Securities Training Corporation®

Series 9

General Securities Sales Supervisor – Options Module

Learning Guide / Workbook

v12

How to Use This Learning Guide

As the instructor presents the material through the On-Demand lecture, use this Learning Guide to take notes, answer questions, and complete activities. Once the On-Demand program is complete, this Learning Guide can be used as an ongoing resource.

About the Series 9 Exam

1	2	3	4	5
Multiple-Choice Questions	One Hour and 30 Minutes Allocated to Complete Exam	5 Additional Questions are Included as Experimental (don't count for or against the score)	Minimum Required Passing Score is 70%	30-, 30-, 180-Day Waiting Period For Failures

Function	Chapters	# of Questions
1. Supervise the Opening and Maintenance of Customer Options Accounts	5 and 6	18 (33% of exam)
2. Supervise the Sales Practices and General Options Trading Activities	1,2,3,4,6 and 7	19 (34% of exam)
3. Supervise Options Communications	6	5 (9% of exam)
4. Supervise Associated Persons and Personnel Management Activities	3,4,5,6 and 7	13 (24% of exam)

Chapter 1 – Option Basics

Key Topics

1	2	3
BASIC OPTIONS	OCC	NON-STANDARD OPTIONS
Learn about the basics of buying and selling calls and puts, as well as the concept of in-the-money and out-of-the-money options.	A brief introduction of the Options Clearing Corporation (OCC), standardized option contracts, and the methods of adjusting options contracts.	Learn about options that don't have standard features including Weeklys, LEAPS, Minis, and Jumbos.

Options – Overview

An option is a contract between two parties

BUYER
- Long the option
- Pays the premium (DEBIT)
- Acquires a right/control

SELLER
- Short the option
- Receives the premium (CREDIT)
- Assumes an obligation

Types of Contracts

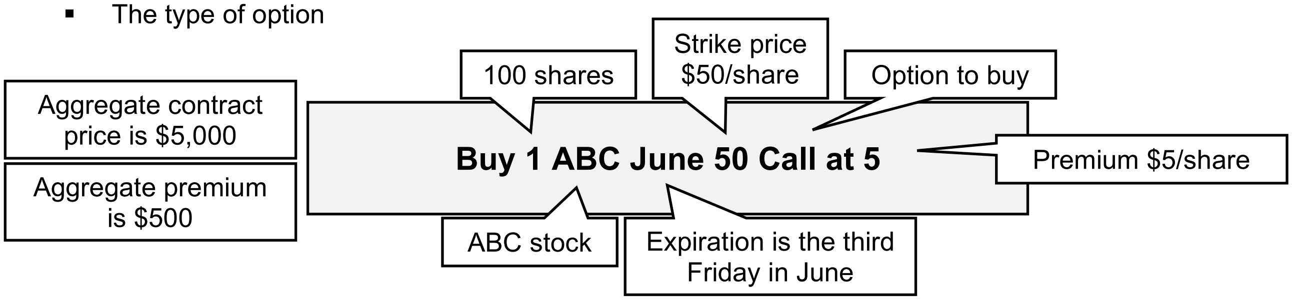
If an option is exercised…

	BUYER'S RIGHT	SELLER'S OBLIGATION
CALL		
PUT		

Standardized Components

An equity option is a contract to buy or sell a specific number of shares of a particular stock at a fixed price over a certain period and is described by:

- The name of the underlying security
- The expiration month of the contract
- The exercise (or strike) price
- The type of option

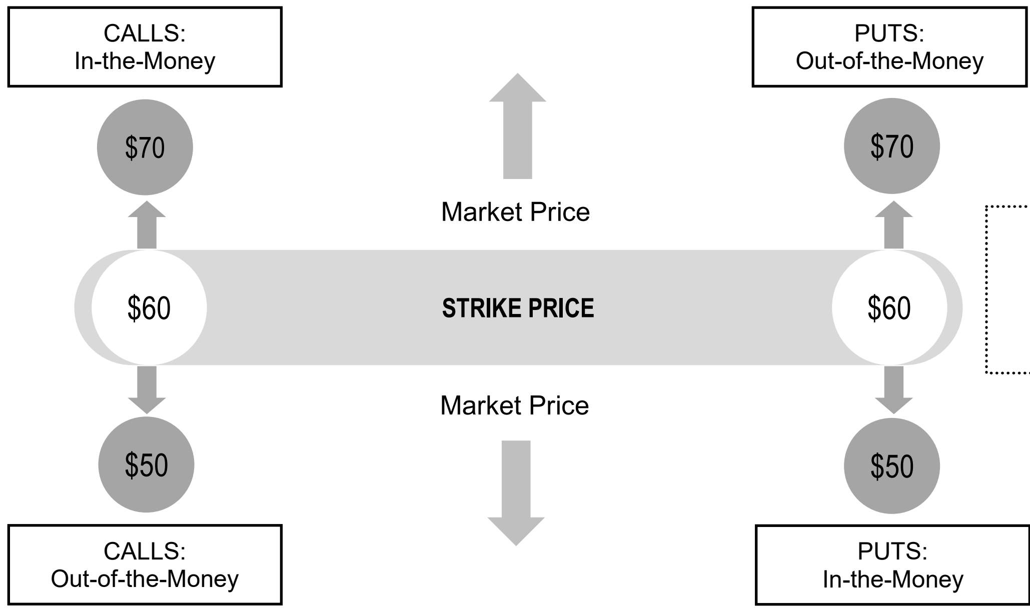


Option Class and Series

CLASS
Options contracts are the same class, if they're of the same type and have the same underlying stock ▪ For example, all ABC calls are of the same class, while all ABC puts are of a different class

SERIES
Options contracts are the same series, if they're of the same class, have the same strike price, and have the same expiration date ▪ For example, all ABC January 50 calls are of the same series, while all ABC February 50 calls and ABC January 40 calls are of a different series

In-the-Money Versus Out-of-the-Money



Calls and Puts are At-the-Money if the option's strike price is equal to the stock's market price.

An Option's Premium

PREMIUM = Intrinsic Value + Time Value

Intrinsic Value: The amount by which an option is in-the-money

Time Value: The portion of an option's premium that exceeds its intrinsic value

A contract has intrinsic value if it's in-the-money.

- Its intrinsic value equals its in-the-money amount.
- It has **zero** intrinsic value if it's out-of-the-money or at-the-money.

Time value is based on:

- Time left until expiration
- Market volatility

The concept of <u>IN</u>trinsic value is tied to options that are <u>IN</u>-the-money.

Activity

Calculate the Time Value

1	Long 1 XYZ Aug 80 Call at 4 XYZ is trading at 82.50	2	Short 1 ABC Dec 45 Call at 3.25 ABC is trading at 45
3	Long 1 RST Jun 60 Put at 2.75 RST is trading at 61.50	4	Short 1 DEF Sep 120 Put at 5.80 DEF is trading at 116.50

Covered and Uncovered Positions

Covered Call:	**Uncovered Call:**
▪ A call is written against stock that's already owned ▪ The sale of the call generates income, thereby increasing the yield on the underlying security ▪ Considered a conservative option strategy which may be executed in either a cash or margin account	▪ A call is written against stock that's not owned ▪ Considered the most speculative option position with unlimited potential risk
Covered Put: ▪ A put is written when the investor has a sufficient amount of cash to satisfy the obligation of being exercised against on the put	**Uncovered Put:** ▪ A put is written without having sufficient cash to meet the obligation of being exercised against on the put ▪ There's significant risk if the underlying security falls

Options Clearing Corporation (OCC)

- Issues and guarantees listed options
- Provides central clearing for option trades
  - Eliminates counter-party risk by acting as a seller for all buyers and a buyer for all sellers
- Uses random selection when assigning exercise notices
- Publishes the Options Disclosure Document (ODD)
- Has NO authority over firm advertising (FINRA does)

Options settle between B/D and OCC on the next business day

Unmatched trades must be resolved by no later than *15 minutes prior to the opening* of trading on the following business day

Deadlines for Equity Options

OCTOBER						
SUN	**MON**	**TUES**	**WED**	**THURS**	**FRI**	**SAT**
		1	2			
6	7	8	9			
13	14	15	16	17	18	19
20	21	22			25	26
27	28	29				

