

The NFA logo consists of the letters "NFA" in a bold, blue, sans-serif font, enclosed within a thin, yellow, curved line that arches over the letters.

NFA

NATIONAL  
FUTURES  
ASSOCIATION

A man in a black suit is walking a tightrope high above a city. He is holding a black umbrella over his head. To his right, a woman in a white top and green pants is walking on a narrow ledge of a building. The background shows a cityscape with buildings and a blue sky with light clouds.

# *Opportunity* AND *Risk*

An Educational Guide to  
Trading  
Futures

National Futures Association is a congressionally authorized self-regulatory organization of the United States futures industry. Its mission is to provide innovative regulatory programs and services that protect investors and ensure market integrity.

NFA has prepared this book as part of its continuing public education efforts to provide information to potential investors. The booklet provides a necessary overview of the opportunities and risks in trading futures and options on futures by presenting important information that investors need to know before they invest.

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# *Opportunity* AND *Risk*

An Educational Guide to  
Trading Futures

# Opportunity AND Risk

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# Introduction

For nearly a century and a half, futures markets have fulfilled an important economic function: providing an efficient and effective mechanism for the management of price risks. Beginning with agricultural futures contracts traded on the Chicago Board of Trade in 1865, the U.S. futures markets now list an ever-expanding number of instruments, including metals, energy, financial instruments, foreign currencies, stock indexes, prediction markets and event futures. Additionally, the industry introduced trading in options on futures contracts in 1982.

Just as the types of instruments traded on futures exchanges have evolved, so has the method of trading those instruments. Until the 1990s, futures trading was conducted primarily on the floor of the exchanges. Traders crowded into trading “pits” or “rings”, shouting and signaling bids and offers to each other. This type of trading, known as open-outcry, resulted in competitive, organized price discovery.

In the 1990s, exchanges introduced electronic trading on certain contracts during off-exchange hours. Since then, electronic trading has expanded to include side-by-side open outcry and electronic trading, as well as contracts that are exclusively traded electronically. Futures trading has truly become a 24 hours a day, seven days a week financial marketplace.

Participants in today’s futures markets include mortgage bankers as well as farmers, bond dealers

*mortgage bankers*

*bond dealers*



## Who Trades?

as well as grain merchants, lending institutions and individual speculators. By buying or selling futures contracts—contracts that establish a price level now for items to be delivered later—individuals and businesses seek to achieve what amounts to insurance against adverse price changes. This is called hedging.

Other futures market participants are speculative investors who accept the price risks that

hedgers seek to avoid. Most speculators have no intention of making or taking delivery of the commodity. They seek instead to profit from a change in the price. That is, they buy when they anticipate rising prices and sell when they anticipate declining prices. The interaction of hedgers and speculators helps to provide active, liquid and competitive markets.

Speculative participation in futures trading has become increasingly widespread with the availability of alternative methods of participation. Whereas many futures traders continue to prefer to make their own trading decisions—such as what to buy and sell and when to buy and sell—others choose to utilize the services of a professional trading advisor, or to avoid day-to-day trading responsibilities by establishing a fully managed trading account or participating in a commodity pool which is similar in concept to a mutual fund.

For those individuals who fully understand and can afford the risks which are involved, the allocation of some portion of their capital to futures trading can provide a means of achieving greater diversification and a potentially higher overall rate of return on their investments. There are also a number of ways in which futures can be used in combination with stocks, bonds and other investments.

**Speculation in futures contracts, however, is clearly not appropriate for everyone. Just as it is possible to realize substantial profits in a short period of time, it is also possible to incur substantial losses in a short period of time.**

The possibility of large profits or losses in relation to the initial commitment of capital stems principally from the fact that futures trading is a highly leveraged form of speculation. Only a relatively small amount of money is required to control assets having a much greater value. As we will discuss and illustrate, the leverage of futures trading can work for you when prices move in the direction you anticipate or against you when prices move in the opposite direction.

The pages which follow are intended to help provide you with the kinds of information you should obtain—and the questions you should seek answers to—before making any decision to trade futures and/or options on futures.

Topics covered include:

- ***The regulatory structure of the futures industry***
- ***How to conduct a background check of a futures firm***
- ***How futures contracts are traded***
- ***The costs of trading***
- ***How gains and losses are realized***
- ***How options on futures are traded***
- ***How to resolve futures-related disputes***

We have also included a Glossary at the back of this Guide for easy reference. In fact, we suggest that you become familiar with some of the terms included in the Glossary before continuing.

It is not the purpose of this Guide to suggest that you should—or should not—participate in futures and/or options on futures trading. That is a decision you should make only after consultation with your broker or financial advisor and in light of your own financial situation and objectives.

Finally, this Guide focuses primarily on exchange-traded futures and options on futures contracts. For information regarding off-exchange foreign currency (forex) futures and options, consult the NFA brochure “Trading in the Off-Exchange Foreign Currency Market: What Investors Need to Know.” The brochure is available free of charge on NFA’s Web site ([www.nfa.futures.org](http://www.nfa.futures.org)).

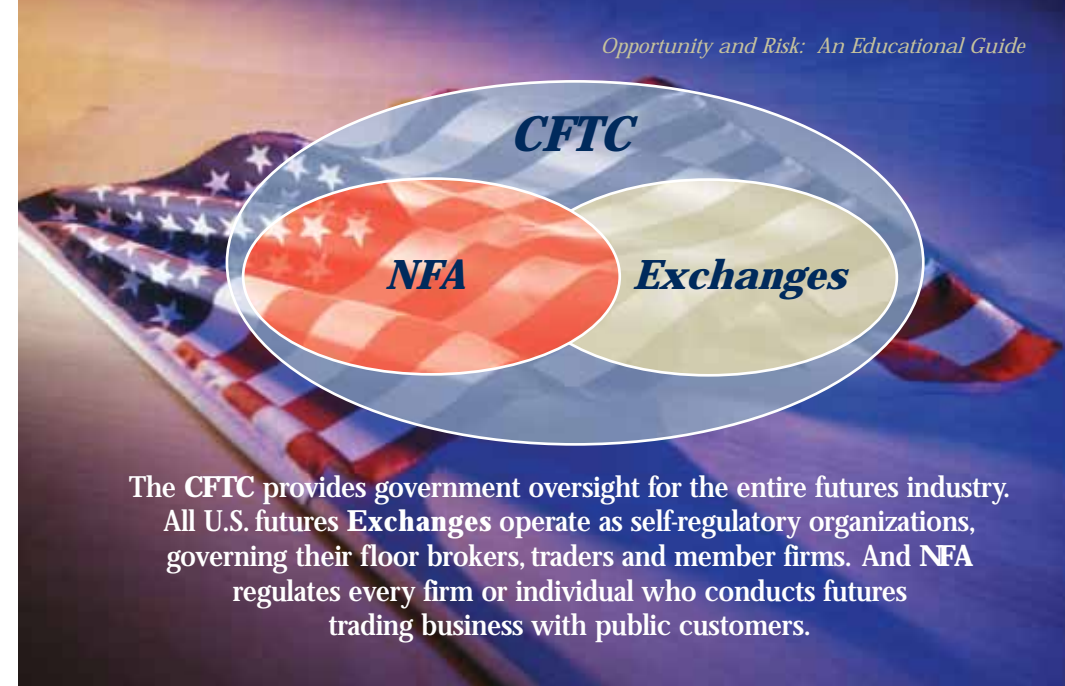
# How the Markets are Regulated

The U.S. futures industry has experienced unprecedented growth in trading volume over the past several years, reflecting the high level of trust and confidence that customers have in the marketplace. This confidence is due in part to a strong, effective regulatory structure that safeguards market integrity and protects investors. This regulatory structure has three main components.

