NFA

NATIONAL FUTURES ASSOCIATION®

What Investors Need to Know

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 booklet as part of its continuing public education efforts to provide information to potential investors. The booklet presents an overview of the retail off-exchange foreign currency market and provides other important information that investors need to know before they invest in the off-exchange foreign currency market.

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Introduction

Retail participation in off-exchange foreign currency (forex) markets has increased dramatically in the past few years. If you are a retail investor considering participating in this market, you need to fully understand the market and some of its unique features.

Like many other investments, off-exchange foreign currency trading carries a high level of risk and may not be suitable for all investors. In fact, you could lose all of your initial investment and may be liable for additional losses. Therefore, you need to understand the risks associated with this product.

You should also understand the language of the forex markets before trading in those markets. The glossary in the back of this booklet defines some of the most commonly used terms.

This booklet does not suggest that you should or should not participate in the retail off-exchange foreign currency market. You should make that decision after consulting with your financial advisor and considering your own financial situation and objectives. In that regard, you may find this booklet helpful as one component of the due diligence process that investors are encouraged to undertake before making any investment decisions about the off-exchange foreign currency market.

Finally, the discussion in this booklet assumes you are funding your forex account with US dollars. The principles in this booklet apply to all currencies, however.

The Foreign Currency Markets

What are foreign currency exchange rates?

Foreign currency exchange rates are what it costs to exchange one country's currency for another country's currency. For example, if you go to England on vacation, you will have to pay for your hotel, meals, admissions fees, souvenirs, and other expenses in British pounds. Since your money is all in US dollars, you will have to use (sell) some of your dollars to buy British pounds.

Assume you go to your bank before you leave and buy $1,000 worth of British pounds. If you get 565.83 British pounds (£565.83) for your $1,000, each dollar is worth .56583 British pounds. This is the exchange rate for converting dollars to pounds.

If £565.83 isn't enough cash for your trip, you will have to exchange more US dollars for pounds while in England. Assume you buy another $1,000 worth of British pounds from a bank in England and get only £557.02 for your $1,000. The exchange rate for converting dollars to pounds has dropped from .56583 to .55702. This means that US dollars are worth less compared to the British pound than they were before you left on vacation.

Assume that you have £100 left when you return home. You go to your bank and use the pounds to buy US dollars. If the bank gives you $179.31, each British pound is worth 1.7931 dollars. This is the exchange rate for converting pounds to dollars.

Theoretically, you can convert the exchange rate for buying a currency to the exchange rate for selling a currency, and vice versa, by dividing 1 by the known rate. For example, if the exchange rate for buying British pounds with US dollars is .56011, the exchange rate for buying US dollars with British pounds is 1.78536 (1 ÷ .56011 = 1.78536).

Similarly, if the exchange rate for buying US dollars with British pounds is 1.78536, the exchange rate for buying British pounds with US dollars is .56011 (1 ÷ 1.78536 = .56011). This is how newspapers often report currency exchange rates.

As a practical matter, however, you will not be able to buy and sell the currency at the same price, and you will not receive the price quoted in the newspaper. This is because banks and other market participants make money by selling the currency to customers for more than they paid to buy it and by buying the currency from customers for less than they will receive when they sell it. The difference is called a spread and is discussed later in this booklet.

How can I trade foreign currency exchange rates?

As you can see from the London vacation example, currency exchange rates fluctuate. As the value of one currency rises or falls relative to another, traders decide to buy or sell currencies to make profits. Retail customers also participate in the forex market, generally as speculators who are hoping to profit from changes in currency rates.

Foreign currency exchange rates may be traded in one of three ways:

1 On an exchange that is regulated by the Commodity Futures Trading Commission (CFTC). For example, the Chicago Mercantile Exchange offers currency futures and options on futures products. Exchange-traded currency futures and options provide their users with a liquid, secondary market for contracts with a set unit size, a fixed expiration date and centralized clearing.

2 On an exchange that is regulated by the Securities and Exchange Commission (SEC). For example, the Philadelphia Stock Exchange 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 have characteristics similar to exchange-traded futures and options (e.g., a liquid, secondary market with a set size, a fixed expiration date and centralized clearing).

3 In the off-exchange, also called the over-the-counter (OTC) market. A retail customer trades directly with a counterparty and there is no exchange or central clearinghouse to support the transaction.