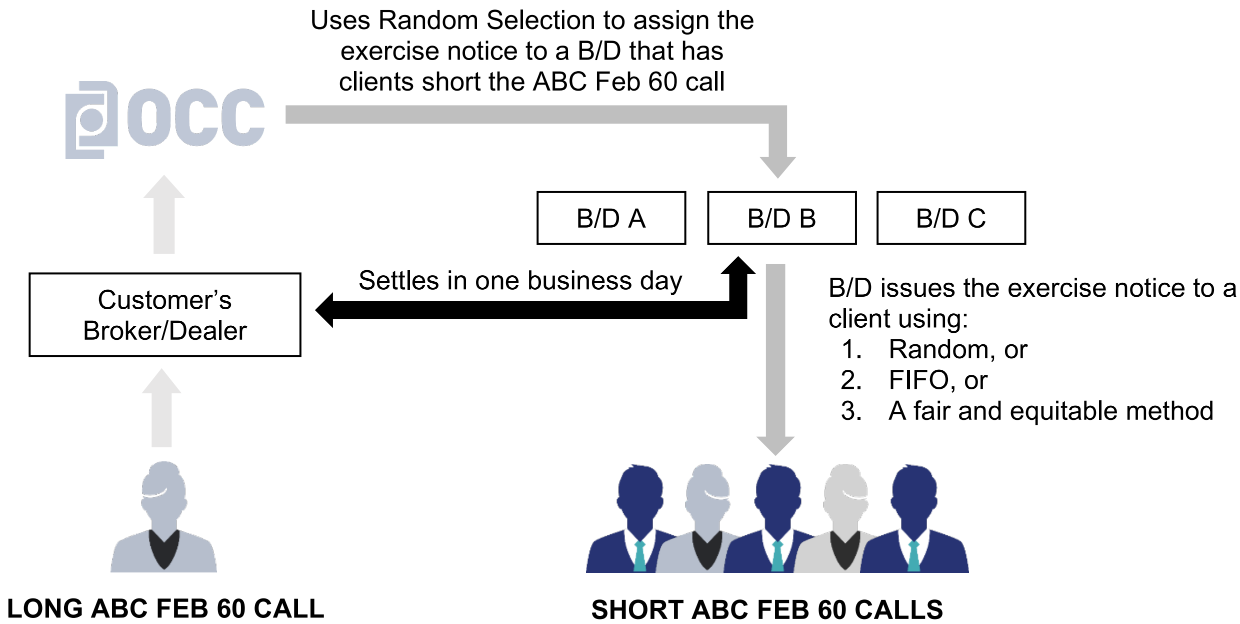
Trading ceases at 4:00 pm ET

Options expire at 11:59 pm ET

Buyer must submit exercise notice to her broker by no later than 5:30 pm ET

Note: At expiration, the OCC will automatically exercise all options that are in-the-money by at least $.01.

Exercising an Equity Option



Contrary Exercise Advice (CEA)

Communication provided to the OCC which instructs it to:

1. **Not exercise** an option that would be automatically exercised
   or
2. **Exercise** an option that would not be automatically exercised

> For example: A client owns an ABT June 50 call and, at expiration, the stock is trading at $50.25. A CEA may be filed to express the client's decision to not exercise.

The CEA must be filed by 7:30 p.m. ET on the business day of expiration

What should an RR do if she's unable to reach her client on the day of expiration?

Exercise and Ex-Dividend Dates

ABC Corporation has declared a $1 dividend with a record date of May 5.

May						
Sun	Mon	Tue	Wed	Thurs	Fri	Sat
1	2	3	4	5	6	7

In order to receive a dividend, when does an owner of an ABC May 50 call need to exercise?

An investor who's primarily interested in income is long ABC stock and short 1 ABC Jun 50 call. If ABC declares a dividend when the stock is trading at $53, what should the investor do if she wants to be guaranteed that she will receive the dividend?

Adjusting Option Contracts

Starting Position:
1 XYZ May 30 Call Option Contract

Aggregate Contract Value:
$3,000

	Number of Contracts	Number of Shares	Strike Price
Even Split (e.g., 2:1)	Increase 1 x 2 ÷ 1 = 2 contracts	Unchanged 100 shares per contract	Decrease $30 x 1 ÷ 2 = $15
Odd Split (e.g., 3:2)	Unchanged 1 contract	Increase 100 shares x 3 ÷ 2 = 150 sh	Decrease $30 x 2 ÷ 3 = $20
Stock Dividend (e.g., 25 %)	Unchanged 1 contract	Increase 100 shares x 125% = 125 sh	Decrease $3,000 ÷ 125 = $24
Cash Dividend	Unchanged 1 contract	Unchanged 100 shares per contract	Unchanged $30

Adjustment of Terms

Corporate actions, such as spinoffs and takeovers, may require an option contract adjustment

- Key phrase for spinoffs: “the contract holder will receive a pro rata number of shares based on a distribution ratio”
- In a takeover, contracts may be adjusted to receiver/deliver shares of another issuer
  (e.g., ABC Corp. options were adjusted so that contract holders receive 62 shares of XYZ Inc.)

A contract adjustment is NOT required for which of the following XYZ Corporation options?

a. XYZ Corp. splits its stock 3 for 1
b. ZRX Corp. buys XYZ, exchanging ½ share of ZRX for each XYZ
c. XYZ places a tender for its own stock
d. XYZ announces a 1 for 5 reverse split

Limitations and Reporting

Large Option Position Reporting (LOPR)	A report is required if a customer has 200 or more contracts on the same side of the market for the same underlying security

Bullish	
Bearish	

Position Limit	Maximum number of contracts that an investor (or group of investors acting in concert) can accumulate on the same side of the market for the same underlying security (ranges from 25,000 to 250,000 contracts); firm cannot make exceptions
Exercise Limit	Maximum number of contracts that an investor may exercise within a five consecutive business day period ▪ Position and exercise limits DO NOT apply to VIX options

The Life of an Option

1. Expire Worthless	2. Exercised	3. Liquidated
If an option is at- or out-of-the-money on the expiration date, the holder of the contract has no incentive to exercise the contract. The contract **expires worthless**. The expiration triggers: ▪ The maximum profit for a seller of a call or put ▪ The maximum loss for the buyer of a call or put	The investor who is long an option has the exclusive right to exercise the option at his own discretion. The two styles of exercise are: ▪ American Style – options may be exercised at any time up until expiration ▪ European Style – options may only be exercised on the day of expiration	Liquidating (closing out) an option position is essentially an alternative to exercising the option. The investor executes an opposite transaction on the same series of option. In other words, what was bought is sold or what was sold is bought.

Liquidate, Trade, or Close-Out

Opening Transaction	Closing Transaction
Opening Purchase (Long/Buyer)	Closing Sale
Opening Sale (Short/Seller)	Closing Purchase

NOTE:
Profit or loss is determined by the difference between the price paid for option and price received from sale.

Non-Standard Options

Weeklys

- CBOE options that expire on any Friday other than the third Friday of the month
  - Typically listed on Thursday to expire on the Friday of the following week
- Settlement is the same as for traditional options on the same underlying interest (i.e., may be A.M. or P.M.)

Long-term Equity Anticipation Security (LEAPS®)

- Exchange-traded; not available for all stocks
- Minimum maturity is 12 months; maximum 39 months
  - Options with maturities exceeding nine months may be purchased on margin (margin call is 75% of cost)
- American style exercise

Non-Standard Options

Mini Options
▪ Provide investors with more flexibility in managing their high-priced stock positions ▪ The contracts represent only 10 shares of an underlying security   • 10 mini contracts = 1 option for position and reporting limits ▪ Available for only certain securities, such as Apple, Google, Amazon, SPDR ETF Trust, and SPDR Gold ETF

Jumbo Options
▪ Designed for institutional investors that prefer larger-sized contracts when executing their strategies ▪ The contracts represent 1,000 shares of an underlying security   • 1 jumbo contract = 10 options for position and reporting limits

Application Question

An investor is long 100,000 shares of ABC stock. Choose the position(s) that would hedge the investor's stock position?

I. Long 10,000 ABC put options

II. Long 100 ABC jumbo put options

III. Long 10,000 ABC mini put options

IV. Long 1,000 ABC put options

Non-Standard Options

Flexible Exchange (FLEX) Options

- Options exchanges have created these customizable FLEX options which are available on equities, indexes, and foreign currencies

FLEX Options
▪ Issued and guaranteed by the OCC

▪ Have negotiable expirations, strikes, exercise style, and exercise-settlement value
  • Expirations may be extended for up to 15 years
  • Expirations may be regulated by exchanges to ensure that they don't coincide with the expirations of non-FLEX options

▪ Have no continuous ready market (i.e., they're illiquid)
▪ Have special position limits

Chapter 2 – Fundamental Options Strategies

Key Topics

1	2
BASIC OPTION STRATEGIES Learn about the strategies, breakeven, profit, and losses for the buying and selling of calls and puts.	STOCK AND OPTION STRATEGIES A brief introduction into stock and option positions, including covered calls, ratio writing, hedging and collars.

Four Key Concepts for Basic Options

Strategy: For option BUYERS, remember the phrase "CALL UP and PUT DOWN" ▪ Buyers of Calls are BULLISH (want stock to rise) ▪ Buyers of Puts are BEARISH (want stock to fall) Sellers are the opposite (Sellers of Calls are BEARISH and Sellers of Puts are BULLISH)	**Breakeven:** To find the stock price (value) at which an investor will breakeven, remember the phrase "CALL UP and PUT DOWN" ▪ For Calls, strike price + premium (CALL UP) ▪ For Puts, strike price – premium (PUT DOWN)
Maximum Gain: For SELLERS of options, the PREMIUM received represents the MAXIMUM GAIN For BUYERS of Calls, the maximum gain is UNLIMITED (since a stock's rise is unlimited) For BUYERS of Puts, the maximum gain is realized if the stock falls to zero (i.e., strike price – premium x 100 shares)	**Maximum Loss:** For BUYERs of options, the PREMIUM paid represents the MAXIMUM LOSS For SELLERS of Calls, the maximum loss is UNLIMITED (since a stock's rise is unlimited) For SELLERS of Puts, the maximum loss is realized if the stock falls to zero (i.e., strike price – premium x 100 shares)

Activity

Determine strategy, breakeven, maximum gain and maximum loss for each position.

1. **Buy 1 ABC Jun 45 Call at 2**
   Answers:
2. **Sell 1 DEF Nov 70 Call at 3.50**
   Answers:
3. **Buy 1 RFQ Dec 30 Put at 4**
   Answers:
4. **Write 1 XYZ Jan 55 Put at 1.25**
   Answers:

Stock and Option Positions

Options may be purchased to hedge either long or short stock positions.
Options may be sold to generate income.

