NATIONAL FUTURES ASSOCIATION

Buying Options on Futures Contracts

A Guide to Uses and Risks

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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 ensure futures industry integrity, protect market participants and help NFA Members meet their regulatory responsibilities.

This booklet has been prepared as a part of NFA's continuing public education efforts to provide information about the futures industry to potential investors.

Disclaimer: This brochure only discusses the most common type of commodity options traded in the U.S.—options on futures contracts traded on a regulated exchange and exercisable at any time before they expire. If you are considering trading options on the underlying commodity itself or options that can only be exercised at or near their expiration date, ask your broker for more information.

Introduction

Although futures contracts have been traded on U.S. exchanges since 1865, options on futures contracts were not introduced until 1982. Initially offered as part of a government pilot program, their success eventually led to widespread use of options on agricultural as well as financial futures contracts.

Options on futures contracts can offer a wide and diverse range of potentially attractive investment opportunities. However, options trading is a speculative investment and should be treated as such. Even though the purchase of options on futures contracts involves a limited risk (losses are limited to the costs of purchasing the option), it is nonetheless possible to lose your entire investment in a short period of time. And for investors who sell rather than buy options, there is no limit at all to the size of potential losses.

This booklet is designed to provide you with a basic understanding of options on futures contracts—what they are, how they work and the opportunities (and risks) involved in trading them.

The booklet consists of four parts:

Part One: The Vocabulary of Options Trading. Options investing has its own language—words or terms you may be unfamiliar with or that have a special meaning when used in connection with options.

Part Two: The Arithmetic of Option Premiums. This section describes the major factors that influence option price movements and the all-important relationship between option prices and futures prices.

Part Three: The Mechanics of Buying and Writing Options. This section outlines the basic steps involved in buying and writing options, as well as the risks involved.

Part Four: A Pre-Investment Checklist. This section lists additional steps you should take before deciding whether to trade options on futures.

Part One: The Vocabulary of Options Trading

These are some of the major terms you should become familiar with, starting with what is meant by an "option."

Option An investment vehicle which gives the option buyer the right—but not the obligation—to buy or sell a particular futures contract at a stated price at any time prior to a specified date. There are two separate and distinct types of options: calls and puts.

Call A call option conveys to the option buyer the right to purchase a particular futures contract at a stated price at any time during the life of the option.

Put A put option conveys to the option buyer the right to sell a particular futures contract at a stated price at any time during the life of the option.

Strike Price Also known as the "exercise price," this is the stated price at which the buyer of a call has the right to purchase a specific futures contract or at which the buyer of a put has the right to sell a specific futures contract.

Underlying Contract This is the specific futures contract that the option conveys the right to buy (in the case of a call) or sell (in the case of a put).

Option Buyer The option buyer is the person who acquires the rights conveyed by the option: the right to purchase the underlying futures contract if the option is a call or the right to sell the underlying futures contract if the option is a put.

Option Seller (Writer) The option seller (also known as the option writer or option grantor) is the party that conveys the option rights to the option buyer.

Premium The "price" an option buyer pays and an option writer receives is known as the premium. Premiums are arrived at through open competition between buyers and sellers according to the rules of the exchange where the options are traded. A basic knowledge of the factors that influence option premiums is important for anyone considering options trading. The premium cost can significantly affect whether you realize a profit or incur a loss. See "The Arithmetic of Option Premiums" on page 10.

Expiration This is the last day on which an option can be either exercised or offset. See definition of "Offset" on page 8. Be certain you know the exact expiration date of any option you have purchased or written. Options often expire during the month prior to the delivery month of the underlying futures contract. Once an option has expired, it no longer conveys any rights. It cannot be either exercised or offset. In effect, the option rights cease to exist.