**The Commodity Futures Trading Commission (CFTC).** In 1974 Congress established the CFTC, a federal regulatory agency with jurisdiction over futures trading. The enforcement powers of the CFTC are

similar to those of other major federal regulatory agencies, including the power to seek criminal prosecution by the Department of Justice where circumstances warrant such action.

**National Futures Association (NFA).** The same legislation authorized the creation of “registered futures associations,” giving the futures industry the opportunity to create a nationwide self-regulatory organization. NFA is the industrywide, self-regulatory organization for the U.S. futures industry. NFA’s mission is to develop rules, programs and services that safeguard market integrity, protect investors and help its Members meet their regulatory responsibilities. Firms and individuals that violate NFA rules of professional ethics and conduct or



## Regulatory Relationships

that fail to comply with financial and record-keeping requirements can, if circumstances warrant, be permanently barred from engaging in any futures-related business with the public.

**U.S. futures exchanges and clearing organizations.** Futures Commission Merchants (FCMs) which are members of an exchange are subject to not only CFTC and NFA regulation but also to regulation by the exchanges and clearing organizations of which they are members. Exchange and clearing corporation staffs are responsi-

ble, subject to CFTC oversight, for monitoring the business conduct and financial responsibility of their member firms. Violations of exchange rules can result in substantial fines, suspension or revocation of trading privileges, and loss of exchange or clearing corporation membership.

Although the various regulatory organizations in the futures industry have their own specific areas of authority, together they form a regulatory partnership that oversees all industry participants.

## Conducting Business with a Registered Firm

Membership in NFA is mandatory, assuring that everyone conducting business with the public on the U.S. futures exchanges—more than 4,000 firms and 55,000 associates—must adhere to the same high standards of professional conduct. You can quickly verify whether a particular firm or person is currently registered with the CFTC and is an NFA Member through NFA's Background Affiliation Status Information Center (BASIC), found on NFA's Web site ([www.nfa.futures.org](http://www.nfa.futures.org)).

BASIC contains current and historical registration informa-



tion concerning all current and former CFTC registrants, including name, business address and registration history in the futures industry. BASIC also contains information concerning disciplinary actions taken by NFA, the CFTC and all the U.S. futures exchanges. If you are researching a firm, you should also conduct a background check of all the individuals listed as principals of the firm, as well as the firm's salespeople.

**A BASIC background check will tell everything you need to know about the status of your financial firm or advisor ([www.nfa.futures.org](http://www.nfa.futures.org)).**

Sometimes the firm will have no disciplinary history, but one or more of the principals or salespeople may have been disciplined while working at other firms.

In addition, BASIC gives you details concerning NFA arbitration matters involving disputes between investors and NFA

Members if the case went to hearing and an award was issued after January 1, 1990. You will also find summary data concerning the number of cases filed by investors against registered firms and individuals with the CFTC reparations program.

# Introduction to Futures Trading Futures Contracts



A futures contract is a legally binding agreement to buy or sell a commodity or financial instrument at a later date. Futures contracts are standardized according to the quality, quantity and delivery time and location for each commodity. The only variable is price.

There are two types of futures contracts, those that provide for physical delivery of a particular commodity or item and those which call for a cash settlement. The month during which delivery or settlement is to occur is specified. For example, a July futures contract is one providing for delivery or settlement in July.

It should be noted that even in the case of delivery-type

futures contracts very few actually result in delivery. Not many speculators have the desire to take or make delivery of 5,000 bushels of wheat or 112,000 pounds of sugar. Rather, the vast majority of speculators in futures markets choose to realize their gains or losses by buying or selling offsetting futures contracts prior to the delivery date.

Selling a contract that was previously purchased liquidates a futures position in exactly the same way, for example, that selling 100 shares of IBM stock liquidates an earlier purchase of 100 shares of IBM stock. Similarly, a futures contract that was initially sold can be liquidated by an offsetting purchase. In either case, the resulting gain or loss is the difference between the buying price and the selling price less transaction costs (commissions and fees).

Since delivery on futures contracts is the exception rather than the rule, why do most contracts even have a delivery provision? There are two reasons. One is that it offers buyers and sellers the opportunity to take or make delivery of the physical commodity if they so choose. More importantly, however, the fact that buyers and sellers *can* take or make delivery helps to assure that futures prices will accurately reflect the cash market value of the commodity at the time the contract expires—i.e., that futures and cash prices will eventually converge. It is convergence that makes hedging an effective way to obtain protection against an adverse price movement in the cash market.

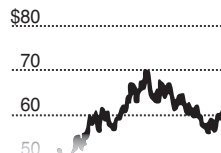
Cash settlement futures contracts are precisely that, contracts which are settled in cash rather than by delivery at the time the contract expires. Stock index futures contracts, for example, are settled in cash on the basis of the index number used for the final settlement. There is no provision for delivery of the shares of stock that make up the various indexes. That would be impractical. With a cash settlement contract, convergence is automatic.

Futures prices are established through competitive bidding and are immediately and continuously relayed around the world by wire and satellite. A farmer in Nebraska, a merchant in Amsterdam, an importer in Tokyo and a speculator in Ohio have simultaneous access to the latest market-derived price quotations. And, should they choose, they can establish a price level for future delivery—or for speculative purposes—simply by having their broker buy or sell the appropriate contracts.

**FUTURES**

Future	Exchange	Monetary units per quantity	Lifetime		Date	Open	High	Low	Settle	Change	Open Interest
			High	Low							
<b>AGRICULTURAL</b>											
Corn	CBT	¢ / bushel	302 3/4	217 1/4	Jul 06	238 1/4	243	238 1/4	240	+ 2	576,182
Soybeans	CBT	¢ / bushel	736	485	Jul 06	606	612	604 1/4	606	+ 1 1/2	225,894
Soybean Meal	CBT	\$/ ton	227.00	158.70	Jul 06	180.00	181.50	178.20	178.80	- 70	93,312
Soybean Oil	CBT	¢ / lb	26.57	19.61	Jul 06	25.10	25.35	25.01	25.28	+ 20	162,452
Wheat	CBT	¢ / bushel	418 1/4	268 3/4	Jul 06	384 1/4	389 1/4	383 1/4	384 1/4	- 1/4	240,326
Winter Wheat	KC	¢ / bushel	474 1/4	342	Jul 06	468 1/4	472 1/4	465	465 1/4	- 2 1/4	83,750
Oats	CBT	¢ / bushel	270 1/4	133 1/4	Jul 06	189	190 1/4	187 1/4	189	- 1/4	8,505
Rough Rice	CBT	\$/ CWT	9.210	6.900	Jul 06	8.460	8.560	8.450	8.545	+ .085	5,695

Crude Oil



# The Market Participants

Should you at some time decide to trade in futures contracts, either for speculation or in connection with a risk management strategy, your orders to buy or sell will be communicated from the brokerage office you use to the appropriate trading pit or electronic trading platform for execution. If you are a buyer, your order will seek a seller at the lowest available price. If you are a seller, your order will seek a buyer at the highest available price. Market fluctuation is a process of finding fair prices for both buyers and sellers.

