

SPECIAL REPORT: RETAIL FX IN 2008



FX OPTIONS:

Alternative Strategies for Multi-Asset Class Trading

SPONSORED FEATURE BY:



INTERNATIONAL SECURITIES EXCHANGE.

FX OPTIONS: Alternative Strategies for Multi-Asset Class Trading

By Steve Meizinger & Kris Monaco, ISE



STEVE MEIZINGER, DIRECTOR OF EDUCATION, ISE



KRIS MONACO, DIRECTOR OF NEW PRODUCT DEVELOPMENT, ISE

The financial crisis has created a unique opportunity for investors to hedge their US dollar exposure and implement their views on the major currencies.

THE GLOBAL FINANCIAL CRISIS OF 2008 HAS HAD AN INVERSE IMPACT ON THE US DOLLAR; AS THE CRISIS WORSENER, DEMAND FOR THE USD ONLY GREW.

US investors have been selling large quantities of international stocks and bonds and bringing the USD back home to meet their liquidity needs. In order to feed this demand for cash, which is not being met in the short-term money markets, dollars are being purchased in the foreign exchange market creating even more demand for the USD. This has only further driven US investors to sell any and all international bids in stocks and bonds.

The financial crisis has created a unique opportunity for investors to hedge their US dollar exposure and implement their views on the major currencies. ISE FX Options, launched in April 2007, provides both retail and institutional investors with an alternative way to hedge their currency exposure and trade their views on the US dollar. ISE FX Options are classified and regulated as securities allowing investors to trade from their existing options-enabled brokerage accounts. In addition, these products are cash-settled, eliminating the need to hold the actual foreign currency. As an exchange-listed product, counter-party risk is mitigated because ISE FX Options are issued and cleared by the Options Clearing Corporation (OCC), which enjoys a Standard & Poor's 'AAA' credit rating. Since displayed prices and quote sizes are always actionable, ISE FX Options are completely transparent. Through its distinctive risk and reward trade-offs, ISE FX Options provide investors with tremendous versatility in implementing their forecasts, regardless of the market condition or whether you are bullish, bearish or neutral on the US dollar.

The US dollar-based convention makes this product easier for investors to understand, while also making them scalable, creating an underlying value similar to traditional equity and index options. Market data vendors, brokers, and market makers are also able to easily incorporate ISE FX Options values into their equity-based systems, thus resulting in little, if any, additional development work.

ISE's multi-asset class platform allows FX-focused institutional and retail investors to take advantage of the same advanced trading functionality that has been available for years in the equity markets. In addition,

CONVENTION	SYMBOL	RATE MODIFIER	UNDERLYING RATE EXAMPLES
USD/AUD	AUX	100	134.18 (1.3418 x 100)
USD/GBP	BPX	100	56.85 (0.5685 x 100)
USD/CAD	CDD	100	108.98 (1.0898 x 100)
USD/EUR	EUI	100	73.95 (0.7395 x 100)
USD/CHF	SFC	100	114.02 (1.1402 x 100)
USD/JPY	YUK	1	103.31 (103.31 x 1)

Another benefit of being an exchange-listed product is that investors have access to special order types, spread trades, new data feeds, and anonymous trading.

exchanges are neutral platforms that allow many market makers to provide liquidity in a cost-efficient and standardised manner, while making this product available through the largest distribution network of brokers. New participants are able to leverage their existing accounts, tools, and relationships to trade this new asset class.

Another benefit of being an exchange-listed product is that investors have access to special order types, spread trades, new data feeds, and anonymous trading. Traders can take advantage of order types like solicitation and customer match orders or spread orders. Spread orders are available to investors that want to automatically execute a spread strategy in a single trade, such as a vertical spread, straddle, or butterfly.