Quotations Premiums for exchange-traded options are reported daily in the business pages of most major newspapers, as well as by a number of internet services. With an understanding of terms previously defined—call, put, strike price and expiration month—it is easy to determine the premium for a particular option. Take a look at the following quotation for gold options:

Gold (100 troy ounces; $ per troy ounce)

Strike	Calls-Settle			Puts-Settle		
Price	Jan	Feb	Apr	Jan	Feb	Apr
285	10.50	10.70	14.80	.20	1.00	2.50
290	5.70	1.20	11.40	.30	1.80	4.10
295	1.60	4.30	7.90	1.10	3.80	5.70
300	.40	2.00	5.40	4.90	6.50	8.30
305	.20	1.20	3.80	9.60	10.60	11.30
310	.10	.60	2.60	14.50	15.10	15.00

Est. Vol.: 4,400 Mn 2,687 calls 5,636 puts
Op Int Mon: 273,658 calls 121,133 puts

The premium for a February gold call option with a strike price of $295 an ounce is $4.30 an ounce. Therefore, for the 100 ounce option, the option buyer would pay a premium of $430 and the option writer would receive a premium of $430.

Exercise An option can be exercised only by the buyer (holder) of the option at any time up to the expiration date.

If and when a call is exercised, the option buyer will acquire a long position in the underlying futures contract at the option exercise price. The writer of the call to whom the notice of exercise is assigned will acquire a short position in the underlying futures contract at the option exercise price.

If and when a put is exercised, the option buyer will acquire a short position in the underlying futures contract at the option exercise price. The writer of the put to whom the notice of exercise is assigned will acquire a long position in the underlying futures contract at the option exercise price.

Offset An option that has been previously purchased or previously written can generally be liquidated (offset) at any time prior to expiration by making an offsetting sale or purchase.

Most options investors choose to realize their profits or limit their losses through an offsetting sale or purchase. When an option is liquidated, no position is acquired in the underlying futures contract.

In-the-money An option is said to be "in the money" if it is worthwhile to exercise. A call option is in-the-money if the option exercise price is below the underlying futures price. A put option is in-the-money if the option exercise price is above the underlying futures price.

Example: The current market price of a particular gold futures contract is $300 an ounce. A call is in-the-money if its exercise price is less than $300. A put is in-the-money if its exercise price is more than $300.

The amount that an option is currently in-the-money is referred to as the option's intrinsic value.

At-the-money An option is said to be "at-the-money" if the underlying futures price and the option's exercise price are the same.

Out-of-the-money A call option whose exercise price is above the underlying futures price is said to be "out-of-the-money." Similarly, a put option is "out-of-the-money" if its exercise price is below the underlying futures price. Neither option is currently worthwhile to exercise, and has no intrinsic value.

Part Two: The Arithmetic of Option Premiums

At the time you purchase a particular option, its premium cost may be $1,000. A month or so later, the same option may be worth only $800 or $700 or $600. Or it could be worth $1,200 or $1,300 or $1,400. Since an option is something that most people buy with the intention of eventually liquidating (hopefully at a higher price), it's important to have at least a basic understanding of the major factors which influence the premium for a particular option at a particular time. There are two, known as intrinsic value and time value. The premium is the sum of these.

Premium = Intrinsic Value + Time Value

Intrinsic Value

Intrinsic value is the amount of money, if any, that could currently be realized by exercising the option at its strike price and liquidating the acquired futures position at the present price of the futures contract.

At a time when a U.S. Treasury bond futures contract is trading at a price of 120-00, a call option conveying the right to purchase the futures contract at a below-the-market strike price of 115-00 would have an intrinsic value of $5,000.

As discussed on page 8, an option that currently has intrinsic value is said to be "in-the-money" (by the amount of its intrinsic value). An option that does not currently have intrinsic value is said to be "out-of-the-money."

At a time when a U.S. Treasury bond futures contract is trading at 120-00, a call option with a strike price of 123-00 would be "out-of-the-money" by $3,000.

Time Value

Options also have time value. In fact, if a given option has no intrinsic value—because it is

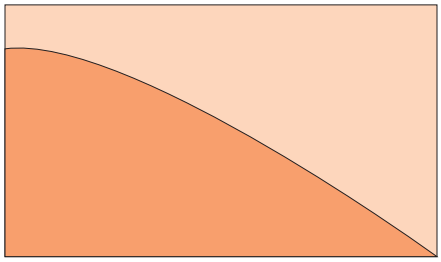
currently "out-of-the-money"—its premium will consist entirely of time value.

What's "time value?"

It's the sum of money option buyers are presently willing to pay (and option sellers are willing to accept)—over and above any intrinsic value the option may have—for the specific rights that a given option conveys. It reflects, in effect, a consensus opinion as to the likelihood of the option's increasing in value prior to its expiration.