In either case, the person who takes the opposite side of your trade may be or may represent someone who is a commercial hedger or perhaps someone who is a public speculator. Or, quite possibly, the other party may be an independent trader. In becoming acquainted with futures markets, you should have at least a general understanding of who these various market participants are, what they are doing and why.

## Hedgers

The details of hedging can be somewhat complex but the principle is simple. Hedgers are individuals and firms that make purchases and sales in the futures market for the purpose of establishing a known price level—weeks or months in advance—for something they later intend to buy or sell in the cash market (such as at a grain

In newspaper financial sections

## How Prices are Quoted

Futures prices are usually quoted the same way prices are quoted in the underlying cash market.

That is, in dollars, cents, and sometimes fractions of a cent, per bushel, pound or ounce; also in dollars, cents and increments of a cent for foreign

currencies; and in points and percentages of a point for financial instruments. Cash settled index contract prices are quoted in terms of an index number, usually stated to two decimal points. Be certain you understand the price quotation system for the particular futures contract you are considering.

On financial services websites

SOYBEANS Delayed Futures -09:20 - Monday, 8 May  
( [Go to Daily](#) ) ( [Profile](#) ) (Click on Contract for Chart)

Contract	Last	Change	Open	High	Low	Prev. Stl.	Time
<a href="#">May '06 (SK06)</a>	594-4	+3-6	597-0	601-4	593-0	590-6	05/05/06
<a href="#">Jul '06 (SN06)</a>	606-4	+2-6	609-4	614-4	605-0	603-6	05/05/06
<a href="#">Aug '06 (SQ06)</a>	612-0	+3-0	615-0	619-0	611-0	609-0	05/05/06
<a href="#">Sep '06 (SU06)</a>	615-4	+2-2	620-0	622-0	614-0	613-2	05/05/06
<a href="#">Nov '06 (SX06)</a>	625-2	+3-0	627-4	631-0	623-4	622-2	05/05/06
<a href="#">Jan '07 (SF07)</a>	632-2	+3-0	636-0	636-0	632-0	629-2	05/05/06
<a href="#">Mar '07 (SH07)</a>	639-0	+4-0	641-0	644-0	636-0	635-0	05/05/06
<a href="#">May '07 (SK07)</a>	640-0	+3-0	641-0	643-0	638-0	637-0	05/05/06
<a href="#">Jul '07 (SN07)</a>	643-0	+3-0	645-0	647-0	643-0	640-0	05/05/06

elevator or in the bond market). In this way they attempt to protect themselves against the risk of an unfavorable price change in the interim. *Consider this example:*

A jewelry manufacturer will need to buy additional gold from his supplier in six months. Between now and then, however, he fears the price of gold may increase. That could be a problem because he has already published his catalog for the year ahead.

To lock in the price level at which gold is presently being quoted for delivery in six months, he buys a futures contract at a price of \$550 an ounce.

If, six months later, the cash market price of gold has risen, he will have to pay his supplier that increased amount to acquire gold. However, the extra cost may be offset by a corresponding profit when the futures contract bought at \$550 is sold for \$570. In effect, the hedge

provided insurance against an increase in the price of gold. It locked in a net cost, regardless of what happened to the cash market price of gold. Had the price of gold declined instead of risen, he would have incurred a loss on his futures position, but this would have been offset by the lower cost of acquiring gold in the cash market.

The number and variety of hedging possibilities are practically limitless. A cattle feeder can hedge against a decline in livestock prices and a meat packer or supermarket chain can hedge against an increase in livestock prices. Borrowers can hedge against higher interest rates, and lenders against lower interest rates. In addition, investors can hedge against a decline in stock prices.

Whatever the hedging strategy, the common denominator is that hedgers willingly give up the opportunity to benefit from favorable price changes in order to achieve protection against unfavorable price changes.



## ***Speculators***

Were you to speculate in futures contracts, the person taking the opposite side of your trade on any given occasion could be a hedger or it might well be a speculator—someone whose opinion about the probable direction of prices may differ from your own.

The arithmetic of speculation in futures contracts—including the opportunities it offers and the risks it involves—will be discussed in detail later on. For now, just know that speculators are individuals and firms who seek to profit from anticipated increases or decreases in futures prices. In so doing, they help provide the risk capital needed to facilitate hedging.

Someone who expects a futures price to increase would purchase futures contracts in the hope of later being able to sell them at a higher price. This is known as “going long.” Conversely, someone who expects a futures price to decline would sell futures contracts in the hope of later being able to buy back identical and offsetting contracts at a lower price. The practice of selling futures contracts in anticipation of lower prices is known as “going short.” One of the unique features of futures trading is that one can initiate a transaction with a sale as well as with a purchase.

	Reasons for <b>BUYING</b> futures contracts	Reasons for <b>SELLING</b> futures contracts
<b>HEDGERS</b>	To lock in a price and thereby obtain protection against rising cash prices	To lock in a price and thereby obtain protection against declining cash prices
<b>SPECULATORS</b>	To profit from rising futures prices	To profit from declining future prices

## The Process of Price Discovery

Futures prices increase and decrease largely because of the myriad factors that influence buyers' and sellers' judgments about what a particular product will be worth at a given time in the future (anywhere from less than a month to more than two years).

As new supply and demand developments occur and as new and more current information becomes available, these judgments

are reassessed, and the price of a particular futures contract may be bid upward or downward. The process of reassessment (price discovery) is continuous.

Thus, in January, the price of a July futures contract would reflect the consensus of buyers' and sellers' opinions at that time as to what the value of a commodity or item will be when the contract expires in July. On any given day, with the arrival of new or more accurate information, the price of the July futures contract might increase or decrease

in response to changing expectations. As the term indicates, futures markets "discover"—or reflect—cash market prices. They do not set them.

Competitive price discovery is a major economic function—and, indeed, a major economic benefit—of futures trading. In summary, futures prices are an ever changing barometer of supply and demand and, in a dynamic market, the only certainty is that prices will change.

### Minimum Price Changes

Exchanges establish the minimum amount that the price can fluctuate upward or downward. This is known as the "tick." For example, each tick for grain is .0025¢ per bushel. On a 5,000 bushel futures contract, that's \$12.50. On a gold futures contract, the tick is 10¢ per ounce, so one tick on a 100 ounce contract is \$10. You'll want to familiarize yourself with the minimum price fluctuation—the tick size—for whatever

futures contracts you plan to trade. You'll also need to know how a price change of any given amount will affect the value of the contract.

