and use of proceeds

Whether those managing your money may trade for their own account

Information on any protection of your principal investment

Transferability and redemption

Liability of participants

Distribution of profits and taxation

When trading will begin

The ownership of the pool

Reporting to pool participants

Before a Commodity Trading Advisor can solicit you concerning the authority to direct or guide your trading, the Commodity Trading Advisor must provide you with a disclosure document containing similar information.

The specific CFTC regulations governing disclosure documents may be obtained by contacting the CFTC Office of Public Affairs.

How does risk affect my returns?

Your returns may change radically at any time because futures and options are subject, by nature, to abrupt changes in price. Commodity prices are volatile because they respond to many unpredictable factors: weather, labor strikes, inflation, foreign exchange rates, government monetary policies, etc. And, in an individual account, because your position in futures and options is leveraged, even a small move against your position may result in a large loss, including the loss of your entire initial margin payment and liability for additional losses. The same risk of loss applies to a commodity pool, but your loss may be limited to the amount of your investment.

Are there strategies for reducing risk?

In an individual account, there are certain types of orders (such as "stop-loss" orders, where permitted under local law, or "stop limit" orders) which are designed to limit losses to certain amounts. However, these orders may not be effective in limiting losses because market conditions may make it impossible to execute your orders at a reasonable price. Strategies using combinations of positions, such as "spread" and "straddle" positions, may be as risky as taking simple "long" or "short" positions. In a commodity pool, you should ask the pool about any

strategies it employs to reduce risk. As always, be wary of claims of guaranteed profit and minimal risk.

Do options carry less risk than futures?

Not necessarily. If you plan to trade through an individual account and are considering trading options on futures contracts, you should familiarize yourself with the types of options (puts or calls) which you contemplate trading and the risks associated with each. You should calculate the extent to which the value of the options must increase for your position to become profitable, taking into account the premium and all transaction costs. You should also understand that certain market conditions (such as lack of liquidity), market rules or the pricing relationships between the underlying interest and the option may increase risk.

Do the risks vary between puts and calls?

The purchaser of an option (known as a "long" call or "long" a put) can do the following with an option position. The purchaser may "exercise" the options or allow the options to expire. The exercise of an option by someone who is "long" results either in a cash settlement or in the purchaser acquiring the underlying interest. If the option is on a future, the purchaser will acquire a futures position with associated liabilities for margin (see the section on Futures above). If the purchased options expire worthless, you will suffer a total loss of your investment which will consist of the option premium plus transaction costs. If you are contemplating purchasing "deep-out-of-the-money" options, you should be aware that the chance of such options becoming profitable ordinarily is remote.

Selling an option generally entails considerably greater risk than purchasing options. Although the premium received by the seller is fixed, the seller may sustain a loss well in excess of that amount. The seller will be liable for additional margin to maintain the position if the market moves unfavorably. The seller will also be exposed to the risk that the purchaser will exercise the option, obligating the seller to either settle the option in cash or to acquire and deliver the underlying interest. If the position is "covered" by the seller holding a corresponding position in the underlying interest or a future or another option, the risk of loss may be reduced, but the loss may still exceed the premium received. If the option is not covered, the risk of loss can be unlimited.

How do commissions and fees affect my rate of return?

Obviously, fees will reduce your rate of return and should, therefore, be examined carefully. In an individual account, the disclosure statement does specify fees and expenses. However, you are encouraged to consult your broker and be fully aware of the fees you will be charged. A commodity pool is required to provide you with a complete description of fees, commissions and other expenses. Before allocating any funds to a pool, you should pay particular attention to the "break-even analysis" and other required fee disclosures to determine how fees will affect your potential rate of return.

Is there a limit on potential losses?

Before participating in a commodity pool, read the disclosure document closely for information on losses. Losses to commodity pool participants are ordinarily (but not always) limited to the amount of your participation. Sometimes in a commodity pool, in order to protect against

catastrophic losses, a loss to the fund of more than a given percentage will trigger the sale of all open positions and will result in closing the pool account. The disclosure document must clearly state this possible course of action.