The three principal factors that affect an option's time value are:

1. Time remaining until expiration. Time value declines as the option approaches expiration. At expiration, it will no longer have any time value. (This is why an option is said to be a wasting asset.)



2. Relationship between the option strike price and the current price of the underlying futures contract. The further an option is removed from being worthwhile to exercise—the further "out-of-the-money" it is—the less time value it is likely to have.

3. Volatility. The more volatile a market is, the more likely it is that a price change may eventually make the option worthwhile to exercise. Thus, the option's time value and therefore premium are generally higher in volatile markets.

Commission Charges

Before you decide to buy and/or write (sell) options, you should understand the other costs involved in the transaction—commissions and fees. Commission is the amount of money, per option purchased or written, that is paid to the brokerage firm for its services, including the execution of the order on the trading floor of the exchange. The commission charge increases the cost of purchasing an option and reduces the sum of money received from writing an option. In both cases, the premium and the commission should be stated separately.

Each firm is free to set its own commission charges, but the charges must be fully disclosed in a manner that is not misleading. In considering an option investment, you should be aware that:

• Commission can be charged on a per-trade or a round-turn basis, covering both the purchase and sale.

• Commission charges can differ significantly from one brokerage firm to another.

• Some firms have fixed commission charges (so much per option transaction) and others charge a percentage of the option premium, usually subject to a certain minimum charge.

• Commission charges based on a percentage of the premium can be substantial, particularly if the option is one that has a high premium.

• Commission charges can have a major impact on your chances of making a profit. A high commission charge reduces your potential profit and increases your potential loss.

You should fully understand what a firm's commission charges will be and how they're

calculated. If the charges seem high—either on a dollar basis or as a percentage of the option premium—you might want to seek comparison quotes from one or two other firms. If a firm seeks to justify an unusually high commission charge on the basis of its services or performance record, you might want to ask for a detailed explanation or documentation in writing.

Leverage

Another concept you need to understand concerning options trading is the concept of leverage. The premium paid for an option is only a small percentage of the value of the assets covered by the underlying futures contract. Therefore, even a small change in the futures contract price can result in a much larger percentage profit—or a much larger precentage loss—in relation to the premium. Consider the following example:

An investor pays $200 for a 100-ounce gold call option with a strike price of $300 an ounce at a time when the gold futures price is $300 an ounce. If, at expiration, the futures price has risen to $303 (an increase of only one percent), the option value will increase by $300 (a gain of 150 percent on your original investment of $200).

But always remember that leverage is a two-edged sword. In the above example, unless the futures price at expiration had been above the option's $300 strike price, the option would have expired worthless, and the investor would have lost 100 percent of his investment plus any commissions and fees.

The First Step: Calculate the Break-Even Price

Before purchasing any option, it's essential to precisely determine what the underlying futures price must be in order for the option to be profitable at expiration. The calculation isn't difficult. All you need to know to figure a given option's break-even price is the following:

- The option's strike price;
- The premium cost; and
- Commission and other transaction costs.

Determining the break-even price for a call option

Option strike price	+	Option premium	+	Commission & transaction costs	=	Break-even price

Example: It's January and the 1,000 barrel April crude oil futures contract is currently trading at around $12.50 a barrel. Expecting a potential significant increase in the futures price over the next several months, you decide to buy an April crude oil call option with a strike price of $13. Assume the premium for the option is 95¢ a barrel and that the commission and other transaction costs are $50, which amounts to 5¢ a barrel.

Before investing, you need to know how much the April crude oil futures price must increase by expiration in order for the option to break even or yield a net profit after expenses. The answer is that the futures price must increase to $14 for you to break even and to above $14 for you to realize any profit.

Option strike price	+	Premium	+	Commission & transaction costs	=	Break-even price
$13.00	+	95¢	+	5¢	=	$14.00

The option will exactly break even if the April crude oil futures price at expiration is $14 a barrel. For each $1 a barrel the price is above $14, the option will yield a profit of $1,000.

If the futures price at expiration is $14 or less, there will be a loss. But in no event can the loss exceed the $1,000 total of the premium, commission and transaction costs.