### Daily Price Limits

Exchanges establish daily price limits for trading in some futures contracts. The limits are stated in terms of the previous day's closing price plus and minus so many cents or dollars per trading unit. Once a futures price has increased by its daily limit, there can be no trading at any higher price until the next trading session. Conversely, once a futures price has declined by its daily limit, there can be no trading at any lower price until the next session. Thus, if the daily limit for a particular grain is currently 10¢ a bushel and the previous day's settlement was \$3.00, there cannot be trading during the current day at any price below 2.90 or above 3.10. The price is allowed to increase or decrease by the limit amount each day.

For some contracts, daily price limits are eliminated during the month in which the contract expires. Because prices can become particularly volatile during the expiration month (also called the “delivery” or “spot” month), persons lacking experience in futures trading may wish to liquidate their positions prior to that time. At the very least, they should trade cautiously and with an understanding of the risks which may be involved.

Daily price limits set by the exchanges are subject to change. They can, for example, be increased or decreased on successive days. Because of daily price limits, there may be occasions when it is not possible to liquidate an existing futures posi-

tion at will. In this event, possible alternative strategies should be discussed with a broker.

### ***Position Limits***

Although the average trader is unlikely to ever approach them, exchanges and the CFTC establish limits on the maximum speculative position that any one person can have at one time in any one futures contract. The purpose is to prevent one buyer or seller from being able to exert undue influence on the price in either the establishment or liquidation of positions. Position limits are stated in number of contracts or total units of the commodity.

The easiest way to obtain the types of information just discussed is to ask your broker or other advisor to provide you with a copy of the contract specifications for the specific futures contracts you are thinking about trading. You can also obtain the information from the exchange where the contract is traded.

## ***Daily Close***

At the end of a day’s trading, the exchange’s clearing organization matches each clearing firm’s purchases made that day with corresponding sales and tallies each clearing firm’s gains or losses based on that session’s price changes—a massive undertaking considering that several million futures contracts are bought and sold on an average day. Each firm, in turn, calculates the gains and losses for each of its customers having futures contracts.

Gains and losses on futures contracts are not only calculated on a daily basis, they are credited and deducted by the clearing firm on a daily basis.

For example, if a speculator were to have a \$300 profit as a result of the day’s price changes, that amount would be immediately credited to his brokerage account and, unless required for other purposes, could be withdrawn. On the other hand, if the day’s price changes had resulted in a \$300 loss, his account would be immediately debited for that amount.

The process just described is known as a daily cash settlement and is an important feature of futures trading. As will be seen when we discuss margin requirements (see page 27), it is also the reason a customer who incurs a loss on a futures position may be called on to deposit additional funds to his account.

# The Arithmetic of Futures Trading

## Leverage

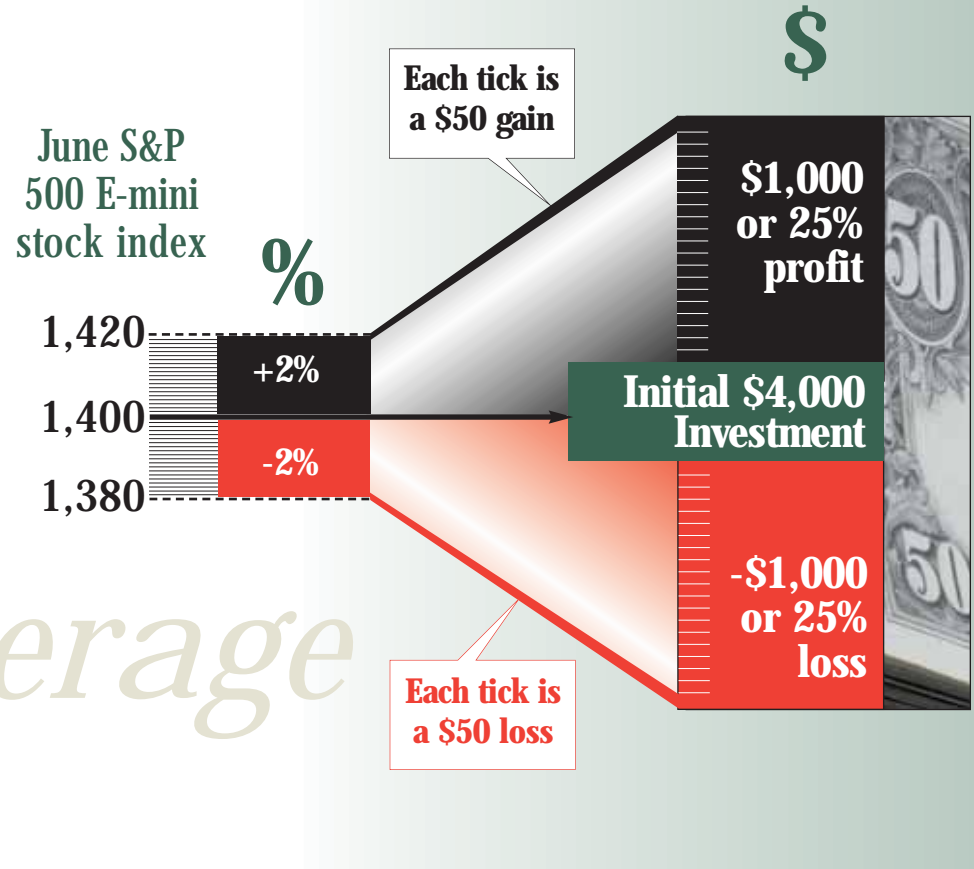
To say that gains and losses in futures trading are the result of price changes is an accurate explanation but by no means a complete explanation. Perhaps more so than in any other form of speculation or investment, gains and losses in futures trading are highly leveraged. An understanding of leverage—and of how it can work to your advantage or disadvantage—is crucial to an understanding of futures trading.

The leverage of futures trading stems from the fact that only a relatively small amount of money (known as initial margin) is required to buy or sell a futures contract. On a particular day, a margin deposit of only \$1,000 might enable you to buy or sell a futures contract covering \$25,000 worth of soybeans. Or for \$20,000, you might be able to purchase a futures contract covering common stocks worth



\$200,000. The smaller the margin in relation to the value of the futures contract, the greater the leverage will be.

If you speculate in futures contracts and the price moves in the direction you anticipated, high leverage can produce large profits in relation to your initial margin. Conversely, if prices move in the opposite direction, high leverage can produce large losses in relation to your initial margin. Leverage is a two-edged sword.



**Small movements in the market can create big changes in your account.**

For example, assume that in anticipation of rising stock prices you buy one June S&P 500 E-mini stock index futures contract at a time when the June index is trading at 1400. And assume your initial margin requirement is \$4,000. Since the value of the futures contract is 50 times the index, each one point change in the index represents a \$50 gain or loss.

Thus, an increase in the index from 1400 to 1420 would produce a \$1,000 profit (20 x \$50) and a decrease from 1400 to 1380 would be a \$1,000 loss on your \$4,000 margin deposit. That's a 25 percent gain or loss as the result of less than a 2 percent change in the stock index.

Said another way, while buying (or selling) a futures contract provides exactly the same dollars and cents profit potential as owning (or selling short) the actual commodities or items covered by the contract, low margin requirements sharply increase the percentage profit or loss potential.