In an individual account, the leveraged nature of transactions can result in significant losses or gains, and losses may exceed your initial margin deposit. If so, you are responsible for covering those losses with additional funds.

How can I evaluate a broker's track record?

If you plan to participate in a commodity pool, information on past performance must be included in the risk disclosure document required to be provided by a Commodity Pool Operator. Bear in mind that past performance is not a predictor of future results.

If you authorize a Commodity Trading Advisor to direct trading in your individual account, the Commodity Trading Advisor must provide you with a disclosure document including information on past performance. In reading the disclosure document, note whether the performance results are based on actual trading results of client accounts. The Commodity Trading Advisor must disclose whether information is based on the Advisor's own proprietary (personal) account, or based on hypothetical or simulated results. If the information is based on hypothetical or simulated results, the Commodity Trading Advisor must disclose the inherent limitations of these results. No representation may be made that any account will or is likely to achieve profits or losses similar to those shown.

If you plan to open an individual account, and plan to ask your Futures Commission Merchant, Introducing Broker, or one of their Associated Persons for advice or have the firm or associated person trade on your behalf, get as much information as possible about the firm's or associated person's track record on behalf of other clients. While the firm or associated person is not required to provide this information, be wary of any firm or associated person who is not forthcoming or who provides you with incomplete information.

Can I withdraw my investment at any time?

The funds needed to meet initial margin requirements in an individual account can only be withdrawn after trades are settled and, in some cases, after all open positions are closed. Accruals on futures contracts are paid out daily. Funds held in an individual account above and beyond the required margin or account opening requirements should be withdrawable. If you participate in a commodity pool, you may or may not be able to withdraw some or all of your money at any given time. Some pools have limitations on when funds can be withdrawn. You may only be able to redeem your funds on a monthly, quarterly, or even annual basis. Restrictions on the withdrawal of money should be evaluated by reading the disclosure document and asking questions before you invest in the pool.

What information should my broker give me once I open an account?

In the case of an individually managed or personal account, you should receive confirmation by mail of all purchases and sales, and a month-end summary of transactions, showing gains, losses, and a mark-to-market valuation of your open positions and current account value. Your broker should also be willing and able to provide you with this information on a daily basis. In a

commodity pool, your pool operator ordinarily should send you a monthly statement of net asset value. However, if commodity pool assets do not exceed $500,000 at the beginning of the pool's fiscal year, reporting will be made quarterly.

Are my funds protected?

In an individual account, funds that you have deposited with your commodity brokerage firm to trade on commodity exchanges located in the United States are required to be segregated (held separately) from any of the brokerage firm's own funds. The amount segregated will increase or diminish as you make or lose money from your trading. Also, even though your brokerage firm is required to segregate your funds, you may still not be able to recover the full amount of any funds in your account if the brokerage firm becomes insolvent and there are insufficient funds available to cover the obligations to all of its customers. Your account is <u>not</u> insured.

If, in your individual account, you trade on commodity markets located outside of the United States, your brokerage firm will set up a trading account for you which is in addition to the account

set up for your trading on U.S. markets. The funds in your foreign account will be segregated by your brokerage firm only while you maintain an open position on a foreign market, and then only to the extent of any margin required on that position, plus or minus any unrealized gain or loss on that position. You should ask your broker about account protection and should be aware of the limitations imposed on the protection of the funds in your commodity trading accounts.

A commodity pool operator is required to disclose what percentage of the pool's assets will be held in segregation.

RESOLVING DISPUTES AND ASKING QUESTIONS

Where can I get help if I have a problem with my broker or account?

If you have a dispute arising out of your commodity futures or option account, first try to resolve the problem with your broker and his or her supervisor at the firm which employs or guarantees the broker. If that fails, commodity futures customers have several options for resolving disputes: (1) the CFTC Reparations program; (2) industry sponsored arbitration; or (3) court litigation. In selecting a particular approach, you may want to consider the cost, length of time involved and whether or not the assistance of an attorney is required. More information on dispute resolution is available from the CFTC's Office of Proceedings (202-418-5250).