This brochure focuses on the off-exchange foreign currency market.

How does the off-exchange currency market work?

The off-exchange forex market is a large, growing and liquid financial market that operates 24 hours a day, 5 days a week. It is not a market in the traditional sense because there is no central trading location or "exchange." Most of the trading is conducted by telephone or through electronic trading networks.

The primary market for currencies is the "interbank market" where banks, insurance companies, large corporations and other large financial institutions manage the risks associated with fluctuations in currency rates. The true interbank market is only available to institutions that trade in large quantities and have a very high net worth.

In recent years, a secondary OTC market has developed that permits retail investors to participate in forex transactions. While this secondary market does not provide the same prices as the interbank market, it does have many of the same characteristics.

How are foreign currencies quoted and priced?

Currencies are designated by three letter symbols. The standard symbols for some of the most commonly traded currencies are:

EUR – Euros
USD – United States dollar
CAD – Canadian dollar
GBP – British pound
JPY – Japanese yen
AUD – Australian dollar
CHF – Swiss franc

Forex transactions are quoted in pairs because you are buying one currency while selling another. The first currency is the base currency and the second currency is the quote currency. The price, or rate, that is quoted is the amount of the second currency required to purchase one

unit of the first currency. For example, if EUR/USD has an ask price of 1.2178, you can buy one Euro for 1.2178 US dollars.

Currency pairs are often quoted as bid-ask spreads. The first part of the quote is the amount of the quote currency you will receive in exchange for one unit of the base currency (the bid price) and the second part of the quote is the amount of the quote currency you must spend for one unit of the base currency (the ask or offer price). In other words, a EUR/USD spread of 1.2170/1.2178 means that you can sell one Euro for $1.2170 and buy one Euro for $1.2178.

A dealer may not quote the full exchange rate for both sides of the spread. For example, the EUR/USD spread discussed above could be quoted as 1.2170/78. The customer should understand that the first three numbers are the same for both sides of the spread.

What transaction costs will I pay?

Although dealers who are regulated by NFA must disclose their charges to retail customers, there are no rules about how a dealer charges a customer for the services the dealer provides or that limit how much the dealer can charge. Before opening an account, you should check with several dealers and compare their charges as well as their services. If you were solicited by or place your trades through someone other than the dealer, or if your account is managed by someone, you may be charged a separate amount for the third party's services.

Some firms charge a per trade commission, while other firms charge a mark-up by widening the spread between the bid and ask prices they give their customers. In the earlier example, assume that the dealer can get a EUR/USD spread of 1.2173/75 from a bank. If the dealer widens the spread to 1.2170/78 for its customers, the dealer has marked up the spread by .0003 on each side.

Some firms may charge both a commission and a mark-up. Firms may also charge a different mark-up for buying the base currency than for selling it. You should read your agreement with the dealer carefully and be sure you understand how the firm will charge you for your trades.

How do I close out a trade?

Retail forex transactions are normally closed out by entering into an equal but opposite transaction with the dealer. For example, if you bought Euros with U.S. dollars you would close out the trade by selling Euros for U.S. dollars. This is also called an offsetting or liquidating transaction.

Most retail forex transactions have a settlement date when the currencies are due to be delivered. If you want to keep your position open beyond the settlement date, you must roll the position over to the next settlement date. Some dealers roll open positions over automatically, while other dealers may require you to request the rollover. On most open positions, interest is earned on the long currency and paid on the short currency every time the position is rolled over. The interest that is earned or paid is usually the target interest rate set by the central bank of the country that issued the currency. If the interest rates of the two countries are different, then there is usually an interest rate differential which will result in a net earning or payment of interest. This net interest is often called the rollover rate. It is calculated and either added or deducted from the trader's account at the rollover time of each trading day that the position is open. You should check your agreement with the dealer to see what, if anything, you must do to roll a position over and what fees you will pay for the rollover.

How do I calculate profits and losses?

When you close out a trade, you can calculate your profits and losses using the following formula:

Price (exchange rate) when selling the base currency - **Price when buying the base currency X transaction size** = **Profit or loss**

Assume you buy Euros (EUR/USD) at 1.2178 and sell Euros at 1.2188. If the transaction size is 100,000 Euros, you will have a $100 profit.

($1.2188 – $1.2178) X 100,000 = $.001 X 100,000 = $100

Similarly, if you sell Euros (EUR/USD) at 1.2170 and buy Euros at 1.2180, you will have a $100 loss.