Futures trading, therefore, requires not only the necessary financial resources but also the

necessary emotional tempering. For example, it can be one thing to have the value of your portfolio of common stocks decline from \$200,000 to \$190,000 (a five percent loss) but quite another, at least emotionally, to deposit \$20,000 as margin and end up losing half of it as the result of only a five percent decline.

It is essential for anyone considering trading in futures contracts—whether it's sugar or stock indexes, pork bellies or petroleum—to clearly understand the concept of leverage as well as the amount of gain or loss that will result from any given change in the futures price of the particular futures contract you would be trading. If you cannot afford the risk, or even if you are uncomfortable with the risk, the only sound advice is don't trade. Futures trading is not for everyone.

## ***Margins***

As is apparent from the preceding discussion, the arithmetic of leverage is the arithmetic of margins. An understanding of margins—and of the several different kinds of margin—is essential to an understanding of futures trading.

If your previous investment experience has mainly involved common stocks, you know that the term margin—as used in connection with securities—has to do with the cash down payment and money borrowed from a broker to purchase stocks. But used in connection with futures trading, margin has an altogether different meaning and serves an altogether different purpose.

Rather than providing a down payment, the margin required to buy or sell a futures contract is solely a deposit of good faith money that can be drawn on by your brokerage firm to cover losses that you may incur in the course of

futures trading. It is much like money held in an escrow account.

Minimum margin requirements for a particular futures contract at a particular time are set by the exchange on which the contract is traded. They are typically about five percent of the current value of the futures contract.

Exchanges continuously monitor market conditions and risks and, as necessary, raise or reduce their margin requirements. Individual brokerage firms may require higher margin amounts from their customers than the exchange-set minimums.

There are two margin-related terms you should know: initial margin and maintenance margin.

Initial margin (sometimes called original margin) is the sum of money that the customer must deposit with the brokerage firm for each futures contract to be bought or sold. On any day that profits accrue on your open positions, the profits will be added to

*Initial Margin Needed*  
\$2,000

*Maintenance Margin Requirement*  
\$1,500

*Margin Call*  
\$600

*If Your Account Drops to*  
\$1,400

# margin

the balance in your margin account. On any day losses accrue, the losses will be deducted from the balance in your margin account.

If and when the funds remaining available in your margin account are reduced by losses to below a certain level—known as the maintenance margin require-

Assume, for example, that the initial margin needed to buy or sell a particular futures contract is \$2,000 and that the maintenance margin requirement is \$1,500. Should losses on open positions reduce the funds remaining in your trading account to \$1,400 (an amount less than the maintenance requirement), you will receive a margin call for the \$600 needed to restore your account to \$2,000.

ment—your broker will require that you deposit additional funds to bring the account back to the level of the initial margin. You may also be asked for additional margin if the exchange or your brokerage firm raises its margin requirements. Requests for additional margin are known as margin calls.

Before trading in futures contracts, be sure you understand the brokerage firm's Margin Agreement and know how and when the firm expects margin calls to be met. Some firms may require only that you mail a personal check. Others may insist you wire transfer funds from your bank or provide same-day or next-day delivery of a certified or cashier's check. If margin calls are not met in the prescribed time and form, the firm can protect itself by liquidating your open positions at the available market price (possibly resulting in a loss for which you would be liable).

## Basic Trading Strategies

Even if you should decide to participate in futures trading in a way that doesn't involve having to make day-to-day trading decisions (such as a managed account or commodity pool), it is nonetheless useful to understand the dollars and cents of how futures trading gains and losses are realized. If you intend to trade your own account, such an understanding is essential.

Dozens of different strategies and variations of strategies are employed by futures traders in pursuit of speculative profits. Here is a brief description and illustration of several basic strategies.



### ***Buying (Going Long) to Profit from an Expected Price Increase***

Someone expecting the price of a particular commodity or item to increase over a given period of time can seek to profit by buying futures contracts. If correct in forecasting the direction and timing of the price change, the futures contract can later be sold for the higher price, thereby yielding a profit.\* If the price declines rather than increases, the trade will result in a loss. Because of leverage, the gain or loss may be greater than the initial margin deposit.

For example, assume it's now January, the July soybean futures contract is presently quoted at \$6.00 a bushel, and over the coming months you expect the price to increase. You decide to deposit the required initial margin of \$1,000 and buy one July soybean futures contract. Further assume that by April the July soybean futures price has risen to \$6.40, and you decide to take your profit by selling. Since each contract is for 5,000 bushels, your 40-cent a bushel profit would be 5,000 bushels x 40¢ or \$2,000 less transaction costs.

		Price Per Bushel	Value of 5,000 Bushel Contract
<b>January</b>	Buy 1 July soybean futures contract	\$6.00	\$30,000
<b>April</b>	Sell 1 July soybean futures contract	\$6.40	\$32,000
	<b>GAIN</b>	\$ .40	\$ 2,000

*\*For simplicity, examples do not take into account commissions and other transaction costs. These costs are important, however, and you should be sure you fully understand them.*

		Price Per Bushel	Value of 5,000 Bushel Contract
<b>January</b>	Buy 1 July soybean futures contract	\$6.00	\$30,000
<b>April</b>	Sell 1 July soybean futures contract	\$5.60	\$28,000
	<b>LOSS</b>	\$ .40	\$ 2,000

Suppose, however, that rather than rising to \$6.40, the July soybean futures price had declined to \$5.60 and that, in order to avoid the possibility of further loss, you elect to sell the contract at that price. On 5,000 bushels your 40-cent a bushel loss would thus come to \$2,000 plus transaction costs.

Note that the loss in this example exceeded your \$1,000 initial deposit. Your broker would then call upon you, as needed, for additional funds to cover the loss. Had you not offset the position and the soybean contract was open in your account, your broker would ask you to deposit more margin funds into your account to

cover the projected losses marked to the settlement price.

***Selling (Going Short) to Profit from an Expected Price Decrease***

The only way going short to profit from an expected price decrease differs from going long to profit from an expected price increase is the sequence of the trades. Instead of first buying a futures contract, you first sell a futures contract. If, as expected, the price declines, a profit can be realized by later purchasing an offsetting futures contract at the lower price. The gain per unit will be the amount by which the purchase price is below the earlier selling price.

For example, assume that in January your research or other available information indicates a probable decrease in cattle prices over the next several months. In the hope of profiting, you deposit an initial margin of \$700 and sell one April live cattle futures contract at a price of, say, 85¢ a pound. Each contract is for 40,000 pounds, meaning each 1¢ a pound change in price will increase or decrease the value of the futures contract by \$400. If, by March, the price has declined to 80¢ a pound, an offsetting futures contract can be purchased at 5¢ a pound below the original

selling price. On the 40,000 pound contract, that's a gain of 5¢ x 40,000 lbs. or \$2,000 less transaction costs.



		Price Per Pound	Value of 40,000 Pound Contract
<b>January</b>	Sell 1 April live cattle futures contract	85¢	\$34,000
<b>March</b>	Buy 1 April live cattle futures contract	80¢	\$32,000
	<b>GAIN</b>	5¢	\$ 2,000

		Price Per Pound	Value of 40,000 Pound Contract
<b>January</b>	Sell 1 April live cattle futures contract	85¢	\$34,000
<b>March</b>	Buy 1 April live cattle futures contract	90¢	\$36,000
	<b>LOSS</b>	5¢	\$ 2,000

Assume you were wrong. Instead of decreasing, the April live cattle futures price increases to 90¢ a pound by the time in March when you eventually liquidate your short futures position through an offsetting purchase. The outcome would be as shown above.