Determining the break-even price for a put option

The arithmetic is the same as for a call option except that instead of adding the premium,

commission and transaction costs to the strike price, you subtract them.

Option strike price	–	Option premium	–	Commission & transaction costs	=	Break-even price

Example: The price of gold is currently about $300 an ounce, but during the next few months you think there may be a sharp decline. To profit from the price decrease if you are right, you consider buying a put option with a strike price of $295 an ounce. The option would give you the right to sell a specified gold futures contract at $295 an ounce at any time prior to the expiration of the option.

Assume the premium for the put option is $3.70 an ounce ($370 in total) and the commission and transaction costs are $50 (equal to 50¢ an ounce).

For the option to break even at expiration, the futures price must decline to $290.80 an ounce or lower.

Option strike price	–	Premium	–	Commission & transaction costs	=	Break-even price
$295	–	$3.70	–	50¢	=	$290.80

The option will exactly break even at expiration if the futures price is $290.80 an ounce. For each $1 an ounce the futures price is below $290.80 it will yield a profit of $100.

If the futures price at expiration is above $290.80, there will be a loss. But in no case can the loss exceed $420—the sum of the premium ($370) plus commission and other transaction costs ($50).

Factors Affecting the Choice of an Option

If you expect a price increase, you'll want to consider the purchase of a call option. If you expect a price decline, you'll want to consider the purchase of a put option. However, in

addition to price expectations, there are two other factors that affect the choice of option:

- The length of the option; and
- The option strike price

The length of the option

One of the attractive features of options is that they allow time for your price expectations to be realized. The more time you allow, the greater the likelihood the option will eventually become profitable. This could influence your decision about whether to buy, for example, an option on a March futures concontract or an option on a June futures contract.

Bear in mind that the length of an option (such as whether it has three months to expiration or six months) is an important variable affecting the cost of the option. A longer option commands a higher premium.

The option strike price

The relationship between the strike price of an option and the current price of the underlying futures contract is, along with the length of the option, a major factor affecting the option premium. At any given time, there may be trading in options with a half dozen or more strike prices—some of them below the current price of the underlying futures contract and some of them above.

A call option with a low strike price will have a higher premium cost than a call option with a high strike price because it will more likely and more quickly become worthwhile to exercise. For example, the right to buy a crude oil futures contract at $11 a barrel is more valuable than the right to buy a crude oil futures contract at $12 a barrel.

Conversely, a put option with a high exercise price will have a higher premium cost than a put option with a low exercise price. For example, the right to sell a crude oil futures contract at $12 a barrel is more valuable than the

right to sell a crude oil futures contract at $11 a barrel.

While the choice of a call option or put option will be dictated by your price expectations, and your choice of expiration month by when you look for the expected price change to occur, the choice of strike price is somewhat more complex. That's because the strike price will influence not only the option's premium cost but also how the value of the option, once purchased, is likely to respond to subsequent changes in the underlying futures contract price. Specifically, options that are out-of-the-money do not normally respond to changes in the underlying futures price the same as options that are at-the-money or in-the-money.

Generally speaking, premiums for out-of-the-money options do not reflect, on a dollar for dollar basis, changes in the underlying futures price. The change in option value is usually less. Indeed, a change in the underlying futures price could have little effect, or even no effect at all, on the value of the option. This could be the case if, for instance, the option remains deeply out-of-the-money after the price change or if expiration is near.

If you purchase an out-of-the-money option, bear in mind that no matter how much the futures price moves in your favor, the option will still expire worthless, and you will lose your entire investment unless the option is in-the-money at the time of expiration. To realize a profit, it must be in-the-money by some amount greater than the option's purchase costs. This is why it's crucial to calculate an option's break-even price *before* you buy it.

Example: At a time when the March crude oil futures price is $11 a barrel, an investor expecting a substantial price increase buys a March call option with a strike price of $12.50. By expiration, as expected, there has

been a substantial price increase to $12.50. But since the option is still not worthwhile to exercise, it expires worthless and the investor has lost his total investment.

After You Buy an Option, What Then?

At any time prior to the expiration of an option, you can:

- Offset the option.
- Continue to hold the option.
- Exercise the option.