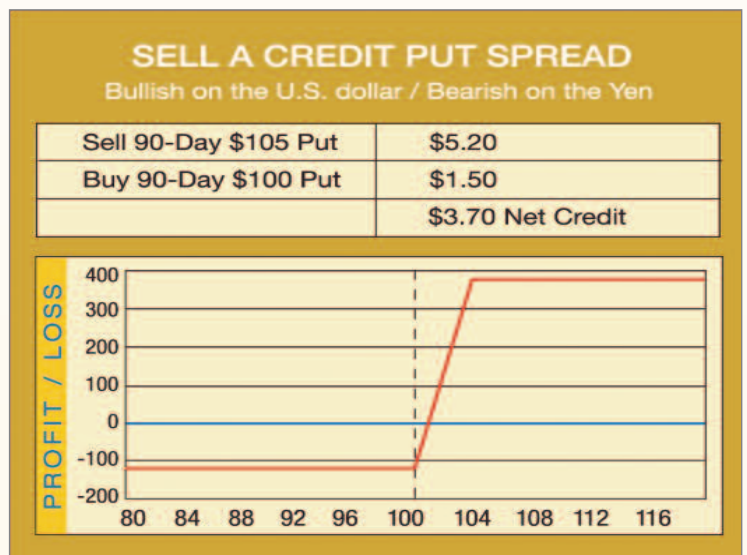
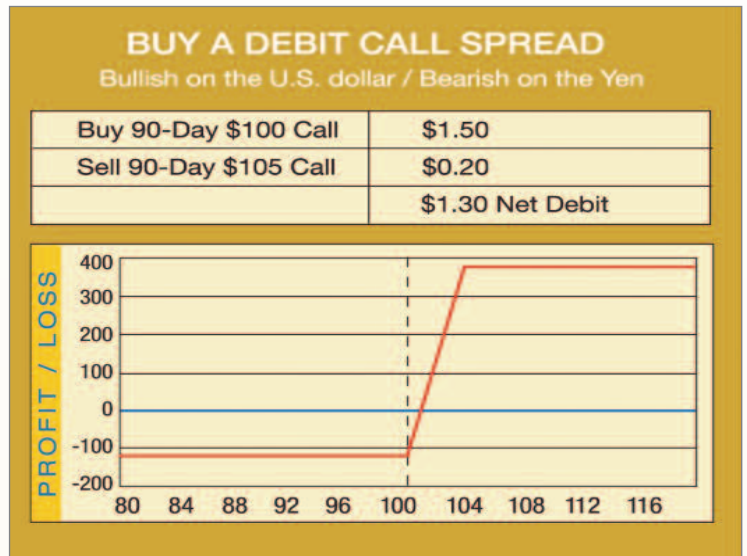
A key advantage of exchange trading is market structure. ISE's market structure ensures that customer orders receive priority on the book while still maintaining a fair playing field for multiple market makers that quote aggressively. The result is a liquid, transparent market that still provides counterparty anonymity.

Solicitation and customer match orders cater to interdealer brokers that look to source or provide liquidity while still taking advantage of exchange functionality and central clearing. Further, ISE has made this product cost-efficient by capping the transaction fees on orders of 5,000 contracts or greater.

Recently, ISE launched a colocation service that provides ultra low-latency connectivity to the exchange. ISE member firms are able to place their trading hardware in the same building as ISE's data center, which facilitates network transit times of less than 200 microseconds. QualityTech, the facilities management firm at ISE's data center, offers the colocation service in conjunction with ISE. QualityTech, connects members to the ISE servers located in the same building via a secure and certified cross-connect. QualityTech also offers a range of related services including space, power, and a managed technology environment.

ISE also recently announced the launch of the ISE Spread Book Feed, a real-time data feed that provides access to all multi-legged options orders on ISE's options exchange. This data feed includes order information for all spread orders up to four options series legs. Traders can now use that functionality for ISE FX Options.

ISE also offers historical tick data in all its listings including ISE FX Options. Historical tick data is provided as a comprehensive end-of-day file of all trades and best



bid/offer quotes. Traders use this data to analyse a day's trading activity, as well as to back-test algorithmic trading models.

HOW ISE FX OPTIONS ARE CALCULATED

ISE FX Options are currently available in six major currency pairs.

In order to provide retail investors with an indication of the spot price, ISE FX Options have an underlying value for each currency pair, which is structured in a way that makes each currency pair resemble an index value except that it is based on a composite rate from Reuters. For example, the underlying spot rates for USD/EUR options are disseminated on the exchange tape as 68.53 via the ticker symbol "EUT". ISE simply makes all the rates USD-based (i.e., inverts the rates in some cases) and multiplies those rates by 100 to create an underlying value that has the same magnitude of a stock or index.