Who can I contact if I have questions?

General information on the commodity futures markets and the CFTC is available through the World Wide Web. The CFTC's website is http://www.cftc.gov. You can also report suspected wrongdoing to the Commission's Division of Enforcement website (http://www.cftc.enf.gov). You may write or call the CFTC Office of Proceedings (202-418-5250) for information on filing complaints, or call the Office of Public Affairs (202-418-5080) for general information about CFTC. Call the main number of the CFTC (202-418-5000) if you are not sure which office may have the information you need. The National Futures Association also provides general information about futures and options as well as information on the registration status and

disciplinary history of its members. Information on futures and option trading may also be available directly from commodity exchanges.

CFTC offices can be found in the following locations:

Headquarters
Three Lafayette Centre
1155 21st Street N.W.
Washington, D.C. 20581

Office of Proceedings: (202) 418-5250
Office of Public Affairs: (202) 418-5080
CFTC General Number: (202) 418-5000

Central Region
300 South Riverside Plaza
Suite 1600 North
Chicago, IL 60606

Phone: (312) 353-5990

Southwestern Office
4900 Main Street
Suite 721
Kansas City, MO 64112

Phone: (816) 931-7600

Western Office
Murdock Plaza
10900 Wilshire Boulevard
Suite 400
Los Angeles, CA 90024

Phone: (310) 235-6783

Minneapolis Office
510 Grain Exchange Building
Minneapolis, MN 55415

Phone: (612) 370-3255

Eastern Region
One World Trade Center
Suite 3747
New York, NY 10048

Phone: (212) 466-2061

The following organizations are designated as self-regulatory organizations by the CFTC:

National Futures Association
200 West Madison Street
Chicago, IL 60606

Toll free: 1-800-621-3570
In Illinois: 1-800-572-9400

Amex Commodities Corporation
86 Trinity Place
New York, New York 10006

(212) 306-1000

Chicago Board of Trade
141 West Jackson Boulevard
Chicago, Illinois 60604

(312)435-3500

Chicago Mercantile Exchange
30 South Wacker Drive
Chicago, Illinois 60606

(312) 930-1000

Coffee, Sugar & Cocoa Exchange, Inc.
Four World Trade Center
New York, New York 10048

(212) 742-6000

Commodity Exchange, Inc., Division of
the New York Mercantile Exchange
Four World Trade Center
New York, New York 10048

(212) 938-2900

Kansas City Board of Trade
4800 Main Street, Suite 303
Kansas City, Missouri 64112

(816) 753-7500

**MidAmerica Commodity Exchange
141 West Jackson Boulevard
Chicago, Illinois 60604**

(312) 435-3500

**Minneapolis Grain Exchange
400 South Fourth Street
Minneapolis, Minnesota 55415**

(612) 338-6212

**New York Cotton Exchange & Affiliates:
Financial Instrument Exchange, Citrus Associates
of the New York Cotton Exchange, New York Futures Exchange**

**Four World Trade Center
New York, New York 10048**

(212) 742-5028

**New York Mercantile Exchange
Four World Trade Center
New York, New York 10048**

(212) 748-3250

**Philadelphia Board of Trade
Philadelphia Stock Exchange Building
1900 Market Street
Philadelphia, Pennsylvania 19103**

(215) 496-5000

A "BEFORE-YOU-TRADE" CHECKLIST

Before you trade futures or options, have you:

Clearly identified your financial goals, including the amount of risk and loss you can sustain?

Determined how much assistance you want from a trading advisor in making trading decisions?

Checked the registration status and disciplinary history of the advisor or pool you select with the National Futures Association?

Received and thoroughly reviewed the disclosure document before you open an account?

Clearly understood the disclosure document, including the statement of fees, the potential for loss, your right to withdraw your funds and the "break-even analysis?"

Called the CFTC or the NFA with any questions you may have?

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4900 Main Street - Suite 721
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