To **protect (or hedge)** stock in a volatile market:

- Long Stock + Long Put
  - If the stock decreases, the value gained on the put can offset the loss on the stock
- Short Stock + Long Call
  - If the stock increases, the value gained on the call can offset the loss on the stock

To **generate income** in a stable market:

- Long Stock + Short Call (Covered Call) OR
- Short Stock + Short Put (Covered Put)
  - For both positions, if the stock remains stable, the options will expire and the premiums will be retained
  - However, for the Covered Put, the upside risk is *unlimited*

Long Hedge or Protective Put

An investor who is bullish on ABC stock, but fears the stock's downside risk, does the following:

Buys 100 shares of ABC at 96 and
Buys 1 ABC Jun 90 Put at 3

Strategy:

Maximum Gain:

Breakeven:

At what price must ABC be trading for the investor to breakeven?

Debit (Cash Out)	Credit (Cash In)

Later, ABC falls to $80 and the investor exercises the put. What's the result?

Debit (Cash Out)	Credit (Cash In)

Covered Call Writing

An investor owns DEF stock, but believes it will trade flat for the next short period. To generate income, she could create the following position:

Long 100 shares of DEF at 42 and
Sells 1 DEF Jun 45 Call at 2

What's sacrificed

Loss is realized if DEF stock:

Breakeven:

At what price can DEF be trading for the investor to breakeven?

Debit (Cash Out)	Credit (Cash In)

Later, DEF rises to $67 and the investor is exercised against. What's the result?

Debit (Cash Out)	Credit (Cash In)

Ratio Call Writing

A position that consists of a long stock position, but more calls written than the number of shares owned

Buy 100 shares of XYZ at 50
Write 2 XYZ Jun 50 Calls

Since ratio writing includes an uncovered call, the potential risk is unlimited.

A neutral strategy:

- In the above example, the maximum gain is realized at $50
- One call is covered by the 100-share position, but the second call is uncovered

Collar

Reverse Collar

Collar	Reverse Collar
A collar is created when an investor has a ***long stock*** position, buys a ***protective put*** and writes a ***covered call*** on the stock	A reverse collar is created when an investor has a ***short stock*** position, buys a ***protective call*** and writes a ***covered put*** on the stock
Long 100 shares of ABC at $72 Long 1 ABC Jun 70 Put at 3 Short 1 ABC Jun 80 Call at 2	Short 100 shares of ABC at $77 Short 1 ABC Jun 75 Put at 3 Long 1 ABC Jun 80 Call at 2
An investor is trying to hedge his stock position; the premium on the covered position reduces the cost of hedging	If the premium on the covered option is greater than or equal to the premium of the long option, it's considered a ***cashless*** collar

Activity – Stock and Option Analysis

Short 100 shares of DPM at 87 and Buys 1 DPM Jun 85 Call at 6

1. At what price must DPM be trading for the investor to breakeven?
   A. 87 B. 91 C. 81 D. 79
2. If DPM is trading at 80 at expiration, what will happen to the option?
   A. Exercise B. Expire
3. If DPM is trading at 95 at expiration, what's the investor's result?
   A. $600 gain B. $400 loss C. $400 gain D. $600 loss

Short 100 shares of GPK at 96 and Short 1 GPK Jun 90 Put at 3

4. At what price must GPK be trading for the investor to breakeven?
   A. 87 B. 93 C. 96 D. 99
5. If GPK is trading at 80 at expiration, what will happen to the option?
   A. Exercise B. Expire
6. If GPK is trading at 85 at expiration and the put is exercised, what's the investor's result?
   A. $900 gain B. $300 loss C. $600 gain D. $900 loss

Activity

A. Buy Call	B. Buy Put	C. Sell Call	D. Sell Put

Match the option positions above with the following uses/objectives

1. Investor is short stock and wants protection. ______
2. Investor is long stock and wants income. ______
3. Investor is long stock and wants protection. ______
4. Investor is a bullish speculator. ______
5. Investor is short a call and wants to cover it. ______
6. Investor is short stock and wants income. ______

Chapter 3 – Advanced Option Strategies

Key Topics

1	2	3
STRADDLES	SPREADS	SYNTHETICS
Learn about the strategies, breakeven, profits, and losses on straddles and combinations.	Learn to identify and analyze all of the components of option spreads.	Learn how to create and identify synthetic positions using options and a stock position.

Straddles and Combinations

Created by either:

- **Buying both** a call and a put on the same underlying security OR
- **Selling both** a call and a put on the same underlying security

Strategy

- Long straddle or combination:
- Short straddle or combination:

STRADDLE:

- Same expiration months and strike prices

COMBINATION:

- Different expiration months and/or strike prices

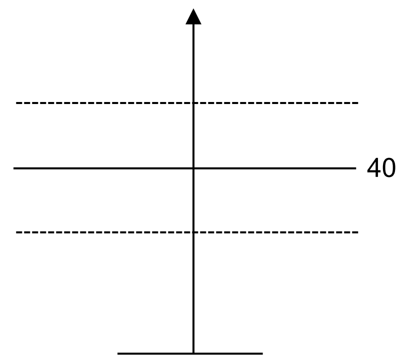
If an investor has one option component and adds another to create a multiple option position, he's considered to have *legged* into the position.

Long Straddle – Analysis

Uncertain of the exact direction in which
ABC stock is going to move, an investor:

Buys 1 ABC Jun 40 Call at 3 Buys 1 ABC Jun 40 Put at 2
The total combined premium is ______

Breakeven Points:



Strategy:

Maximum Gain:

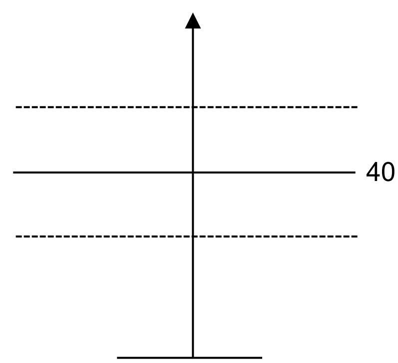
Maximum Loss:

Short Straddle – Analysis

Believing that RST's stock price
will remain flat, an investor:

Sells 1 RST Jun 40 Call at 3 Sells 1 RST Jun 40 Put at 2
The total combined premium is ______

Breakeven Points:



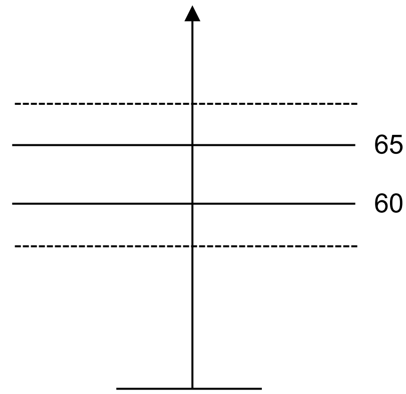
Strategy:

Maximum Gain:

Maximum Loss:

Activity – Combination Analysis

Buy 1 DEF Aug 60 Put at 1
Buy 1 DEF Aug 65 Call at 2



1. Breakeven Points:

2. If exercised when DEF is at $52.50, what's the investor's gain or loss?

Debit (Cash Out)	Credit (Cash In)

3. At what market price will the investor profit?

   A. 67 B. 62.50 C. 55 D. 57

Spreads

Positions which allow an investor to limit losses in exchange for limiting gains

- Created with the sale and purchase of two options of the same *class,* but different *series*
  - Class: options of the same type on the same underlying security
  - Series: options of the same class, same expiration, and same strike prices
- Spreads may be either bullish or bearish and either debit or credit

Price/Dollar/Vertical	**Time/Calendar/Horizontal**	**Diagonal**
Buy 1 ABC Jun **40** Call Sell 1 ABC Jun **50** Call	Buy 1 XYZ **Dec** 40 Call Sell 1 XYZ **Sep** 40 Call	Buy 1 DEF **Sep 40** Put Sell 1 DEF **Mar 30** Put

Call Spread – Analysis

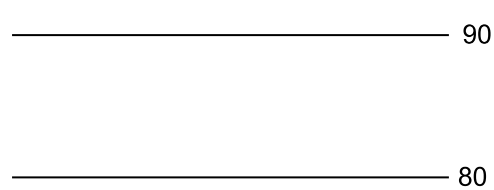
An investor who is moderately bullish on XYZ stock, but wants to minimize the cost of establishing the position, does the following:

Buys 1 XYZ Feb 80 Call at 3
Sells 1 XYZ Feb 90 Call at 1

Spread Rules:

- The breakeven must be between the strikes.
- The max gain PLUS the max loss will equal the difference in the strike prices.

Net Premium:
Buyer or Seller:
Debit or Credit:
Widen or Narrow:
Breakeven:
Bull or Bear:
Maximum Gain:
Maximum Loss:



Put Spread – Analysis

An investor who is moderately bullish on ELG stock, but wants to minimize the risk of a short position, does the following:

Sells 1 ELG Nov 95 Put at 8
Buys 1 ELG Nov 80 Put at 1

Spread Rules:

- The breakeven must be between the strikes.
- The max gain PLUS the max loss will equal the difference in the strike prices.