In this example, the loss of 5¢ a pound on the future transaction resulted in a total loss of the \$2,000 plus transaction costs.

### Spreads

While most speculative futures transactions involve a simple purchase of futures contracts to profit from an expected price increase—or an equally simple sale to profit from an expected price decrease—numerous other possible strategies exist. Spreads are one example.

A spread, at least in its simplest form, involves buying one futures contract and selling another futures contract. The purpose is to profit from an expected change in the relationship between the purchase price of one and the selling price of the other.

As an illustration, assume it's now November, that the March CBOT mini Wheat futures price is presently \$3.50 a bushel and the May CBOT mini Wheat futures price is presently \$3.55 a bushel, a difference of 5¢. Your analysis of market conditions indicates that, over the next few months, the price difference between the two contracts will widen to become greater than 5¢. To profit if you are right, you could sell the March futures contract (the lower priced contract) and buy the May futures contract (the higher priced contract).

Assume time and events prove you right and that, by February, the March futures price has risen to \$3.60 and May futures price is \$3.75, a difference of 15¢. By liquidating both contracts at this time, you can realize a net gain of 10¢ a bushel. Since each contract is 1,000 bushels, the total gain is \$100.



	Spread		
<b>November</b>	Sell March Mini Wheat @ 3.50 bu.	Buy March Mini Wheat @ 3.55 bu.	5¢
<b>February</b>	Buy March Mini Wheat @ 3.60 bu.	Sell March Mini Wheat @ 3.75 bu.	15¢
	<b>\$ .10 LOSS</b>	<b>\$ .20 GAIN</b>	
	Net gain = 10¢ per bushel Gain on 1,000 bushel contract = \$100		

Had the spread (the price difference) narrowed by 10¢ a bushel rather than widened by 10¢ a bushel, the transactions just illustrated would have resulted in a loss of \$100.

Because of the potential of one leg of the spread to hedge against price loss in the other leg and because gains and losses occur only as the result of a change in the price difference—rather than as a result of a change in the overall level of futures prices—spreads are often considered more conservative and less risky than having an outright long or short futures position. In general, this may be the case.

It should be recognized, though, that the loss from a spread can be as great as—or even greater than—that which might be incurred in having an outright futures position. An adverse widening or narrowing of the spread during a particular time period may exceed the change in the overall level of futures prices, and it is possible

to experience losses on both of the futures contracts involved (that is, on both legs of the spread).

Virtually unlimited numbers and types of spread possibilities exist, as do many other, even more complex futures trading strategies. These, however, are beyond the scope of an introductory booklet and should be considered only by someone who fully understands the risk/reward arithmetic involved.



### ***Stop Orders***

A stop order is an order placed with your broker to buy or sell a particular futures contract if and when the price reaches a specified level. Stop orders are often used by futures traders in an effort to limit the amount they might lose if the futures price moves against their position.

For example, were you to purchase a crude oil futures contract at \$61 a barrel and wished to limit your loss to \$1 a barrel, you might place a stop order to sell an offsetting contract if the price should fall to \$60 a barrel. If and when the market reaches whatever price you specify, a stop order becomes an order to execute the desired trade.

There can be no guarantee, however, that it will be possible under all market conditions to execute the order at the price specified. In an active, volatile market, the market price may be declining (or rising) so rapidly that there is no opportunity to liquidate your position at the stop price you have designated. It is important to understand each exchange's rules and regulations as to the type of orders permitted and the nuances of each.

In the event that prices have risen or fallen in a market that utilizes a maximum daily limit, and there is presently no trading in the contract (known as a "lock limit" market), it may not

be possible to execute your order at *any* price. In addition, although it happens infrequently, it is possible that markets may be lock limit for more than one day, resulting in substantial losses to futures traders who may find it impossible to liquidate losing futures positions.

Subject to the kinds of limitations just discussed, stop orders can nonetheless provide a useful tool for the futures trader who seeks to limit his losses.

In addition to providing a way to limit losses, stop orders can also be employed to protect profits.

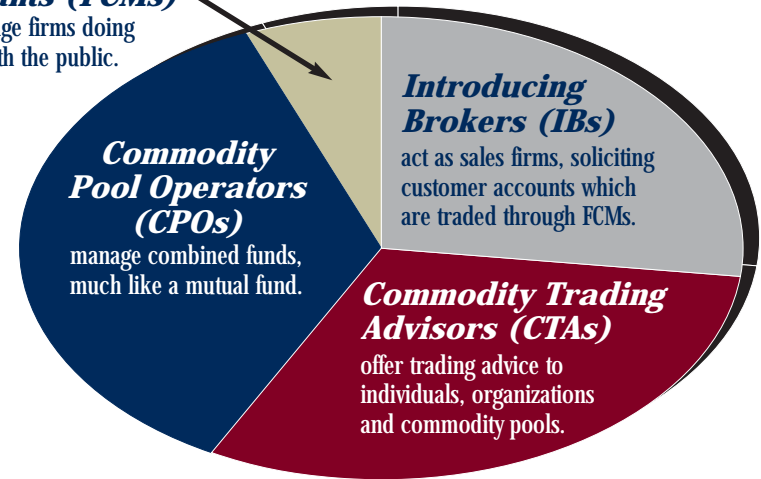
For instance, if you have bought crude oil futures at \$61 a barrel and the price is now at \$64 a barrel, you might wish to place a stop order to sell if and when the price declines to \$63. This (again subject to the described limitations of stop orders) could protect \$2 of your existing \$3 profit while still allowing your position to benefit from any continued increase in price.

# How to Participate in Futures Trading

Now that you have an overview of what futures markets are, why they exist and how they work, the next step is to consider various ways in which you may be able to participate in futures trading. There are a number of alternatives and the only best alternative—if you decide to participate at all—is whichever one is best for you. In addition to describing several possibilities, the pages that follow suggest questions you should ask and information you should obtain before making a decision.

Choosing a method of participating in the futures markets is largely a matter of deciding how directly and extensively you, personally, want to be involved in making trading decisions and managing your account. Many futures traders prefer to do their own research and analysis and make their own decisions about what and when to buy and sell. That is, they manage their own futures trades in much the same way they would manage their own stock portfolios. Others choose to rely on or at least consider the recommendations of a brokerage firm or account executive. Some purchase independent trading advice. Others would rather have someone else be responsible for trading their account and therefore give trading authority to their broker or a trading advisor. Still others purchase an interest in a commodity trading pool.

**Futures Commission Merchants (FCMs)**  
are brokerage firms doing business with the public.



## Categories of NFA Members

There's no formula for deciding. Your decision should, however, take into account such things as your knowledge of and any previous experience in futures trading, how much time and attention you are able to devote to trading, the amount of capital you can afford to commit to futures, and, perhaps most importantly, your individual temperament and tolerance for risk. Some individuals thrive on being directly involved in the fast pace of futures trading. Others are unable, reluctant, or lack the time to make the immediate decisions that are fre-

quently required. Some recognize and accept the fact that futures trading all but inevitably involves having some losing trades. Others lack the necessary disposition or discipline to acknowledge that they were wrong on this particular occasion and liquidate the position.