How many options are needed to hedge currency exposure, what strike prices and what time period should

SPECIAL REPORT: RETAIL FX IN 2008

an investor choose? In order to estimate the hedging quantity, the ISE FX value needs to be multiplied by 100 to get the notional values for each pair in US dollars. For example, if the USD/CAD (CDD) is trading at 101.04, the notional value is $101.04 * 100$, or \$10,104. If you wanted to hedge \$100,000 against the Canadian dollar you would buy $(100,000/10,104)$ or 9.89 or roughly 10 CDD options. Let's look at another example: if the USD/JPY (YUK) is trading at 104.18; the notional value is $104.18 * 100$, or \$10,418. If you wanted to hedge \$100,000 against the Japanese yen you would buy 9.59 or roughly 10 YUK options. Similar calculations can be performed for all the other ISE FX pairs. ISE FX Options are US dollar-based so if you are bullish or wanted to hedge an upside move for the USD/CAD, for example, then you would buy CDD calls; if you were bearish or wanted to hedge a downside move for USD/CAD, for example, then you would buy CDD puts. The strike price selection would be based on your willingness to increase your "deductible," but decrease your premium paid. Investors cannot escape from risk and reward theory in options; the further the option is in-the-money, the greater the cost, and vice versa. The selection of expiry is based on an investor's specific timing needs for hedging. In options trading, the familiar catch phrase "time is money" applies very well. Normally, the greater the time period selected the greater the cost.

WHAT STRATEGIES CAN INVESTORS IMPLEMENT?

Investors can use ISE FX Options to implement their own specific US dollar forecasts whether they are bullish, bearish or neutral. ISE's convention for the underlying spot

rates also makes it easy for retail investors to understand. By making all the currency pairs USD-based, retail investors know that an increase in the underlying rate represents USD strength while a decrease represents USD weakness. Options allow investors tremendous versatility in implementing those forecasts. If an investor is bullish on the USD, they could simply buy call options. If an investor is bearish, they buy put options. Spreads and other more complex strategies are also available.

With ISE FX Options, investors can hedge their currency exposure, purchase calls or puts to implement a foreign exchange market forecast or choose from many options spread strategies. Investors outside the US can hedge their US dollar exposure from their US investments by purchasing put options. For example, a foreign investor with a view that their currency is too strong can simply buy call options to hedge their currency gains. Another example is a US investor who wants to hedge their US dollar exposure can similarly buy put options. If an investor feels that the US dollar may have over-shot to the downside, they could simply buy call options to implement that specific forecast.

As cash-settled, SEC-regulated securities with central clearing, transparency and full anonymity, ISE FX Options provide both retail and institutional investors with a flexible way to trade their views on the strength or weakness of the US dollar. Investors have access to the same advanced trading strategies they are currently using for index and equity options. This product can also be easily traded from all options-enabled online brokerage accounts. With current market conditions, now is the time to take advantage of ISE FX Options. ■

ISE FX OPTIONS™



IT'S A NEW WORLD

NOW WELCOMING THE
AUSTRALIAN DOLLAR AND SWISS FRANC

Exchange-listed foreign currency
options from ISE. It's that simple.

USD/AUD (^AUX) USD/EUR (^EUI)
USD/GBP (^BPX) USD/CHF (^SFC)
USD/CAD (^CDD) USD/JPY (^YUK)

(Use ^ for viewing rates on Yahoo! Finance)

Visit us at www.ise.com/fx



ISE FX Options®, the ISE globe logo, International Securities Exchange® and ISE® are trademarks of the International Securities Exchange, LLC. Options involve risk and are not suitable for all investors. Prior to buying or selling an option, a person must receive a copy of Characteristics and Risks of Standardized Options. Copies of the document may be obtained from your broker or from the International Securities Exchange by calling (212) 943-2400 or by writing the Exchange at 60 Broad Street, New York, NY 10004. © 2008, International Securities Exchange, LLC. All rights reserved.