Net Premium:
Buyer or Seller:
Debit or Credit:
Widen or Narrow:
Breakeven:
Bull or Bear:
Maximum Gain:
Maximum Loss:

95

80

Activity – Spread Analysis

Sells 1 ELG Nov 85 Call at 1
Buys 1 ELG Nov 80 Call at 3

1. Debit or Credit:
2. Widen or Narrow:
3. Breakeven:
4. Bull or Bear:

Sells 1 ABC May 95 Put at 9
Buys 1 ABC May 80 Put at 1

5. Debit or Credit:
6. Widen or Narrow:
7. Breakeven:
8. Bull or Bear:

Sells 1 XYZ June 65 Put at 3
Buys 1 XYZ June 80 Put at 9

9. Debit or Credit:
10. Widen or Narrow:
11. Breakeven:
12. Bull or Bear:

Activity – Spread Analysis

Buys 1 XYZ Feb 80 Call at 1
Sells 1 XYZ Feb 70 Call at 5

1. Maximum Gain:
2. Maximum Loss:

Buys 1 XYZ Feb 70 Put at 4
Sells 1 XYZ Feb 60 Put at 1

3. Maximum Gain:
4. Maximum Loss:

Buys 1 XYZ Feb 80 Call at 2
Sells 1 XYZ Feb 75 Call at 4

5. Maximum Gain:
6. Maximum Loss:

Activity

Match the option with the desired position

1	An investor is Long an ABC November 50 call and wants to create a:

1. Debit spread
2. Credit spread
3. Straddle
4. Combination

A. Long an ABC October 50 Put
B. Short an ABC November 40 Call
C. Long an ABC November 50 Put
D. Short an ABC October 50 Call

2	An investor is Short an XYZ August 80 put and wants to create a:

1. Debit spread
2. Credit spread
3. Straddle
4. Combination

A. Long an XYZ August 70 Put
B. Short an XYZ August 80 Call
C. Long an XYZ August 90 Put
D. Short an XYZ July 90 Call

Spreads – Bull/Bear, Debit/Credit, Widen/Narrow?

Buy an XYZ Nov 90 Call Sell an XYZ Nov 80 Call
For CALL spreads, the dominant leg is always determined by the LOWER strike

Write an ABC Mar 35 Put Buy an ABC Mar 40 Put
For PUT spreads, the dominant leg is always determined by the HIGHER strike

Short a JMK Oct 75 Call Long a JMK Dec 75 Call
For HORIZONTAL spreads, the dominant leg is always determined by the LONGER expiration

Butterfly Spread

A combination of two spreads – one is a debit and the other is a credit

- Can be created with either calls or puts

Long 1 ABC May 60 Call (out-of-the-money)
Short 2 ABC May 50 Calls (at-the-money)
Long 1 ABC May 40 Call (in-the-money)

Butterfly spreads have **four positions** and use **only calls or puts**

1 with a **high** strike
2 with a strike in the **middle**
1 with a **low** strike

Remember: 1-2-1 with only calls or only puts

A neutral strategy:

- Maximum gain is realized at the middle strike price ($50)
- Maximum loss is realized if stock is below the lower strike price ($40) or above the higher strike price ($60)

Iron Butterfly Spread

Created by selling a straddle and buying two options with strikes outside the straddle for protection

Long 1 ABC May 60 Call (out-of-the-money)
Short 1 ABC May 50 Call (at-the-money)
Short 1 ABC May 50 Put (at-the-money)
Long 1 ABC May 40 Put (out-of-the-money)

Iron butterfly spreads have **four positions** and use **calls and puts**

1 call with a **high** strike
1 call with a strike price in the **middle**
1 put with a strike price in the **middle**
1 put with a low strike

Remember: 1-2-1 with calls and puts

A neutral strategy:

- Maximum gain is realized at the middle strike price ($50)
- Maximum loss is realized if stock is below the lower strike price ($40) or above the higher strike price ($60)

Condor Spread

A combination of two spreads – one is a debit and the other is a credit (can be created with either calls or puts)

Long 1 ABC May 60 Call (out-of-the-money)
Short 1 ABC May 55 Call (out-of-the-money)
Short 1 ABC May 45 Call (in-the-money)
Long 1 ABC May 40 Call (in-the-money)

Condor spreads have **four strikes** and use **only calls or only puts**

1 with a **high** strike
1 with a strike **just above** stock
1 with a strike **just below** stock
1 with a **low** strike

A neutral strategy:

- Maximum gain is realized if stock is between the middle strike prices ($45 – $55)
- Maximum loss is realized if stock is below the lower strike price ($40) or above the higher strike price ($60)

Iron Condor Spread

Created by selling a strangle and buying two options with strikes outside the strangle for protection

Long 1 ABC May 60 Call (out-of-the-money)
Short 1 ABC May 55 Call (out-of-the-money)
Short 1 ABC May 45 Put (out-of-the-money)
Long 1 ABC May 40 Put (out-of-the-money)

Iron condor spreads have **four strikes** and use **calls and puts**

1 with a **high** strike
1 with a strike **just above** stock
1 with a strike **just below** stock
1 with a **low** strike

A neutral strategy:

- Maximum gain is realized if stock is between the middle strike prices ($45 – $55)
- Maximum loss is realized if stock is below the lower strike price ($40) and above the higher strike price ($60)

Synthetic Options

A combination of options or stock and options that creates the same profit and loss characteristics of another position.

Synthetic		Positions
Long Call	=	Long Stock + Long Put
Short Call	=	Short Stock + Short Put
Long Put	=	Short Stock + Long Call
Short Put	=	Long Stock + Short Call
Long Stock	=	Long Call + Short Put
Short Stock	=	Long Put + Short Call

Working with Synthetics

1. Begin with the synthetic long call formula: Long Call = Long Stock + Long Put
2. From this starting point, let's create a synthetic Long Put. To do this, isolate the Long Put by rearranging the positions so that the Long Put is alone on the right side of the equal sign.
3. The long stock position needs to be moved to the other side of the equal sign. However, when a position is moved to the other side of the equal sign, it changes from long to short. As with a math problem, when a number is moved across the equal sign, a positive becomes a negative or vice versa.

Start: Long Call = Long Stock + Long Put

After moving the Long Stock to the other side of the equation, a synthetic long put is:

Finish: Long Call + Short Stock = Long Put

The same process can be used to create all of the positions

Activity

Determine whether the following statements are TRUE or FALSE.

A LONG PUT AND A LONG STOCK ARE A SYNTHETIC LONG CALL.	
A LONG CALL AND A SHORT STOCK ARE A SYNTHETIC LONG PUT.	
A SHORT CALL AND A SHORT PUT ARE A SYNTHETIC SHORT CALL.	
SHORT CALL AND A LONG STOCK ARE A SYNTHETIC SHORT PUT.	

Measuring Risk

<table>
<tr><td rowspan="2">BETA</td><td>Measures the volatility of a stock relative to the overall market</td></tr>
<tr><td>▪ The S&P 500 is typically used as estimate of the overall market and has a beta of 1.00
▪ A stock that a beta more than 1.00 will have more volatility than the S&P 500. Options on stocks with a higher beta will have higher premiums (i.e., more time value)
▪ A stock that has a beta less than 1.00 will have less volatility than the S&P 500. Options on stocks with a lower beta will have lower premiums (i.e., less time value)</td></tr>
</table>

<table>
<tr><td rowspan="2">DELTA</td><td>Measures the volatility of an option relative to the underlying stock</td></tr>
<tr><td>▪ Delta is the percentage change in an option premium for every $1 change in the underlying stock price
    • If the underlying stock prices rises $1, a long call option with a delta of .75 will see a $0.75 (.75 x $1.00) increase in the premium
▪ In-the-money-options will have deltas approaching 1.0 for calls or -1.0 for puts
▪ At-the-money-options will have deltas around .50 for calls or -.50 for puts
▪ Out-of-the-money options have deltas approaching 0</td></tr>
</table>

Chapter 4 – Non-Equity Options

Key Topics

1	2	3	4
INDEX OPTIONS	VIX OPTIONS	CURRENCY OPTIONS	FUTURES AND SWAPS
Learn about index options, their uses, and the different ways in which they settle.	A brief introduction into the CBOE's Volatility Index (VIX) and options that are based on the VIX.	Learn the contract specifics on world currency options and how they can be used.	A short discussion of the characteristics of futures and swap contracts.

Index Options

Provide the opportunity to speculate on, or hedge against, the movement of the market, rather than the movement of a specific stock

Broad-based Index: reflects performance of the entire market
- SPX – S&P 500
- OEX – S&P 100
- VIX – Volatility Index
- DJX – Dow Jones Industrial
- RUT – Russell 2000
- WLX – Wilshire 5000 (broadest)

Narrow-based Index: reflects performance of a particular sector
- Biotechnology
- Computer Technology
- Oil

Index Option Specifications

	Equity	Index
Underlying Interest	Stock	Value or average of an index
Multiplier	100 shares	$100
Exercise	Receive or deliver stock	Receive or deliver cash
Settlement on Exercise	One business day	One business day
Exercise Style	American	European

Most index options don't have position limits

Activity – Index Options Analysis

1	How can a fund manager use index options to generate income?

A. Buy SPX Calls
B. Buy SPX Puts
C. Sell SPX Puts
D. Sell SPX Calls

2	How can a fund manager use index options to hedge the portfolio?

A. Buy OEX Calls
B. Buy OEX Puts
C. Sell OEX Puts
D. Sell OEX Calls

A.M. and P.M. Options

Index option settlement styles:

A.M. Settlement	▪ Uses the morning opening price as the exercise/settlement value ▪ Traditional S&P 500 Index (SPX) options use the third Thursday as the last trading day with exercise/settlement value based on the third Friday's opening value
P.M. Settlement	▪ Uses the market's closing price on the expiration date as the exercise/settlement value • S&P 100 Index (OEX) or Non-traditional S&P 500 Index (SPX) (e.g., weeklys) ▪ Non-traditional S&P 500 options often have expirations on a date other than the third Friday (e.g., SPX Wednesday Weeklys expire on Wednesdays)

Volatility Index (VIX) Options

The VIX is a barometer of investor sentiment and expected market volatility based on the premiums for S&P 500 Index options over the next 30 days

- VIX options are cash settled, with each point equal to $100 (value of 11.27 x $100 = $1,127)
- Use European style exercise

When does volatility tend to increase?