Many experienced traders suggest that, of all the things you need to know before trading in futures contracts, one of the most important is to know *yourself*. This can help you make the right decision about whether to participate at all and, if so, in what way.

It bears repeating, that you should never participate in futures trading unless the capital you would commit is risk capital. That is, capital you can afford to lose. It should be capital over and above that needed for necessities, emergencies, savings and achieving your long-term investment objectives. You should also understand that, because of the leverage involved in futures, the profit and loss fluctuations may be wider than in most types of investment activity and you may be required to cover deficiencies due to losses over and above what you had expected to commit to futures.

## ***Trade Your Own Account***

This involves opening your individual trading account and—with or without the recommendations of the brokerage firm—making your own trading decisions. You will also be responsible for assuring that adequate funds are on deposit with the brokerage firm for margin purposes, or that such funds are promptly provided as needed.

Practically all of the major brokerage firms you are familiar with, and many you may not be familiar with, have departments or even separate divisions to serve clients who want to allocate some portion of their investment capital to futures trading. All brokerage firms conducting



futures business with the public must be registered with the CFTC as Futures Commission Merchants (FCMs) or Introducing Brokers (IBs) and must be Members of NFA.

Different firms offer different services. Some, for example, have extensive research departments and can provide current information and analysis concerning market developments as well as specific trading suggestions. Others tailor their services to clients who prefer to make market judgments and arrive at trading decisions on their own. Still others offer various combinations of these and other services.

An individual trading account can be opened either directly with an FCM or through an IB. Whichever course you choose, the account itself will be carried by an FCM, as will your money. IBs do not accept or handle customer funds but most offer a variety of trading-related services. FCMs are required to maintain the funds and property of their customers in segregated accounts, separate from the firm's own money, if used for trading futures or options on futures on an exchange.

In addition to the particular services a firm provides, you should also discuss the commissions and trading costs that will be involved. And, as mentioned, clearly understand how the firm requires that any margin calls be met. ***Remember, you should always conduct a background check on the firm using NFA's BASIC system on NFA's Web site ([www.nfa.futures.org](http://www.nfa.futures.org)) or contact NFA's Information Center toll-free at 800-621-3570.***

## ***Have Someone Manage Your Account***

A managed account is also your individual account. The major difference is that you give someone else—an account manager—written power of attorney to make and execute decisions about what and when to trade. He or she will have discretionary authority to buy or sell for your account or will contact you for approval to make trades he or she suggests. You, of course, remain fully responsible for any losses which may be incurred and, as necessary, for meeting margin calls, including making up any deficiencies that exceed your margin deposits.

Although an account manager is likely to be managing the accounts of other persons at the same time, there is no sharing of gains or losses of other customers. Trading gains or losses in your account will result solely from trades which were made for your account.

Many FCMs and IBs accept managed accounts. In most instances, the amount of money needed to open a managed account is larger than the amount required to establish an account you intend to trade yourself. Different firms and account managers, however, have different requirements and the range can be quite wide. Be certain to read and understand all of the literature and agreements you receive from the broker.

Some account managers have their own trading approaches and accept only clients to whom that approach

is acceptable. Others tailor their trading to a client's objectives. In either case, obtain enough information and ask enough questions to assure yourself that your money will be managed in a way that's consistent with your goals.

**Discuss fees.** In addition to commissions on trades made for your account, it is not uncommon for account managers to charge a management fee, and/or there may be some arrangement for the manager to participate in the net profits that his management produces. These charges are required to be fully disclosed in advance. Make sure you know about every charge to be made to your account and what each charge is for.



Finally, take note of whether the account management agreement includes a provision to automatically liquidate positions and close out the account if and when losses exceed a certain amount. And, of course, you should know and agree on what will be done with profits, and what, if any, restrictions apply to withdrawals from the account.

## ***Use a Commodity Trading Advisor***

As the term implies, a Commodity Trading Advisor (CTA) is an individual (or firm) that, for a fee, provides advice on commodity trading, including specific trading recommendations such as when to establish a particular long or short position and when to liquidate that position. Generally, to help you choose trading strategies that match your trading objectives, advisors offer analysis and judgments as to the prospective rewards and risks of the trades they suggest. Trading recommendations may be communicated by phone, electronically via the

Internet or through the mail. Some provide a frequently updated hot-line or Web site you can access for current information and trading advice.

Even though you may trade on the basis of an advisor's recommendations, you will need to open your own account with, and send your margin payments directly to, an FCM. CTAs cannot accept or handle their customers' funds unless they are also registered as FCMs.

Some CTAs offer managed accounts, with the advisor designated in writing to make and execute trading decisions on a discretionary basis. The account itself, however, must still be with an FCM and in your name.

**CFTC Regulations require that CTAs provide their customers, in advance, with what is called a Disclosure Document. Read it carefully and ask the CTA to explain any points you don't understand. If your money is important to you, so is the information contained in the Disclosure Document!**

The prospectus-like document contains information about the advisor, his experience and his current (and any previous) performance records. If you use an advisor to manage your account, he must first obtain a signed acknowledgment from you that you have received and understood the Disclosure Document. As in any method of participating in futures trading, discuss and understand the advisor's fee arrangements. And if he will be managing your account, ask the

same questions you would ask of any account manager you are considering.

Most CTAs must be registered as such with the CFTC, and registered CTAs that accept authority to manage customer accounts must also be Members of NFA.

***You can verify whether an advisor is registered and an NFA Member by conducting a background check using NFA's BASIC system on NFA's Web site ([www.nfa.futures.org](http://www.nfa.futures.org)) or by calling NFA toll-free at 800-621-3570.***

## Participate in a Commodity Pool

Another alternative method of participating in futures trading is through a commodity pool, which is similar in concept to a common stock mutual fund. It is the only method of participation in which you will not have your own individual trading account. Instead, your money will be combined with that of other pool participants and, in effect, traded as a single account. You share in the profits or losses of the pool in proportion to your investment in the pool. One potential advantage is greater diversification of risks than you might obtain

if you were to establish your own trading account. Another is that your risk of loss is generally limited to your investment in the pool, because most pools are formed as limited partnerships. And you won't be subject to margin calls.

Bear in mind, however, that the risks which a pool incurs in any given futures transaction are no different than the risks

risks incurred by an individual trader. The pool still trades in futures contracts which are highly leveraged and in markets which can be highly volatile. And like an individual trader, the pool can suffer substantial losses. A major consideration, therefore, is who will be managing the pool in terms of directing its trading.

While a pool must execute all of its trades through a brokerage firm which is registered with the CFTC as an FCM, it may or may not have any other affiliation with the brokerage firm. Some brokerage firms, to serve those customers who prefer to participate in commodity trading through a pool, either operate or have a relationship with one or more commodity trading pools. Other pools operate independently.

