Investor Bulletin:
Foreign Currency Exchange (Forex) Trading For Individual Investors

Individual investors who are considering participating in the foreign currency exchange (or "forex") market need to understand fully the market and its unique characteristics. Forex trading can be very risky and is not appropriate for all investors.

It is common in most forex trading strategies to employ leverage. Leverage entails using a relatively small amount of capital to buy currency worth many times the value of that capital. Leverage magnifies minor fluctuations in currency markets in order to increase potential gains and losses. By using leverage to trade forex, you risk losing all of your initial capital and may lose even more money than the amount of your initial capital. You should carefully consider your own financial situation, consult a financial adviser knowledgeable in forex trading, and investigate any firms offering to trade forex for you before making any investment decisions.

Background: Foreign Currency Exchange Rates, Quotes, and Pricing

A foreign currency exchange rate is a price that represents how much it costs to buy the currency of one country using the currency of another country. Currency traders buy and sell currencies through forex transactions based on how they expect currency exchange rates will fluctuate. When the value of one currency rises relative to another, traders will earn profits if they purchased the appreciating currency, or suffer losses if they sold the appreciating currency. As discussed below, there are also other factors that can reduce a trader's profits even if that trader "picked" the right currency.

Currencies are identified by three-letter abbreviations. For example, USD is the designation for the U.S. dollar, EUR is the designation for the Euro, GBP is the designation for the British pound, and JPY is the designation for the Japanese yen.

Forex transactions are quoted in pairs of currencies (*e.g.*, GBP/USD) because you are purchasing one currency with another currency. Sometimes purchases and sales are done relative to the U.S. dollar, similar to the way that many stocks and bonds are priced in U.S. dollars. For example, you might buy Euros using U.S. dollars. In other types of forex transactions, one foreign currency might be purchased using another foreign currency. An example of this would be to buy Euros using British pounds – that is, trading both the Euro and the pound in a single transaction. For investors whose local currency is the U.S. dollar (*i.e.*, investors who mostly hold assets denominated in U.S. dollars), the first example generally represents a single, positive bet on the Euro (an expectation that the Euro will rise in value), whereas the second example represents a positive bet on the Euro and a negative bet on the British pound (an expectation that the Euro will rise in value relative to the British pound).

There are different quoting conventions for exchange rates depending on the currency, the market, and sometimes even the system that is displaying the quote. For some investors, these differences can be a source of confusion and might even lead to placing unintended trades.

For example, it is often the case that the Euro exchange rates are quoted in terms of U.S. dollars. A quote for EUR of 1.4123 then means that 1,000 Euros can be bought for approximately 1,412 U.S. dollars. In contrast, Japanese yen are often quoted in terms of the number of yen that can be purchased with a single U.S. dollar. A quote for JPY of 79.1515 then means that 1,000 U.S. dollars can be bought for approximately 79,152 yen. In these examples, if you bought the Euro and the EUR quote increases from 1.4123 to 1.5123, you would be making money. But if you bought the yen and the JPY quote increases from 79.1515 to 89.1515, you would actually be losing money because, in this example, the yen would be depreciating relative to the U.S. dollar (*i.e.*, it would take more yen to buy a single U.S. dollar).

Before you attempt to trade currencies, you should have a firm understanding of currency quoting conventions, how forex transactions are priced, and the mathematical formulae required to convert one currency into another.

Currency exchange rates are usually quoted using a pair of prices representing a "bid" and an "ask." Similar to the manner in which stocks might be quoted, the "ask" is a price that represents how much you will need to spend in order to purchase a currency, and the "bid" is a price that represents the (lower) amount that you will receive if you sell the currency. The difference between the bid and ask prices is known as the "bid-ask spread," and it represents an inherent cost of trading – the wider the bid-ask spread, the more it costs to buy and sell a given currency, apart from any other commissions or transaction charges.

Generally speaking, there are three ways to trade foreign currency exchange rates:

1. On an exchange that is regulated by the Commodity Futures Trading Commission (CFTC). An example of such an exchange is the Chicago Mercantile Exchange, which offers currency futures and options on currency futures products. Exchange-traded currency futures and options provide traders with contracts of a set unit size, a fixed expiration date, and centralized clearing. In centralized clearing, a clearing corporation acts as single counterparty to every transaction and guarantees the completion and credit worthiness of all transactions.

2. On an exchange that is regulated by the Securities and Exchange Commission (SEC). An example of such an exchange is the NASDAQ OMX PHLX (formerly the Philadelphia Stock Exchange), which offers options on currencies (*i.e.*, the right but not the obligation to buy or sell a currency at a specific rate within a specified time). Exchange-traded options on currencies also provide investors with contracts of a set unit size, a fixed expiration date, and centralized clearing.

3. In the off-exchange market. In the off-exchange market (sometimes called the over-the-counter, or OTC, market), an individual investor trades directly with a counterparty, such as a forex broker or dealer; there is no exchange or central clearinghouse. Instead, the trading generally is conducted by telephone or through electronic communications networks (ECNs). In this case, the investor relies entirely on the counterparty to receive funds or to be able to trade out of a position.

Risks of Forex Trading

The forex market is a large, global, and generally liquid financial market. Banks, insurance companies, and other financial institutions, as well as large corporations, use the forex markets to manage the risks associated with fluctuations in currency rates.

