

Out of business

Prop firm shuts down

Another sign the good old days are gone forever occurred in mid-October: WorldCo, a New York-based proprietary trading firm, closed its doors and filed for bankruptcy.

During the bull market, WorldCo was one of the leading prop firms in terms of number of traders and trading capital. However, a dwindling client base and declining revenues led to the shutdown.

WorldCo traders were required to put up a certain amount of money before trading. WorldCo made money by the commissions generated from the traders and also took a small percentage of the traders' profits.

During the market boom, when traders were making dozens of trades per day and riding the Nasdaq wave to huge profits, WorldCo's business model allowed it to thrive and flourish. But as trading volume fell off and fewer traders were able to make a profit, WorldCo was unable to keep up with its expenses. It's unclear how many traders were still at WorldCo when it closed down, although many of them have since moved over to other proprietary firms.

Many traders had money on account with WorldCo, and the firm's bankruptcy leaves the status of those funds in question. The company has said it will try to refund as much money to traders as possible, although its first obligation is to its creditors — landlords, data vendors, etc.

Industry impact

While the bankruptcy could be considered a "black eye" to proprietary trading, some involved in the industry think it could serve as a warning to traders.

"I would not be surprised if more firms went out of business," says Bob Bright, co-founder of Bright Trading, a Las Vegas-based prop firm with more than 40 branches nationwide. "A lot of

firms are undercapitalized and being led by people who aren't really traders."

Andrew Fishman, executive vice president of Schonfeld Securities, knows newcomers to the prop trading industry may worry that what happened to WorldCo could happen to other firms.

But, different proprietary firms have different agreements — in some instances, the prop firm puts up all the money and takes a significant portion of profits. In others, a firm requires an initial deposit and takes a monthly fee but returns a higher percentage of profits.

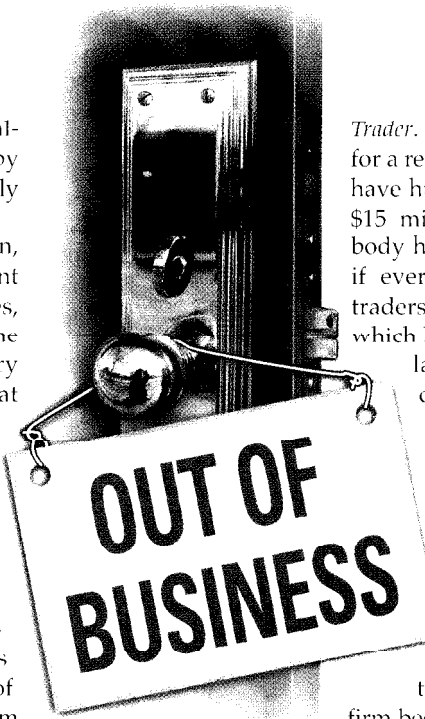
For instance, Schonfeld's Fishman says the firm paid its traders for profits they had earned years earlier — in some cases millions of dollars — even if a trader had current losses greater than what was earned, and even if the firm was losing money.

"Traders do not deposit any money with us, so they are not going to be putting any capital up," Fishman says.

What traders should know

While the deferred compensation used by Schonfeld may work because traders at Schonfeld are classified as employees, that's not always the case. In many instances, traders at a prop firm are members of a Limited Liability Company (LLC).

"In some cases, deferred compensation is a term that is bandied about but has no meaning," says Robert Green, an accountant who specializes in trader tax issues and a regular contributor to *Active*



Trader. "It is a disguise term for a reserve. Firms say they have huge capital — \$10 or \$15 million — and everybody has 10:1 leverage. But if everyone has 10:1, and traders are losing money, which has been the case the last few years, that capital has been stretched very thin.

"So while firms are telling traders to take deferred compensation because it's a good thing for taxes, they really are saying that they need the capital left in the firm because it is needed for other traders. In effect, it's like a pyramid scheme."

Green says if traders are being misinformed as to why their money is being withheld, they may be victims of fraud and could file a class-action suit against the firm. In any event, he thinks traders need to be more observant before they agree to any contract.

"You should take with a grain of salt what you hear from management," he says. "You should look for tell tale signs of financial weakness, ask these firms to declare what the true capital they are trading is and account for it without smoke and mirrors and blanket statements. Every prop trader needs to have a lawyer represent them and look at their agreements and put pressure on the prop firms to not have those agreements be so one-sided."

Signs of financial weakness would include an unusual amount of traders leaving the firm, the closing of branch offices and leverage suddenly being cut dramatically. Green says traders have a right to examine a firm's audited financial statement. **1**