If an investor believes the S&P 500 Index will fall in value, she may:

Application Question

Which of the following statements is TRUE about VIX options?

A. They use American exercise and physical settlement.

B. They use American exercise and cash settlement.

C. They use European exercise and physical settlement.

D. They use European exercise and cash settlement.

World Currency Options

Provide the opportunity to speculate on, or hedge against, the movement of exchange rates on foreign currencies compared to the U.S. dollar

- Currency spot prices are established in the **Interbank Market** which:
  - Has unlimited trading hours (spot trades)
  - Is unregulated and decentralized
- Currency options trade on NASDAQ PHLX and currencies are selected by the exchange

World Currency Option Specifications

Expiration:	▪ The third Friday of the expiration month
Exercise:	▪ U.S. dollar-settled, European style exercise
Contract Size:	▪ 10,000 units, except Yen which is 1 million
Quoted:	▪ Most are quoted in cents per unit ($.01) • Yen quoted in units of 1/100th of one U.S. cent per unit ($.0001)
Multiplier:	▪ $100 (e.g. 2.25 x $100 = $225)
Position Limits:	▪ 300,000 contracts for options on Mexican peso, Brazilian real, Chinese yuan, Danish krone, Norwegian krone, Russian ruble, South African rand, South Korean won, Swedish krona ▪ 600,000 contracts for options on British pound, Swiss franc, Canadian dollar, Australian dollar, Japanese yen, and New Zealand dollar ▪ 1,200,000 contracts for options on the Euro

Currency Option Strategy

A speculator believes the U.S. dollar will weaken, resulting in a Euro rally. The speculator decides to:

Buy 1 Euro Jun 160 Call at 3.35

Breakeven:

Strategy:

Maximum Gain:

Maximum Loss:

If the Euro increases to 166 and the option is closed out at its in-the-money amount, the result is:

Debit (Cash Out)	Credit (Cash In)

Activity – Non-Equity Options Analysis

1	If a U.S. firm is importing cars from Japan, how could it hedge exchange-rate risk on the trade?

A. Buy U.S. Dollar Puts
B. Buy Yen Calls
C. Buy U.S. Dollar Calls
D. Buy Yen Puts

2	If a U.S. firm is exporting oil to Europe, how could it hedge exchange-rate risk on the trade?

A. Buy U.S. Dollar Puts
B. Buy Euro Calls
C. Buy U.S. Dollar Calls
D. Buy Euro Puts

Futures and Swaps

Futures Contracts	A futures contract is an agreement to buy or sell a commodity at a future date. ▪ Commodities can be created on corn, wheat, soybeans, gold, silver, crude oil and natural gas ▪ Futures contracts are exchange traded and have standardized terms (e.g., size, type, delivery date, and location) ▪ Futures contracts are not considered securities
Swap Contracts	A swap contract is an agreement to exchange cash flows or obligations with another party. ▪ Swaps can be created on interest rates, foreign currencies, debt and equity, as well as payment if an issuer defaults on its bond ▪ Swaps are not considered securities

Chapter 5 – Taxation and Margin

Key Topics

1	2	3	4
TAXES	REGULATION T	MARGIN	PORTFOLIO MARGIN
Learn about the tax consequences of buying, selling, and exercising option contracts.	A brief introduction into Reg. T and the payment date.	Learn about the basics of margin accounts and the rules for opening margin accounts.	Learn about portfolio margin rules, day trading accounts, and how they both differ from traditional margin accounts.

Cost Basis and Capital Events

Cost Basis	▪ Represents the total amount paid to acquire a security ▪ Typically includes commissions and other fees paid
Capital Gains	▪ The result of the sale or redemption of an asset if the proceeds exceed the basis (Holding period is measured from trade date to trade date) • Short-term: Assets that are held for one year or less – Taxed at: • Long-term: Assets that are held for greater than one year – Taxed at:
Capital Losses	▪ The result of the sale of an asset if the proceeds are less than the basis ▪ As it relates to holding period, short-term and long-term losses are defined the same as capital gains ▪ If losses exceed gains up to $3,000 can be used to offset ordinary income

A return of capital is when the investor receives some of the original investment back.

Option Taxation

Tax result is determined by the method of option disposal

Expire Worthless	Liquidated, Offset, Closed-out	Exercised
▪ Short-term capital gain or loss if option purchased with maturities of one year or less ▪ Long-term if a LEAPS® is purchased and held for more than one year ▪ Short-term if option position is established with a sale (short)	▪ Short-term capital gain or loss if option was held for one year or less ▪ Long-term if a LEAPS® is purchased and held for more than one year ▪ Short-term if option position is established with a sale (short)	▪ The option premium will not generate a gain or loss ▪ To calculate the cost basis or sales proceeds: • Of an exercised call, the premium is added to the strike price (i.e., CALL UP) • Of an exercised put, the premium is subtracted from the strike price (i.e., PUT DOWN)

Taxation of Exercised Call Options

An investor is long one ABC Jun 90 Call at 4. If the option is later exercised, the investor will have:

1. A basis of $9,200
2. A basis of $8,800
3. A basis of $8,600
4. A basis of $9,400

Debit (Cash Out)	Credit (Cash In)

The cost of the stock has NO impact on sales proceeds

An investor owns 100 shares of XYZ at $42 per share and sells an XYZ Dec 40 Call for 3. If the call is exercised, what are the investor's sales proceeds for tax purposes?

1. $3,700
2. $3,900
3. $4,300
4. $4,500

Debit (Cash Out)	Credit (Cash In)

Taxation of Exercised Put Options

An investor is long a DEF Feb 45 Put at 3. If the option is later exercised when DEF is at 40, the investor will have:

1. Proceeds of $200
2. Proceeds of $4,200
3. Proceeds of $4,500
4. Proceeds of $4,800

Debit (Cash Out)	Credit (Cash In)

The stock’s value has NO impact on cost basis

An investor sells one GHI Aug 60 Put for 4. If GHI falls to 50 and the put is exercised, what’s the investor’s cost basis?

1. $4,600
2. $5,400
3. $5,600
4. $6,000

Debit (Cash Out)	Credit (Cash In)

Puts and Holding Periods

Stock Holding Periods	▪ If a stock’s long-term holding period is not yet established: • The purchase of a put terminates the holding period for the stock • The holding period begins anew only after the put expires or is closed out ▪ If a stock’s long-term holding period is already established, a put purchase doesn’t change it (it remains long-term)
Married Put	▪ A put purchased on the same day that stock is purchased • The holding period for the stock starts on the purchase date • The premium paid becomes part of the stock’s basis, even after expiration

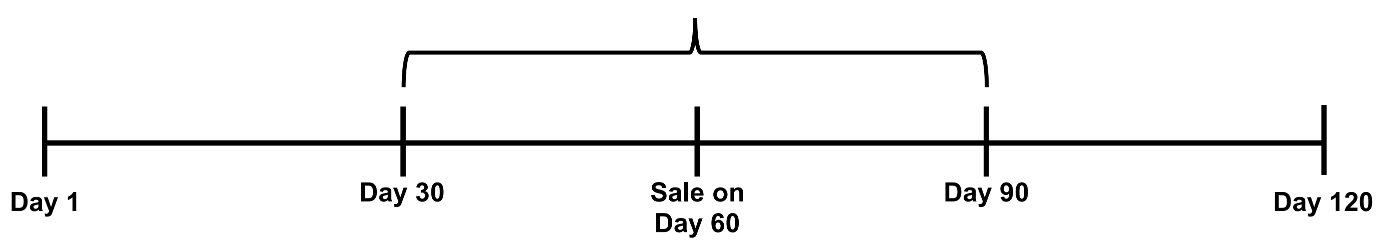
Tax Swaps and Wash Sale Rule

Assets may be sold to generate losses in order to offset taxable gains

However, the IRS will disallow the capital loss if, within 30 days of the sale, the investor purchases *substantially the same* security (or covers a short position and shorts *substantially the same* security)

- Disallowed loss is added to the basis of the newly purchased security
- What’s *substantially the same*?
  - For stock – the stock itself, bonds and preferred stock that are convertible into the stock, as well as rights, warrants and call options that are exercisable into the stock
  - For bonds – bonds of the same issuer, coupon, and maturity

61-Day Wash Sale Period



Activity – Tax Analysis

An investor has an $8,000 short-term gain in stock trading. His option account has the following position:

Short 15 ABC Sep 20 puts at 3

On the Friday of expiration, ABC is trading at $14. To realize the maximum benefit from this position, the investor should:

A. Engage in a closing sale
B. Let the option expire worthless
C. Buy the stock via an exercise assignment notice, and then sell
D. Exercise the put

Regulation T (Customer) Payment Date

The Reg. T payment must be obtained for purchases that are made in either cash or margin accounts within two business days of settlement (S+2)	Before settlement, a customer can request that the broker-dealer transfer a trade from a cash account to a margin account	If no payment is made, the position is closed out (securities sold) on the third business day following settlement	The result of non-payment is that the account is frozen for 90 days (all payments must be made in advance)

Margin Requirements on Options

Buy an option: Deposit 100% of the premium

Sell a covered option: No required deposit on the option

- For a covered call to be "qualified," the strike price must be evaluated in relation to the market price of the stock to determine whether the stock's holding period will be altered
  - For shares priced at:
    - $25 or less, the strike price must be at least 85% of stock price
    - $25.01 to 50, one strike below the stock price is acceptable
    - $50.01 to $150, two strikes below the stock price is acceptable
- A qualified covered call keeps the holding period intact
  - For example:
    - On March 12, a client buys XYZ at 50. On December 12, if XYZ is trading at 83, which calls may be written without suspending the holding period of the stock?
    - Calls with strike prices of 80 or 75 may be written

Sell an uncovered option: Margin deposit required (not calculated)

Portfolio Margin

An alternative to strategy-based margin; the margin requirement is based on the greatest potential net loss in the portfolio (offsets are netted)

- B/D may advertise, but must obtain FINRA approval to offer this service
- Prior to the initial transaction, clients must receive a disclosure statement and acknowledge its receipt in writing
- Reduces margin requirements and increases leverage for hedged portfolios

Eligible securities:
- *Equities*
- *Convertible bonds*
- *Futures*
- *Warrants*
- *Options (but not rights)*

Portfolio Margin

FINRA must approve a B/Ds use of portfolio margin

To utilize portfolio margin, clients must be approved for uncovered options

Clients must receive a disclosure statement prior to the initial transactions, with written acknowledgement of receipt

Margin deficiencies must be met within ***three business days***

Which of the following clients is eligible to use portfolio margin?

a. An accredited client
b. A margin client that holds more than $1 million in unrestricted equity
c. A client that's approved for uncovered option writing
d. A client that's approved by FINRA

Day Trading Regulations

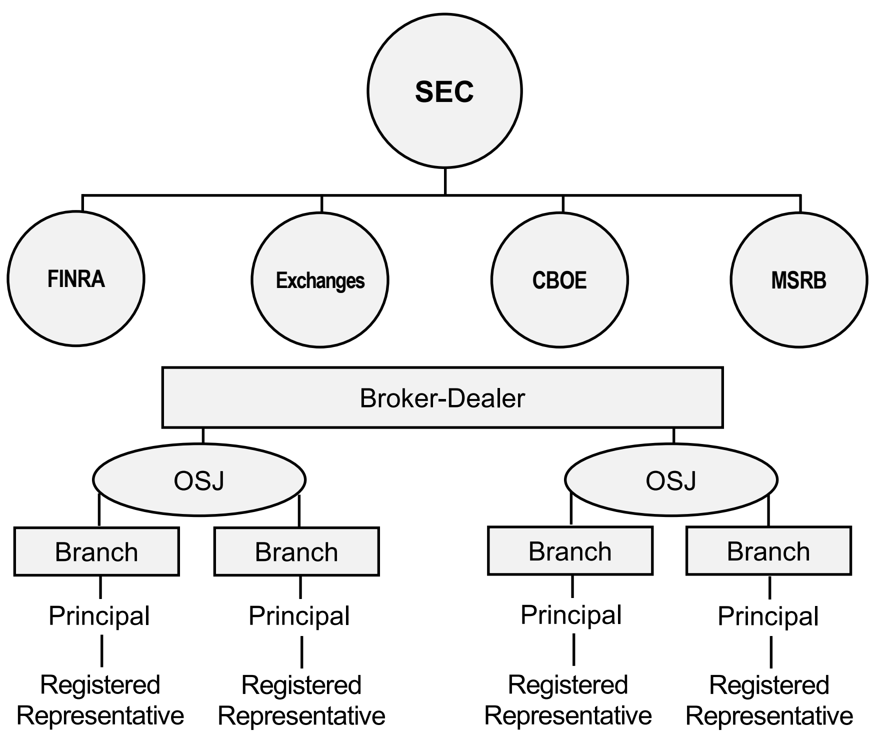
Definitions	▪ Day Trading • The purchase and sale (or short sale and purchase) of the same security, on the same day, in a margin account ▪ Pattern Day Trader • A client who executes four or more day trades within a five-day period
Risk Disclosure Statement	▪ Prior to opening a day trading account for a non-institutional customer, a firm must provide a Risk Disclosure Statement which indicates: • Day trading can be extremely risky • Be wary of claims of large profits from day trading • Day trading requires knowledge of the securities markets and the firm's operations • Day trading will generate substantial commissions • Day trading on margin or short selling may result in losses beyond your initial investments
Approval Procedures	▪ Firm must have reasonable grounds to believe that day trading is appropriate for the customer ▪ If the customer has provided written notice that the account will not be used for day trading, but the firm has evidence of the occurrence of day trading, the account must be approved for day trading within 10 days ▪ Minimum equity is $25,000 ▪ Cross guarantees between accounts or customers are prohibited ▪ A day trader's buying power equals four times the maintenance requirement excess

Chapter 6 – Supervision of Options Accounts

Key Topics

1	2	3	4	5
SUPERVISION	OPENING OPTION ACCOUNTS	SUITABILITY	COMMUNICATIONS	BOOKS AND RECORDS
Learn about supervision of broker-dealers and related industry rules.	Learn about the required information for opening an account, as well as anti-money laundering (AML) rules.	A brief introduction into suitability rules and limitations that apply to customer accounts.	Learn about FINRA's definitions for the different forms of communication with the public and specific filing requirements.	A brief introduction into record retention, how complaints are handled, and the process for dealing with errors that are made by a broker-dealer.

Regulatory/Supervisory Overview



Options Supervision

A firm's options business is supervised by either:
- Registered Options Principal (ROP) – Series 4
- General Securities Sales Supervisor – Series 9 and 10

A firm's supervisory program should include:
- Review of selected accounts
- Acceptance of discretionary accounts
- Guidelines for solicitation material
- Review of assignments/exercise notices; exchange approval is required if methodology changes (FIFO vs. Random)
- Review of transactions for front-running, insider trading, uneconomic trades, clients trading out of their approved level
- Training of personnel regarding new products and regulations

Supervisory Responsibilities

BOM	Branch Office Managers (BOMs) can: ▪ Supervise sales activities and registered representatives ▪ Provide initial approval of option accounts ▪ Review activity in option discretionary accounts ▪ Manage a branch office BOMs cannot oversee option departments, accept discretionary accounts, or approve option communications
ROP	Registered Options Principals (ROPs) must: ▪ Approve new accounts and review existing accounts ▪ Approve orders (not in advance) ▪ Train, register and supervise registered representatives ▪ Review and approve option communications with the public

Opening an Options Account

1. New Account Form
- Client information is obtained including, income, net worth, current employer, affiliation with a different broker-dealer, investing experience and objectives

2. Written approval by an ROP or General Securities Sales Supervisor
- In an office in which **three or fewer** RRs engage in option business, a branch office manager who doesn't have the Series 4 or Series 9 may approve the account, provided the approval of a Registered Option Principal (Series 4) or General Securities Sales Supervisor (Series 9) is obtained within 10 business days
- In an office in which **more than three** RRs are engaged in option business, the branch office manager must qualify as a Registered Option Principal (Series 4) or General Securities Sales Supervisor (Series 9)
- A client who receives approval to trade equity options, must obtain separate approval to trade foreign currency options

Opening an Options Account

3. Opening Trade
▪ Sales Supervisor or Registered Option Principal must approve each trade on the trade date ▪ The Options Disclosure Document (ODD) must be sent at, or prior to, approval of the account

4. Client Signature
▪ Within ***15 calendar days*** of account approval, client signature must be obtained on the account agreement which asserts that the customer: • Attests to the validity of the personal information obtained • Agrees to abide by position and exercise limits • Understands that certain in-the-money options are automatically exercised • Acknowledges the firm's method of exercise assignment – If client verification is not received within 15 days, only ***closing transactions*** are permitted – Example: If account was approved on the 15th, obtain signature by 30th

Application Question

On January 4, a client opened an option account and conducted her first trade on January 12. She must return the signed option agreement by no later than:

A. 10 calendar days after the account is approved

B. 15 calendar days after the account is approved

C. 15 calendar days after the first trade

D. 15 calendar days after receiving the Options Disclosure Document

USA PATRIOT Act

Amendment to the Bank Secrecy Act; designed to deter, detect, and punish terrorism and money-laundering concerns both inside and outside of the U.S.