Offsetting the option

Liquidating an option in the same marketplace where it was bought is the most frequent method of realizing option profits. Liquidating an option prior to its expiration for whatever value it may still have is also a way to reduce your loss (by recovering a portion of your investment) in case the futures price hasn't performed as you expected it would, or if the price outlook has changed.

In active markets, there are usually other investors who are willing to pay for the rights your option conveys. How much they are willing to pay (it may be more or less than you paid) will depend on (1) the current futures price in relation to the option's strike price, (2) the length of time still remaining until expiration of the option and (3) market volatility.

Net profit or loss, after allowance for commission charges and other transaction costs, will be the difference between the premium you paid to buy the option and the premium you receive when you liquidate the option.

Example: In anticipation of rising sugar prices, you bought a call option on a sugar futures contract. The premium cost was $950 and the commission and transaction costs were $50. Sugar prices have subsequently risen and the option now commands a premium of $1,250. By liquidating the option at this price, your net gain is $250. That's the selling price of $1,250 minus the $950 premium paid for the

option minus $50 in commission and transaction costs.

Premium paid for option	$ 950
Premium received when option is liquidated	$ 1,250
Increase in premium	$ 300
Less transaction costs	$ 50
Net profit	$ 250

You should be aware, however, that there is no guarantee that there will actually be an active market for the option at the time you decide you want to liquidate. If an option is too far removed from being worthwhile to exercise or if there is too little time remaining until expiration, there may not be a market for the option at any price.

Assuming, though, that there's still an active market, the price you get when you liquidate will depend on the option's premium at that time. Premiums are arrived at through open competition between buyers and sellers according to the rules of an exchange.

Continuing to hold the option

The second alternative you have after you buy an option is to hold an option right up to the final date for exercising or liquidating it. This means that even if the price change you've anticipated doesn't occur as soon as you expected—or even if the price initially moves in the opposite direction—you can continue to hold the option if you still believe the market will prove you right. If you are wrong, you will have lost the opportunity to limit your losses through offset. On the other hand, the most you can lose by continuing to hold the option is the sum of the premium and transaction costs. This is why it is sometimes said that option buyers have the advantage of staying power. You should be aware, however, options decline in value as they approach expiration. (See "Time Value" on page 10.)

Exercising the option

You can also exercise the option at any time prior to the expiration of the option. It does not have to be held until expiration. It is essential to understand, however, that exercising an option on a futures contract means that you will acquire either a long or short position in the underlying futures contract—a long futures position if you exercise a call and a short futures position if you exercise a put.

Example: You've bought a call option with a strike price of 70¢ a pound on a 40,000 pound live cattle futures contract.The futures price has risen to 75¢ a pound. Were you to exercise the option, you would acquire a long cattle futures position at 70¢ with a "paper gain" of 5¢ a pound ($2,000). And if the futures price were to continue to climb, so would your gain.

But there are both costs and significant risks involved in acquiring a position in the futures market. For one thing, the broker will require a margin deposit to provide protection against possible fluctuations in the futures price. And if the futures price moves adversely to your position, you could be called upon—perhaps even within hours—to make additional margin deposits. There is no upper limit to the extent of these margin calls.

Secondly, unlike an option which has limited risk, a futures position has potentially unlimited risk. The further the futures price moves against your position, the larger your loss.

Even if you were to exercise an option with the intention of promptly liquidating the futures position acquired through exercise, there's the risk that the futures price which existed at the moment may no longer be available by the time you are able to liquidate the futures position. Futures prices can and often do change rapidly.

For all these reasons, only a small percentage of option buyers elect to realize option trading profits by exercising an option. Most choose the alternative of having the broker offset—i.e., liquidate—the option at its currently quoted premium value.

Who Writes Options and Why

Up to now, this booklet has discussed only the buying of options. But it stands to reason that when someone buys an option, someone else sells it. In any given transaction, the seller may be someone who previously bought an option and is now liquidating it. Or the seller may be an individual who is participating in the type of investment activity known as option writing.

The attraction of option writing to some investors is the opportunity to receive the premium that the option buyer pays. An option buyer anticipates that a change in the option's underlying futures price at some point in time prior to expiration will make the option worthwhile to exercise. An option writer, on the other hand, anticipates that such a price change won't occur—in which event the option will expire worthless and he will retain the entire amount of the option premium that was received for writing the option.