In most instances, a Commodity Pool Operator (CPO) cannot accept your money until it has provided you

with a Disclosure Document that contains information about the pool operator, the pool's principals and any outside persons who will be providing trading advice or making trading decisions. It must also disclose the previous performance records, if any, of all persons who will be operating or advising the pool (or, if none, a statement to that effect). Disclosure Documents contain important information and should be carefully read before you invest your money. Another requirement is that the Disclosure Document advise you of the risks involved.

In the case of a new pool, there is frequently a provision that the pool will not begin trading until (and unless) a certain amount of money is raised. Normally, a time deadline is set and the CPO is required to state in the Disclosure Document what that deadline is (or, if there is none, that the time period for raising funds is indefinite). Be sure you understand the terms, including how your money will



be invested in the meantime, what interest you will earn (if any), and how and when your investment will be returned in the event the pool does not commence trading.

Determine whether you will be responsible for any losses in excess of your investment in the pool. If so, this must be indicated prominently at the beginning of the pool's Disclosure Document.

Ask about fees and other costs, including what, if any, initial charges will be made against your investment for organizational or administrative expenses. Such information should be noted in the Disclosure Document. You should also determine from the Disclosure Document how the pool's operator and advisor are compensated. Understand, too, the procedure for redeeming your shares in the pool, any restrictions that may exist, and provisions for liquidating and dissolving the pool if more than a certain percentage of the capital were to be lost.

Ask about the pool operator's general trading philosophy, what types of contracts will be traded, whether they will be day-traded, etc.

# *fees*      *costs* *restrictions* *disclosures*

***With a few exceptions, CPOs must be registered with the CFTC and be Members of NFA. You can verify that these requirements have been met by conducting a background search on NFA's BASIC system at NFA's Web site ([www.nfa.futures.org](http://www.nfa.futures.org)) or by contacting NFA toll-free at 800-621-3570.***



## ***Establishing an Account***

At the time you apply to establish a futures trading account, you can expect to be asked for certain information beyond simply your name, address and phone number. The requested information will generally include (but not necessarily be limited to) your income, net worth, what previous investment or futures trading experience you have had, and any other information needed in order to advise you of the risks involved in trading futures contracts. You will also be required to provide proof of identity to comply with federal law.



At a minimum, the person or firm who will handle your account is required to provide you with risk disclosure documents or statements specified by the CFTC and obtain written acknowledgment that you have received and understood them.

Opening a futures account is a serious decision and should obviously be approached as such.

Just as you wouldn't consider buying a car or a house without carefully reading and understanding the terms of the contract, neither should you establish a trading account without first reading and understanding the Account Agreement and all other documents supplied by your broker. It is in your interest and the firm's interest that you clearly

know your rights and obligations as well as the rights and obligations of the firm with which you are dealing before you enter into any futures transaction. If you have questions about exactly what any provisions of the Agreement mean, don't hesitate to ask. A good and continuing relationship can exist only if both parties have, from the outset, a clear understanding of the relationship.

Nor should you be hesitant to ask, in advance, what services you will be getting for the trading commissions the firm charges. As indicated earlier, not all firms offer identical services, and not all clients have identical needs. If it is important to you, for example, you might inquire about the firm's research capability and whatever reports it makes available to clients. Other subjects of inquiry could be how transaction and statement information will be provided, and how your orders will be handled and executed.

## ***If a Dispute Should Arise***

All but a small percentage of transactions involving regulated futures and options on futures contracts take place without problems or misunderstandings. However, in any business in which millions of contracts are traded each day, occasional disagreements are inevitable. Obviously, the best way to resolve a disagreement is through direct discussions by the parties involved. Failing this, however, participants in futures markets have several alternatives (unless some particular method has been agreed to in advance).

In many circumstances, it may be possible to seek resolution through the exchange where the futures contracts were traded or to file a claim for reparations with the CFTC. Unless you have signed a pre-dispute arbitration agreement, you can also file a claim in court. However, most investors choose to resolve the disagreement through the arbitration program conducted by National Futures Association.



The best way to resolve a disagreement is through direct discussions by the parties involved.

### *There are several advantages:*

- n It tends to be faster and less expensive than the other alternatives.
- n You have a choice of selecting industry or non-industry related arbitrators.
- n You do not necessarily have to know what the law is to successfully prove your claim.
- n In some cases, it may be possible to conduct arbitration entirely through written submissions.
- n If a hearing is required, it can generally be scheduled at a time and place convenient for both parties.
- n Unless you wish to do so, you do not have to employ an attorney.

For a plain language explanation of the arbitration program and how it works, write or phone NFA for a copy of *Arbitration: A Way to Resolve Futures-Related Disputes*. This free booklet is also available on NFA's Web site.

# ***Additional Resources***

Commodity Futures Trading  
Commission (CFTC)  
Three Lafayette Centre  
1155 21st Street, NW  
Washington, DC 20581  
(202) 418-5800  
[www.cftc.gov](http://www.cftc.gov)

CBOE Futures Exchange (CFE)  
400 S. LaSalle St.  
Chicago, IL 60605  
(312) 786-5600  
[www.cfe.cboe.com](http://www.cfe.cboe.com)

Chicago Board of Trade (CBOT)  
141 W. Jackson Blvd.  
Chicago, IL 60604  
(312) 435-3500  
[www.cbott.com](http://www.cbott.com)

Chicago Climate Futures Exchange (CCFE)  
400 S. LaSalle St.  
Chicago, IL 60605  
(312) 554-3350  
[www.chicagoclimatex.com](http://www.chicagoclimatex.com)

Chicago Mercantile Exchange (CME)  
30 S. Wacker Dr.  
Chicago, IL 60606  
(312) 930-1000  
[www.cme.com](http://www.cme.com)

HedgeStreet  
1825 S. Grant St., Suite 500  
San Mateo, Ca 94402  
[www.hedgestreet.com](http://www.hedgestreet.com)

Kansas City Board of Trade (KCBT)  
4800 Main St., Suite 303  
Kansas City, MO 64112  
(816) 753-7500  
[www.kcbt.com](http://www.kcbt.com)

Minneapolis Grain Exchange (MGE)  
400 S. Fourth St.  
Minneapolis, MN 55415  
(612) 321-7101  
[www.mgex.com](http://www.mgex.com)

New York Board of Trade (NYBOT)  
174 Hudson St.  
New York, NY 10013  
(718) 391-7000  
[www.nybot.com](http://www.nybot.com)

New York Mercantile Exchange (NYMEX)  
One North End Avenue  
World Financial Center  
New York, NY 10282-1101  
(212) 299-2000  
[www.nymex.com](http://www.nymex.com)

OneChicago  
141 W. Jackson Blvd., Suite 2240  
Chicago, IL 60604  
(312) 424-8500  
[www.onechicago.com](http://www.onechicago.com)

Philadelphia Board of Trade (PBOT)  
1900 Market St.  
Philadelphia, PA 19103  
(215) 496-5000  
[www.phlx.com/pbot](http://www.phlx.com/pbot)

U.S. Futures Exchange (Eurex US)  
233 S. Wacker Dr., Suite 2450  
Chicago, IL 60606  
(312) 544-1100  
[www.eurexus.com](http://www.eurexus.com)