

The principal risks of holders and writers of foreign currency options are discussed in Chapter X. Readers interested in buying or writing foreign currency options should not only read this chapter but should also carefully read Chapter X, particularly the discussions under the headings "Risks of Option Holders," "Risks of Option Buyers," "Other Risks," and "Special Risks of Foreign Currency Options."

## **MARKET FOR FOREIGN CURRENCIES**

Understanding the risks inherent in foreign currency options requires familiarity with the characteristics of the markets for the underlying currencies. Readers will find extensive literature on the subject, and this chapter can do no more than briefly summarize the most fundamental characteristics of those markets as they pertain to foreign currency options.

Foreign exchange rates can be free floating or may be subject to a variety of formal or informal governmental exchange rate control mechanisms. Exchange rates of most Western nations are permitted to fluctuate in value relative to the U.S. dollar and to each other. It must be kept in mind, however, that sovereign governments rarely voluntarily allow their currencies to float freely in response to economic forces. To the contrary, sovereign governments use a variety of techniques, such as intervention by a country's central bank or imposition of regulatory controls, to affect the exchange rates of their currencies. Thus, a special risk in trading options on foreign currencies is that governmental actions might be instituted which could interfere with freely determined currency valuation or even with movement of currencies across borders. These risks are specifically addressed under "Special Risks of Foreign Currency Options" in Chapter X.

The market in foreign currencies exists in every large financial center in the world, and primarily consists of trading by the world's international banks. In contrast to the stock market, the market for foreign currencies is decentralized, essentially free from government regulation designed to protect investors (although, as noted above, governments may take various actions that affect their own currencies and the markets on which they are traded), and extremely large. Trading is generally conducted in units equivalent to \$1 million to \$5 million, and the market is not structured for trading or delivery of small amounts of currency. While a "retail market" for foreign currencies is available for tourists and others engaged in smaller transactions, the