- B/Ds must appoint an AML officer and notify regulators
- If officer is changed, regulators must be notified by next quarter

FinCEN Reports:

Currency Transaction Report (CTR)	Currency/Monetary Instrument Report (CMIR)	Suspicious Activity Report (SAR)
▪ Transactions by a single customer during one business day EXCEEDING $10,000 ▪ Includes structured transactions ▪ Filed within 15 days	▪ Physical transport or receipt of cash (or equivalents) EXCEEDING $10,000 into, or out of the U.S. ▪ Filed within 15 days	▪ Suspicious transactions (or group of transactions) equaling or EXCEEDING $5,000 ▪ Filed within 30 days

Customer Identification Program (CIP)

Required Identifying Information	To satisfy CIP, the following information must be obtained: ▪ Name ▪ Legal address (residence or business) • For military personnel, an APO or FPO ▪ Date of birth ▪ Identification number (which may be different for U.S. persons compared to non-U.S. persons) ▪ Firm verifies information and maintains records
Identification Number for U.S. Persons	▪ Taxpayer ID or ▪ Social Security number

Identification Number for Non-U.S. Persons	▪ One or more of the following:
	  • Taxpayer ID
	  • Passport number
	  • Alien ID Card number
	  • Any other government-issued document establishing nationality, residence and identity (photograph)

Office of Foreign Assets Control (OFAC)	▪ An OFAC list is maintained to identify the names of terrorists and/or criminals ▪ Referred to as Specially Designated Nationals (SDNs) ▪ If a client's name appears on the OFAC List, transactions are blocked and law enforcement is notified

Discretionary Accounts

If a client is to authorize another person to make investment decisions in her account or deposit and/or withdraw funds, the following forms/steps are required:

- An authorization form signed by the client and the person granted authorization (Power of Attorney)
  - ROP or Sales Supervisor must approve the account in writing prior to its opening
  - Acceptance reviewed by a specific ROP, known as a Designated Option Principal (DROP)
  - If an option program is being used, the client must receive a written description
  - Activity must be monitored for potential churning
  - Discretionary authority on general securities account doesn't carry over to options (i.e., a separate Power of Attorney is needed)

Once Trading commences:
- Computerized surveillance tool overrides daily approval
- Tickets must be marked "discretionary" by RR

Application Question

Which of the following statements is/are TRUE about discretionary accounts?

I. If a customer indicates the option, number of contracts, and whether to buy or sell it's not considered a discretionary order.

II. Trading in a discretionary account cannot be subject to churning violations.

III. Orders must be approved by a ROP by the end of the day.

IV. Orders must be approved by a BOM by the end of the day.

Account Suitability

Key factors in evaluating the suitability include whether the client:

- Understands the strategies
- Can evaluate profit and loss potential
- Is able to assume the risk and meet potential margin calls

Supervisors may choose to limit type of activity based on client profile and level of trading

If ODD is revised, the amendment, but not the entire document, must be sent to clients by no later than confirmation of the next option trade

Re-evaluation of account is required if client wants to assume greater risk (e.g., selling uncovered options)

Protective puts and covered calls are suitable in an IRA

Levels of Trading

Trading levels are essentially how firms control the level of risk to which they and their customers are exposed

For example:

Level	Option Activity Allowed
4	Uncovered Options, Short Straddles, Short Combinations, Uncovered Ratio Spreads
3	Spreads
2	Long Calls, Long Puts, Long Straddles, Long Combinations
1	Covered Calls, Protective Puts

Application Question

A client is long 500 shares of ABC and short 5 ABC Nov 50 calls. The client is approved for writing covered calls only. What's the supervisory concern if the client enters an order to sell 300 shares of her ABC stock?

____

____

Disclosure for Uncovered Writers

Clients must receive a Special Disclosure Document which addresses:

- Description of risk:
  - Uncovered call writing has unlimited risk
  - Uncovered put writing has substantial risk
- No assurance of a secondary market
- Initial and maintenance margin requirements
- Difference in exercise styles
  - American: Holders may exercise at any time up to the expiration date (used for equity options)
  - European: Holders may only exercise on the business day of expiration (used for non-equity options)

How to Cover Short Positions

If an investor writes a call option, he has created an **obligation to SELL**.
How could the call be covered? ▪ Own or buy the underlying stock ▪ Own or buy securities convertible into the underlying stock ▪ Present an escrow receipt for the stock ▪ Long call option with the same or lower strike (i.e., a debit spread)

If an investor writes a put option, she has created an **obligation to BUY**.
How could the put be covered? ▪ Deliver cash equal to the strike price ▪ Maintain a short position in the underlying stock ▪ A bank guarantee letter for cash equal to the strike price ▪ Long put with the same or higher strike price (i.e., a debit spread)

Consider account type for covered (cash or margin) and uncovered (margin only) strategies

Application Question

Which of the following positions will cover 3 short ABC February 50 call options in a cash account?

A. Being long 3 February 60 call options
B. Providing an escrow receipt for 300 shares of ABC common stock
C. Being long 3 ABC convertible bonds, which can be converted into 20 shares of ABC common stock
D. Being long 300 shares of ABC preferred stock

Definitions of Communications

Correspondence	Retail Communication	Institutional Communication
▪ Written or electronic communication that a member firm distributes or makes available to <u>25 or fewer</u> *retail investors* (prospective or existing) within any 30-calendar-day period • Subject to review and supervision	▪ Written or electronic communication that a member firm distributes or makes available to <u>more than 25</u> *retail investors* within any 30-calendar-day period • Often subject to preapproval and filing	▪ Written or electronic communication that a member firm distributes or makes available *only to institutional investors* (NOT to any retail investors) • Subject to review and supervision

Social Media

Interactive Content	Supervision of Interactive Content
▪ Refers to content which is posted or disseminated for direct, real-time interaction (e.g., chatting or messaging) Any posting or dissemination of content to an interactive social networking site, which may be defined as advertising, is supervised in a manner that's similar to correspondence (i.e., it must be reviewed and supervised, but not preapproved) Static content posted for an extended period is not interactive, is considered retail communication, and may be subject to pre-approval	▪ A principal must approve any social media site an RR intends to use for business communications (not sites for strictly personal use) ▪ Social media cannot be used if it automatically deletes and erases content ▪ Records must be maintained for any business communication, including those made through personal devices ▪ Suitability rules apply to recommendations made through social media, and recommendations made by a RR must be pre-approved

Social Media and Third-Party Posts

Third-party posts to a broker-dealer's social media

- Generally not considered a retail communication, but subject to recordkeeping rules
- Will be considered a retail communication if the broker-dealer:
  - Is involved in the preparation of the content (entanglement)
  - Has explicitly or implicitly endorsed or approved the content (adoption)

Links to third-party websites

- Broker-dealers are prohibited from linking to third-party sites that contains false or misleading content
- In a personal communication, an RR can link or share content from the broker-dealer that doesn't relate to the firm's products or services
  - Not considered retail communication
  - For example, sharing a link to a charity event being sponsored by the firm

Testimonial concerns

- Unsolicited third-party opinions to a site that are used by an RR for business are not considered testimonials
- If the RR shares or likes the comments, they're subject to FINRA's rules and may be considered testimonials
- Broker-dealers must disclose if more than $100 is paid for a testimonial

General Approval and Filing Rules

An appropriately qualified registered principal must approve each retail communication before its use or before it's filed with FINRA – whichever comes first

With the exception of completed worksheets, all retail communications used prior to delivery of the ODD must be submitted to FINRA at least 10 calendar days prior to use

- If an annualized return is shown in a completed worksheet, a minimum 60-day experience is required

What's not required to be filed?

- Unaltered reprints, listing of services, telephone listings, retail communications on interactive forums

Application Question

A registered representative wants to distribute options-related marketing materials to all 56 of her existing retail clients. What are the regulatory requirements associated with this activity?

A. A branch office manager (BOM) must review and approve this communication.

B. A registered options principal (ROP) must preapprove this communication.

C. The communication must be filed with a Self-Regulatory Organization (SRO).

D. A branch office manager (BOM) can give verbal permission to the registered representative to use the communication.

Customer Complaint

Defined as a grievance that's delivered in any written form, including letters, e-mails, IMs, or text messages

- Complaints must be forwarded to a supervisor for review/investigation
- Complaint files (including copies) are maintained along with customer identification, description of the complaint, date received, name of the RR, and a report to indicate the action taken to resolve the complaint
- Records are retained for four years
- Quarterly reports are sent to FINRA (not the SEC) to provide statistical and summary complaint information

Order Tickets and Confirmations

TICKET	Information on an order ticket (created before trade)
	▪ Terms of the order (i.e., limit, stop) ▪ Discretionary, solicited or unsolicited ▪ Covered or Uncovered

CONFIRM	Information on a confirmation statement (created after trade)
	▪ Trade and settlement date ▪ Capacity of the broker-dealer • Agency or • Prinicipal

Information on BOTH	
▪ Call or put ▪ Buy or Sell ▪ Number of contracts ▪ Underlying stock	▪ Expiration month ▪ Strike price (but not the aggregate strike) ▪ Opening or closing trade

Activity – Tickets and Confirmations

1. Options confirmations must disclose all of the following, EXCEPT:
   A. Whether the order was discretionary, solicited, or unsolicited
   B. Whether the broker-dealer acted in an agency or principal capacity
   C. Number of contracts bought or sold

2. An option order ticket must indicate which of the following?
   A. The commission, mark-up or mark-down to the customer
   B. The trade and settlement date
   C. Whether it's an opening or closing transaction

Retention of Books and Records

Lifetime	Six Years	Three Years
Corporate and partnership documents	Blotters (records of original entry), ledgers, new account forms, powers of attorney, municipal complaints*	Order tickets, confirmations, statements, Forms U4 and U5, employee records, all forms of communication, trial balances

