LEARNING THE LANGUAGE OF OPTIONS: A REFRESHER COURSE – PART 5

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In last week's article *Learning the Language of Options* we outlined some other key concepts that are unique to options. This week we look at some more elements of the options market.

The role of the option market maker

Simply put, market makers make a market in options by providing a bid/offer spread price that anyone can buy or sell into. They play an important role in the options market by assisting in the price discovery process, so that other traders and investors are more easily able to price and value an option position. Market makers compete against one another while trading on their own account and at their own risk. They effectively create liquidity in the options market so that it is easier for anyone to buy or sell options at a fair price. This involves quoting buy and sell prices for a certain number of series, and/or responding to requests from other market participants (brokers) for prices. Market makers will often receive a fee incentive from the relevant exchange when they achieve minimum quoting benchmarks.

All market makers attempt to control the risks of their positions, most of them by spreading options against other options or the underlying stock or index futures. Nearly every market maker is looking for a synthetic arbitrage trade. That is a trade that can be combined with other trades to produce a profit with very low risk. Put simply, the market maker will attempt to enter two or more offsetting trades that cancel out the risk and do this for a net profit. Competition among market makers often forces them to accept risks that are not hedged; however, most will not accept directional risk for more than a very short time.

How dividends affect the price of call and put options

Dividend payouts typically cause a fall in share price by the amount of dividend being paid. In other words, a $1.00 dividend is paid on a stock – all other things being equal – should cause the share price to drop by $1.00 following the ex-dividend date. As noted earlier, options factor into their pricing this anticipated fall in the share price well before the ex-dividend date. So a call option will have a lower value prior to the stock going ex-dividend than if there were no dividend being paid, and a put option will have a higher premium value.

How trading halts affect exchange traded options

ASX market rules prohibit the exchange traded option (ETO) market being open when the listed entity is in a trading halt. Any such trading halt over the ETO expiry causes difficulty for option Holders and options writers concerning the expiry process. To mitigate these difficulties ASX does and will re-open ETOs for two hours on the afternoon of the expiry day when the entity is in a trading halt. ASX does this to offer a mechanism whereby options buyers/writers looking to roll or trade out prior to the ETO expiry get a chance to do so.

Choosing the right stock options

Generally the top 20 stocks by market capitalisation have more actively traded options. Some are more actively traded than others. Stocks can also be split up into their various sectors. It is always a good idea to check with your broker to determine the suitability of a particular stock option for trading before entering into a strategy.

The role of the clearing house in exchange traded options transactions

Following the initial transaction between an individual buyer and seller, through a process called novation, the clearing house effectively takes the other side of the trade to ensure that the obligations of the contracts it clears are fulfilled. In this way counter-party risk is virtually eliminated. In Australia, the ASX through the ASX Clearing Corporation's wholly owned subsidiary, ASX Clear, provides this and other important functions that underpin the efficient functioning of the Australian options market. In the United States the Options Clearing Corporation (OCC) is the world's largest equity derivative clearing organisation. The OCC operates under the jurisdiction of both the Securities and Exchange Commission (SEC) and the Commodities Futures Trading Commission (CFTC).

The process of option exercise and assignment

In Australia, if an option buyer decides to exercise his or her option, he or she instructs their broker who then, on behalf of the client, will lodge a Notice of Exercise with ASX Clear. ASX Clear then randomly assigns that exercise to an account with an open written position in the same option series. The following morning, the broker whose client has the account receives the Notice of Assignment, and advises the client that they have been assigned. Settlement of the share transaction as a result of the option exercise takes place three business days (T+3) after the date the buyer of the option exercises the option. A very similar process takes place with regard to exercise on US options, with the resulting same settlement timeframe.

The treatment of out of the money options at expiry

Out of the money options following expiry will cease to exist with no further rights or obligations. Option buyers will lose the premium paid for the options and the option writer (seller) will keep the premium received.

Automatic exercise of in the money options at expiry

Physical settlement occurs whereby shares change hands when options expire in the money. Both bought call and put options that expire in the money will be exercised and delivery of shares will take place on a settlement of T+3 (three days following the transaction date).

Option margins explanation

A margin is the amount calculated by the option clearing house as necessary to cover the risk of financial loss on a written option contract due to an adverse market movement. If you only buy options, then margins are generally not payable. Also if you have written an option and are holding the underlying shares or equivalent option position then you may not have to pay margin. For example, in Australia the strategy of covered call writing, where the risk of the written call option is completely covered by the underlying shares, means that no margin is required. It is best to check with your broker as margin requirements from broker to broker can differ.

This is particularly pertinent when trading US stocks and options as different rules can apply depending on the broker. In the US, shares are typically purchased without paying the full amount by making use of some form of margin lending facility. The typical margin requirement is 50 per cent, which means the client will only pay for half of the value of their stock purchase whilst the brokerage firm will lend the balance. The stock is lodged with the broker as collateral to protect the margin loan. The level of lending and the rates will vary amongst providers and can be subject to change.

Next week in the final article in this series we look at the components of the option order.