The risk of loss for individual investors who trade forex contracts can be substantial. The only funds that you should put at risk when speculating in foreign currency are those funds that you can afford to lose entirely, and you should always be aware that certain strategies may result in your losing even more money than the amount of your initial investment. Some of the key risks involved include:

- Quoting Conventions Are Not Uniform. While many currencies are typically quoted against the U.S. dollar (that is, one dollar purchases a specified amount of a foreign currency), there are no required uniform quoting conventions in the forex market. Both the Euro and the British pound, for example, may be quoted in the reverse, meaning that one British pound purchases a specified amount of U.S. dollars (GBP/USD) and one Euro purchases a specified amount of U.S. dollars (EUR/USD). Therefore, you need to pay special attention to a currency's quoting convention and what an increase or decrease in a quote may mean for your trades.
- Transaction Costs May Not Be Clear. Before deciding to invest in the forex market, check with several different firms and compare their charges as well as their services. There are very limited rules addressing how a dealer charges an investor for the forex services the dealer provides or how much the dealer can charge. Some dealers charge a per-trade commission, while others charge a mark-up by widening the spread between the bid and ask prices that they quote to investors. When a dealer advertises a transaction as "commission-free," you should not assume that the transaction will be executed without cost to you. Instead, the dealer's commission may be built into a wider bid-ask spread, and it may not be clear how much of the spread is the dealer's mark-up. In addition, some dealers may charge both a commission and a mark-up. They may also charge a different mark-up for buying a currency than selling it. Read your agreement with the dealer carefully and make sure you understand how the dealer will charge you for your trades.
- Transaction Costs Can Turn Profitable Trades into Losing Transactions. For certain currencies and currency pairs, transaction costs can be relatively large. If you are frequently trading in and out of a currency, these costs can in some circumstances turn what might have been profitable trades into losing transactions.
- You Could Lose Your Entire Investment or More. You will be required to deposit an amount of money (usually called a "security deposit" or "margin") with a forex dealer in order to purchase or sell an off-exchange forex contract. A small sum may allow you to hold a forex contract worth many times the value of the initial deposit. This use of margin is the basis of "leverage" because an investor can use the deposit as a "lever" to support a much larger forex contract. Because currency price movements can be small, many forex traders employ leverage as a means of amplifying their returns. The smaller the deposit is in relation to the underlying value of the contract, the greater the leverage will be. If the price moves in an unfavorable direction, then high leverage can produce large losses in relation to your initial deposit. With leverage, even a small move against your position could wipe out your entire investment. You may also be liable for additional losses beyond your initial deposit, depending on your agreement with the dealer.
- Trading Systems May Not Operate as Intended. Though it is possible to buy and hold a currency if you believe in its long-term appreciation, many trading strategies capitalize on small, rapid moves in the currency markets. For these strategies, it is common to use automated trading systems that provide buy and sell signals, or even automatic execution, across a wide range of currencies. The use of any such system requires specialized knowledge and comes with its own risks, including a misunderstanding of the system parameters, incorrect data that can lead to unintended trades, and the ability to trade at speeds

greater than what can be monitored manually and checked.

- Fraud. Beware of get-rich-quick investment schemes that promise significant returns with minimal risk through forex trading. The SEC and CFTC have brought actions alleging fraud in cases involving forex investment programs. Contact the appropriate federal regulator to check the membership status of particular firms and individuals.

Special Risks of Off-Exchange Forex Trading

As described above, forex trading in general presents significant risks to individual investors that require careful consideration. Off-exchange forex trading poses additional risks, including:

- There Is No Central Marketplace. Unlike the regulated futures and options exchanges, there is no central marketplace in the retail off-exchange forex market. Instead, individual investors commonly access the forex market through individual financial institutions – or dealers – known as "market makers." Market makers take the opposite side of any transaction; for example, they may be buying and selling the same foreign currency at the same time. In these cases, market makers are acting as principals for their own account and, as a result, may not provide the best price available in the market. Because individual investors often do not have access to pricing information, it can be difficult for them to determine whether an offered price is fair.
- There Is No Central Clearing. When trading futures and options on regulated exchanges, a clearing organization can act as a central counterparty to all transactions in a way that may afford you some protection in the event of a default by your counterparty. This protection is not available in the off-exchange forex market, where there is no central clearing.

Regulation of Off-Exchange Forex Trading

The Commodity Exchange Act permits persons regulated by a federal regulatory agency to engage in off-exchange forex transactions with individual investors only pursuant to rules of that federal regulatory agency. Keep in mind that there may be different requirements or treatment for forex transactions depending on which rules and regulations might apply in different circumstances (for example, with respect to bankruptcy protection or leverage limitations).

You should also be aware that, for brokers and dealers, many of the rules and regulations that apply to securities transactions may not apply to forex transactions. The SEC is actively interested in business practices in this area and is currently studying whether additional rules and regulations would be appropriate.

Related Information

National Futures Association Investor Information on Forex Trading

CFTC/NASAA Investor Alert on Foreign Exchange Currency Fraud

Press Release: SEC Charges Forex Ponzi Operator Who Fled After Scheme Unraveled