- Account statements must be sent quarterly; broker-dealer balance sheets are sent semi-annually
- For account transfers between broker-dealers, an electronic signature on the Automated Customer Account Transfer (ACAT) is an acceptable record

Handling Errors

Error Account

- Maintained by all B/Ds; used if the firm or an RR executes a trade in error (e.g., wrong security/quantity or wrong side of market)
- To place trades in the account, principal authorization is required

Clients may refuse trades if their *instructions were not followed* (e.g., failing to execute at the client's limit price or better OR buying more contracts than ordered)

- To correct the error, a principal must be consulted

B/Ds are not responsible for errors that are *caused by the client* (e.g., placing order for wrong stock or failing to cancel an order)

If a client receives an erroneous trade report, the *actual price is binding*

- For example: A client enters a buy limit order at $10. If the broker-dealer executes the order at $9.90, but reports it at $9.09, the actual execution of $9.90 must be accepted

Uneconomic Trade

Buy 1 QCOM June 35 call at $10.70
Sell 1 QCOM June 45 call at $0.80

The net debit of $9.90 (i.e., the maximum loss) is almost as big as the $10 difference in strike prices

This vertical spread doesn't make economic sense because the maximum gain is only $0.10
- $10 difference in strike prices – $9.90 net debit = $0.10 maximum gain

To identify an ***economic*** trade:
- Look for a ***debit*** spread with the ***smallest*** debit (i.e., maximum loss)
- Look for a ***credit*** spread with the ***largest*** credit (i.e., maximum gain)

Application Question

Which of the following is/are uneconomic?

I. Short 50 call and long 45 call with a net debit of $4.95
II. Long 50 call and short 40 call with a net credit of $8
III. Long 75 put and short 60 put with a net debit of $6
IV. Long 90 put and short 80 put with a net debit of $10

Insider Trading

Insider trading involves the purchase or sale of securities using material, non-public information about an issuer to make a profit or avoid a loss.

TIPPERS AND TIPPEES ▪ Refers to inside information passed from one party (tipper) to another (tippee) who then trades on that information ▪ If trading occurs, both parties are in violation	**PROCEDURES** Broker-dealers must have written policies designed to prevent insider trading. These must include: ▪ A system to prevent corporations from writing uncovered options on their own stock ▪ Corporate officers and directors are permitted to write options if the appropriate forms are filed with the SEC under Rule 144
INSIDER TRADING PENALTIES ▪ Civil – The SEC may demand disgorgement of profits and the payment of treble damages (three times the damage) ▪ Criminal – An individual may be subject to a maximum fine of $5 million, and/or up to 20 years in prison	**BOUNTIES** The SEC can award bounties of up to 30% of the penalty for information leading to those responsible for the violation.

Chapter 7 – Execution of Orders and Exchange Trading

Key Topics

1	2	3
ORDERS	MARKET PARTICIPANTS	FLOOR ACTIVITIES
A brief introduction into the different types of orders.	Learn about the firms and persons who process trades on an options exchange.	A brief introduction into fast markets, trading rotations, trading halts, cabinet trading, and the opening process.

Order Types

Market Order	Limit Order	Stop Order
▪ Broker-dealer executes at the best price available	▪ Buy at limit price or lower ▪ Sell at limit price or higher	▪ Sell if the price falls to or below the stop price ▪ Buy if the price rises to or above the stop price

Order Types

Not Held (NH)	▪ An order which gives a floor broker discretion over the time and/or the price of execution for one day (doesn't require power of attorney) ▪ Customer must specify action (i.e., buy or sell), amount (i.e., number of contracts), and asset (i.e., type, class, and series) ▪ If the floor broker doesn't believe the trade should be made, it cannot be held responsible for not executing it
All-or-None (AON)	▪ An order which is either executed in its entirety or not at all ▪ Partial fills are not acceptable
Immediate-or-Cancel (IOC)	▪ An order which needs to be executed as soon as it's entered; however, **partial fills are acceptable**
Fill-or-Kill (FOK)	▪ An order which needs to be executed as soon as it's entered (like a FOK order); however, **partial fills are not acceptable** (like an AON order)

Application Question

A customer enters a fill-or-kill (FOK) to buy 100 contracts. If a floor broker is only able to buy 60 contracts, he will:

A. Buy 60 contracts and attempt to buy the remainder later in the day
B. Cancel the entire order
C. Buy 60 contracts and cancel the remainder of the order
D. Buy 60 and enter a GTC order for the remainder of the order

Dealer-to-Dealer Markets

Designated Primary Market Maker	A member of the Chicago Board Options Exchange (CBOE) that provides liquidity for a particular class of options ▪ Acts as a dealer-specialist trading for its proprietary account ▪ Obligated to maintain a fair and orderly market ▪ Must post a firm quote for at least one contract on either side of the market (i.e., firm quote rule)
Floor Broker	▪ A member of the options exchange that accepts and executes orders for its clients and other members ▪ If it accepts public orders, it must be registered with FINRA
Professional Customer	▪ Any person or entity that's not a broker-dealer ▪ On average, places more than 390 orders per day in listed options during a calendar month • The orders only need to be entered, but not executed ▪ Professional customer orders have different execution rules than public orders (e.g., public limit orders are given priority over non-public orders at the same price)

Floor Activities

Fast Market	**Trading Rotations**	**Non-Regulatory Halts**	**Cabinet Trading**
Officials may declare a "fast" market for unusual activity. In a fast market, officials can: ▪ Assign contracts to another post ▪ Authorize clerks to execute trades ▪ Institute trading rotations ▪ Suspend firm quote rule	Opens trading each business day or during fast markets Provides for sequential quoting of series: 1. XYZ Jan 50 calls 2. XYZ Jan 55 calls 3. XYZ Jan 60 calls 4. Then another rotation for the next expiration	Once notified by the primary market that an individual equity has been halted, two Floor Officials must be in agreement before a halt in trading for the options on the halted equity can be imposed.	Accommodation for offsetting near worthless positions ▪ Opening and closing trades for $1.00 per contract ▪ Typically done for tax reasons ▪ Requires reconciliation on the trade date

Hybrid Opening System (HOSS)

HOSS is the CBOE's automated auction system for initiating trading at the beginning of each trading day

The system allows buyers and sellers to enter orders in the pre-market
- However, Immediate-or-Cancel (IOC) and Fill-or-Kill (FOK) orders are not permitted during the pre-market period

Before the market opens, HOSS will disseminate Expected Opening Information (EOI)
- EOI includes the expected opening price and size

HOSS messages:
- Need More Buyers – If there are more sellers than buyers (i.e., imbalance)
- Need More Sellers – If there are more buyers than sellers (i.e., imbalance)
- Need Quote to Open – If there aren't enough quotes or the bid/offer is too wide to open under exchange rules

Checklist for Success

- Review the Study Manual
- Review your On-Demand Learning Guide
- Complete all practice exams and check *My Scores* for diagnostics
- Don't memorize questions…learn the material
- Review latest version of Crunch Time Facts and Trending Topics
- Instructor Hotline: 1-800-782-3926

Answer Key

CHAPTER 1:

Page 4 – Activity

	Premium	=	Intrinsic Value	+	Time Value
1.	4	=	2.50	+	1.50
2.	3.25	=	0	+	3.25
3.	2.75	=	0	+	2.75
4.	5.80	=	3.50	+	2.30

Page 9 – Application Question

II, III, and IV

CHAPTER 2:

Page 11 – Activity

1. Strategy = Bullish; B/E = 47;
   Max. Gain = Unlimited; Max. Loss = $200
2. Strategy = Bearish; B/E = 73.50;
   Max. Gain = $350; Max. Loss = Unlimited
3. Strategy = Bearish; B/E = 26;
   Max. Gain = $2,600; Max. Loss = $400
4. Strategy = Bullish; B/E = 53.75;
   Max. Gain = $125; Max. Loss = $5,375

Page 13 – Activity

1. C
2. B
3. B
4. D
5. A
6. A

Page 13 – Activity

1. A
2. C
3. B
4. A
5. A
6. D

CHAPTER 3:

Page 16 – Activity

1. BE Points 68 and 57
2. $450 gain
3. C

Page 17 – Activity

Position 1:
1. Debit 2. Widen 3. BE = 82 4. Bullish

Position 2:
1. Credit 2. Narrow 3. BE = 87 4. Bullish

Position 3:
1. Debit 2. Widen 3. BE = 74 4. Bearish

Page 17 – Activity

Position 1:
1. MG = $400 net premium 2. ML = $600

Position 2:
1. MG = $700 2. ML = $300 net premium

Position 3:
1. MG = $200 net premium 2. ML = $300

Page 18 – Activity

Position 1:
1. D 2. B 3. C 4. A

Position 2:
1. C 2. A 3. B 4. D

Page 20 – Activity

True
True
False
True

CHAPTER 4:

Page 22 – Activity

1. D
2. B

Page 23 – Application Question

D

Page 24 – Activity

1. B
2. D

CHAPTER 5:

Page 28 – Activity

C

CHAPTER 6:

Page 32 – Application Question
B

Page 33 – Application Question
I and III

Page 34 – Application Question
The client is trading outside of her approved level. Since selling the stock creates an uncovered call position, the client may also need to open a margin account.

Page 35 – Application Question
B

Page 36 – Application Question
B

Page 37 – Activity
1. A
2. C

Page 38 – Application Question
I and IV

CHAPTER 7:

Page 40 – Application Question
B