($1.2170 – $1.2180) X 100,000 = – $.001 X 100,000 = – $100

You can also calculate your unrealized profits and losses on open positions. Just substitute the current bid or ask rate for the action you will take when closing out the position. For example, if you bought Euros at 1.2178 and the current bid rate is 1.2173, you have an unrealized loss of $50.

($1.2173 – $1.2178) X 100,000 = – $.0005 X 100,000 = – $50

Similarly, if you sold Euros at 1.2170 and the current ask rate is 1.2165, you have an unrealized profit of $50.

($1.2170 – $1.2165) X 100,000 = $.0005 X 100,000 = $50

If the quote currency is not in US dollars, you will have to convert the profit or loss to US dollars at the dealer's rate. Further, if the dealer charges commissions or other fees, you must subtract those commissions and fees from your profits and add them to your losses to determine your true profits and losses.

How much money do I need to trade forex?

Forex dealers can set their own minimum account sizes, so you will have to ask the dealer how much money you must put up to begin trading. Most dealers will also require you to have a certain amount of money in your account for each transaction. This security deposit, sometimes called margin, is a percentage of the transaction value and may be different for different currencies. A security deposit acts as a performance bond and is not a down payment or partial payment for the transaction.

Dealers who are regulated by the CFTC and NFA are required to calculate and collect security deposits that equal or exceed the percentage set by their rules. Although the percentage of the security deposit remains constant, the dollar amount of the security deposit will change with changes in the value of the currency being traded.

The formula for calculating the security deposit is: :

Current price of base currency X transaction size X **Security deposit %** = **Security deposit requirement given in quote currency**

Returning to our Euro example with an initial price of $1.2178 for each Euro and a transaction size of 100,000 Euros, a 2% security deposit would be $2,435.60.

$1.2178 X 100,000 X .02 = $2,435.60

Security deposits allow customers to control transactions with a value many times larger than the funds in their accounts. In this example, $2,435.60 would control $121,780 worth of Euros..

Value of Euros = $1.2178 X 100,000= $121,780

This ability to control a large amount of one currency, in this case the Euro, using a very small percentage of its value is called leverage or gearing. In our example, the leverage is 50:1 because the security deposit controls Euros worth 50 times the amount of the deposit.

The higher the leverage, the more likely you are to lose your entire investment if exchange rates go down when you expect them to go up (or go up when you expect them to go down). Leverage of 50:1 means that you will lose your initial investment when the currency loses (or gains) 2% of its value, and you will lose more than your initial investment if the currency loses (or gains) more than 2% of its value. If you want to keep the position open, you may have to deposit additional funds to maintain a 2% security deposit.

Dealers may not guarantee that you will not lose more than you invest, which includes both the initial deposit and any subsequent deposits to keep the position open. Dealers may charge you for losses that are greater than the amount you invested.

The Risks of Trading in the Forex Market

Although every investment involves some risk, the risk of loss in trading off-exchange forex contracts can be substantial. Therefore, if you are considering participating in this market, you should understand some of the risks associated with this product so you can make an informed decision before investing.

As stated in the introduction to this booklet, off-exchange foreign currency trading carries a high level of risk and may not be suitable for all customers. The only funds that should ever be used to speculate in foreign currency trading, or any type of highly speculative investment, are funds that represent risk capital – i.e., funds you can afford to lose without affecting your financial situation. There are other reasons why forex trading may or may not be an appropriate investment for you, and they are highlighted in the following pages:

THE MARKET COULD MOVE AGAINST YOU. No one can predict with certainty which way exchange rates will go, and the forex market is volatile. Fluctuations in the foreign exchange rate between the time you place the trade and the time you close it out will affect the price of your forex contract and the potential profit and losses relating to it.

YOU COULD LOSE YOUR ENTIRE INVESTMENT. You will be required to deposit an amount of money (often referred to as a “security deposit” or "margin") with your forex dealer in order to buy or sell an off-exchange forex contract. As discussed earlier, a relatively small amount of money can enable you to hold a forex position worth many times the account value. This is referred to as leverage or gearing. The smaller the deposit in relation to the underlying value of the contract, the greater the leverage.

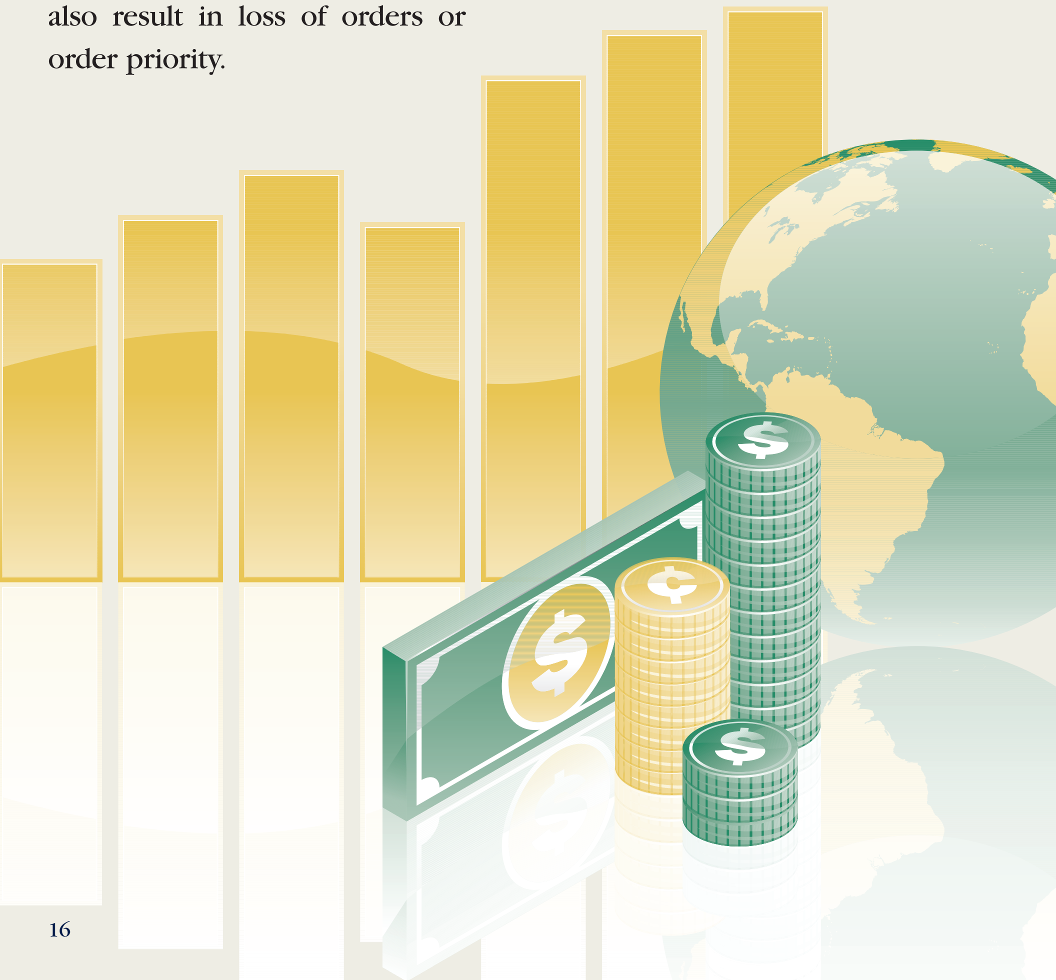
If the price moves in an unfavorable direction, high leverage can produce large losses in relation to your initial deposit. In fact, even a small move against your position may result in a large loss, including the loss of your entire deposit. Depending on your agreement with your dealer, you may also be required to pay additional losses.

YOU ARE RELYING ON THE DEALER'S CREDITWORTHINESS AND REPUTATION. Your dealer's trades are not guaranteed by a clearing organization. Furthermore, your dealer may commingle your funds with its own operating funds or use them for other purposes. In the event your dealer declares bankruptcy, any funds the dealer is holding for you in addition to any amounts owed to you resulting from trading, whether or not any assets are maintained in separate deposit accounts by the dealer, may be treated as an unsecured creditor's claim.

THERE IS NO CENTRAL MARKETPLACE. Unlike regulated futures exchanges, in the retail off-exchange forex market there is no central marketplace with many buyers and sellers. The forex dealer determines the execution price, so you are relying on the dealer's integrity for a fair price.

THE TRADING SYSTEM COULD BREAK DOWN. If you are using an Internet-based or other electronic system to place trades, some part of the system could fail. In the event of a system failure, it is possible that, for a certain time period, you may not be able to enter new orders, execute existing orders, or modify or cancel orders that were previously entered. A system failure may also result in loss of orders or order priority.

YOU COULD BE A VICTIM OF FRAUD. As with any investment, you should protect yourself from fraud. Beware of investment schemes that promise significant returns with little risk. You should take a close and cautious look at the investment offer itself and continue to monitor any investment you do make.



Other Issues to Consider

In addition to understanding how the off-exchange forex market works and some of the risks associated with this product, there are other unique features about the market that you need to understand before you decide whether to invest in this market and which dealer to use.

Who regulates off-exchange foreign currency trading?

The Commodity Futures Trading Commission (CFTC) has regulatory authority over retail off-exchange forex markets. The Commodity Exchange Act (CEA) allows the sale of OTC forex futures and options to retail customers if, and only if, the counterparty (the person on the other side of the transaction) is a regulated entity. These regulated entities include the following:

- **Financial institutions, such as banks and savings associations,**
- **SEC-registered broker-dealers and certain of their affiliates,**
- **CFTC-registered futures commission merchants (FCMs) and certain of their affiliates,**
- **CFTC-Registered Retail Foreign Exchange Dealers**
- **Financial holding companies,**
- **insurance companies,** *and*
- **investment bank holding companies.**

In addition, except for the regulated entities noted above, any entity or individual soliciting retail forex orders, managing retail forex accounts or operating a retail forex pool must register with the CFTC as an Introducing Broker, Commodity Trading Advisor or Commodity Pool Operator or as an associated person of one of these entities. These entities and individuals must also become Members of National Futures Association.

NFA has rules to protect customers in the retail off-exchange forex market. For example, NFA's rules require Forex Dealer Members to:

- **observe high standards of commercial honor and just and equitable principles of trade in connection with the retail forex business;**
- **supervise their employees and agents and any affiliates that act as counterparties to retail forex transactions;**
- **maintain a minimum net capital requirement; and**
- **collect security deposits from customers.**

In addition, all CFTC-registered forex firms and individuals are subject to NFA rules covering every aspect of their business, including recordkeeping, promotional material and sales practices.

How can I learn more about the firms and individuals with whom I am trading?

You can verify CFTC registration and NFA membership status of a particular firm or individual and check their disciplinary history by phoning NFA at **800-621-3570** or **(312) 781-1410**. You can also visit the broker/firm information section (BASIC) of NFA's website at **www.nfa.futures.org/basicnet/**. You may also contact the other organizations listed at the end of this booklet in the Additional Resources section.

What are my rights and obligations?

Your relationship with your dealer is governed by your forex account agreement. Just as you wouldn't consider buying a house or a car without carefully reading and understanding the terms of the contract, neither should you establish a forex account without first reading and understanding the account agreement and all other documents supplied by your dealer.

You should know your rights, responsibilities, and the firm's obligations before you enter into any forex transaction. If you have questions about the agreement, don't hesitate to ask.

What should I do if I have a problem with my forex account?

Disagreements are bound to occur from time to time in any industry. Your first step should be to contact the firm you have a disagreement with and try to reach a settlement. Both the CFTC and NFA offer programs that may be available for resolving monetary disputes involving your forex account. Whether NFA or the CFTC can accept your case depends on several factors, however, including the party your claim is against.

NFA offers an arbitration program to help customers and NFA Members resolve disputes. Information about NFA's arbitration program is available by calling NFA at 800-621-3570 or visiting the Dispute Resolution section of its website at www.nfa.futures.org.

The CFTC offers a reparation program for resolving disputes. If you want information about filing a CFTC reparations complaint, contact the CFTC's Office of Proceedings at 202-418-5250 or visit the CFTC's website at www.cftc.gov.

In addition, if you suspect any wrongdoing or improper business conduct in your forex account, you may contact or file a complaint with NFA by telephone at **800-621-3570** or **(312) 781-1410** or online at **www.nfa.futures.org/basicnet/Complaint.aspx**.

You may also file a complaint with the CFTC. The CFTC has prepared a questionnaire form to assist the public in reporting suspicious activities or transactions. The questionnaire form is available on the CFTC's website at http://www.cftc.gov/enf/enfform.htm. You can transmit the form to the CFTC electronically or by mail to CFTC, 1155 21st Street, N.W., Washington, D.C. 20581.

Conclusion

This booklet cannot tell you whether or not you should participate in the retail off-exchange foreign currency market. You should make that decision after consulting with your financial advisor and considering your own financial situation and objectives. However, we hope that this booklet is helpful in raising some of the issues that you need to consider in order to make a fully informed investment decision.

Glossary of Terms

Ask – The quoted price at which a customer can buy a currency pair. Also referred to as the 'offer,' 'ask price,' or 'ask rate.'

Base Currency – For foreign exchange trading, currencies are quoted in terms of a currency pair. The first currency in the pair is the base currency. For example, in a USD/JPY currency pair, the US dollar is the base currency. Also may be referred to as the primary currency.

Bid – The quoted price where a customer can sell a currency pair. Also known as the 'bid price' or 'bid rate.'

Bid/Ask Spread – The point difference between the bid and ask (offer) price.

Counterparty – The counterparty is the person who is on the other side of an OTC trade. For retail customers, the dealer will always be the counterparty.

Cross-rate – The exchange rate between two currencies where neither of the currencies are the US dollar.

Currency pair – The two currencies that make up a foreign exchange rate. For example, USD/YEN is a currency pair.

Dealer – A firm in the business of acting as a counterparty to foreign currency transactions.

Euro – The common currency adopted by eleven European nations (i.e., Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain) on January 1, 1999.

Forward transaction – A true forward transaction is an agreement that expects actual delivery of and full payment for the currency to occur on a future date. This term may also be used to refer to transactions that the parties expect to offset at some time in the future, but these transactions are not true forward transactions and are governed by the federal Commodity Exchange Act.

Interbank market – A loose network of currency transactions negotiated between financial institutions and other large companies.

Leverage – The ability to control large dollar amount of a commodity with a comparatively small amount of capital. Also known as 'gearing.'

Margin – See **Security Deposit**.

Offer – See **Ask**.

Open position – Any transaction that has not been closed out by a corresponding opposite transaction.

Glossary of Terms (con'd)

Pip – The smallest unit of trading in a foreign currency price.

Quote Currency – The second currency in a currency pair is referred to as the quote currency. For example, in a USD/JPY currency pair, the Japanese yen is the quote currency. Also referred to as the secondary currency or the counter currency.

Rollover – The process of extending the settlement date on an open position by rolling it over to the next settlement date.

Retail customer – Any party to a forex trade who is not an eligible contract participant as defined under the Commodity Exchange Act. This includes individuals with assets of less than $10 million and most small businesses.

Security deposit – The amount of money needed to open or maintain a position. Also known as 'margin.'

Settlement – The actual delivery of currencies made on the maturity date of a trade.

Spot market – A market of immediate delivery of and payment for the product, in this case, currency.

Spot transaction – A true spot transaction is a transaction requiring prompt delivery of and full payment for the currency. In the interbank market, spot transactions are usually settled in two business days. This term may also be used to refer to transactions that the parties expect to offset or roll over within two business days, but these transactions are not true spot transactions and are governed by the federal Commodity Exchange Act.

Spread – The point or pip difference between the ask and bid price of a currency pair.

Sterling – Another term for British currency, the pound.

NFA INFORMATION AND RESOURCES

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Information Center
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World Wide Web
www.nfa.futures.org

NFA's website offers information regarding the Association's history and organizational structure. The investing public can download publications to help them understand the commodity futures industry as well as their rights and responsibilities as market participants. All visitors to NFA's website can ask questions, make comments and order publications via e-mail.

BASIC
www.nfa.futures.org/basic/about.asp

Anyone with access to the Internet is able to perform online background checks on the firms and individuals involved in the futures industry by using NFA's Background Affiliation Status Information Center (BASIC). NFA, the CFTC and the US futures exchanges have supplied BASIC with information on CFTC registration, NFA membership, disciplinary history and non-disciplinary activities, such as CFTC reparations and NFA arbitration cases.

For further information, you should also consult the following resources:

Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, NW
Washington, DC 20581
202.418.5080
www.cftc.gov

Other regulatory bodies and authorities:

- **US Securities and Exchange Commission (www.sec.gov)**
- **Financial Industry Regulatory Authority (www.finra.org)**
- **Your state's securities commissioner (www.nasaa.org)**

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