Example: At a time when the March U.S. Treasury Bond futures price is 125-00, an investor expecting stable or lower futures prices (meaning stable or higher interest rates) earns a premium of $400 by writing a call option with a strike price of 129. If the futures price at expiration is below 129-00, the call will expire worthless and the option writer will retain the entire $400 premium. His profit will be that amount less the transaction costs.

While option writing can be a profitable activity, it is also an extremely high risk activity. In fact, an option writer has an unlimited risk. Except for the premium received for writing the option, the writer of an option stands to lose any amount the option is in-the-money at the

time of expiration (unless he has liquidated his option position in the meantime by making an offsetting purchase).

In the previous example, an investor earned a premium of $400 by writing a U.S. Treasury Bond call option with a strike price of 129. If, by expiration, the futures price has climbed above the option strike price by more than the $400 premium received, the investor will incur a loss. For instance, if the futures price at expiration has risen to 131-00, the loss will be $1,600. That's the $2,000 the option is in-the-money less the $400 premium received for writing the option.

As you can see from this example, option writers as well as option buyers need to calculate a break-even price. For the writer of a call, the break-even price is the option strike price plus the net premium received after transaction costs. For the writer of a put, the break-even price is the option strike price minus the premium received after transaction costs.

An option writer's potential profit is limited to the amount of the premium less transaction costs. The option writer's potential losses are unlimited. And an option writer may need to deposit funds necessary to cover losses as often as daily.

Risk Caution

Option writing as an investment is absolutely inappropriate for anyone who does not fully understand the nature and the extent of the risks involved and who cannot afford the possibility of a potentially unlimited loss. It is also possible in a market where prices are changing rapidly that an option writer may have no ability to control the extent of his losses. Option writers should be sure to read and thoroughly understand the *Risk Disclosure Statement* that is provided to them.

Part Four: A Pre-Investment Checklist

√ Take the time to check out any firm or individual that you don't know through previous experience or reputation. All firms and persons offering options on U. S. futures contracts are required by law to be registered with the Commodity Futures Trading Commission (CFTC) and to be Members of National Futures Association (NFA). You can do this quickly, easily and without cost by accessing NFA's Background Affiliation Status Information Center (BASIC), located at NFA's web site (www.nfa.futures.org). BASIC will provide you with the firm and/or individual's registration status as well as any disciplinary actions taken by NFA, the CFTC or any U.S. exchanges. This same information is also available by calling NFA toll-free at 800-621-3570.

√ Understand what a firm's commission charges will be and how they're calculated. If the charges seem high—either on a dollar basis or as a percentage of the option premium—you might want to seek comparison quotes from one or two other firms. If a firm seeks to justify an unusually high commission charge on the basis of its services or performance record, you might want to ask for a detailed explanation or documentation in writing.

√ Calculate exactly the break-even price for any option you are considering buying or writing. You should know the specific futures price above or below which the option, at expiration, will be profitable.

√ Read and fully understand the required *Risk Disclosure Statement* before making any commitment to purchase or write an option.

√ Learn enough about the commodity you would be investing in to have a reasonable expectation that the necessary price change will occur prior to the expiration of the option. Be

certain you understand the risks inherent in acquiring a futures position through the exercise of an option.

√ Don't purchase an option unless you understand that you could lose your entire investment. Don't write an option unless you understand that option writing involves potentially unlimited losses. And don't make any investment commitment unless the money you could potentially lose can legitimately be regarded as risk capital.

√ Don't make any investment on the basis of high-pressure sales tactics. Reputable firms don't operate that way. It's far better to miss out on an investment opportunity than to be rushed into a decision you may later regret. And don't make an investment that is presented to you as a sure thing. They don't exist!

√ Always seek the advice of other persons such as a knowledgeable financial advisor, attorney or accountant before making any major investment decision.

NFA Information and Resources

Information Center:
800.621.3570

World Wide Web:
http://www.nfa.futures.org
NFA's web site offers information regarding the Association's history and organizational structure. NFA Members also will find the current issues of the Member newsletter and Activity Report, Notices to Members and rule interpretations. 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 web site can ask questions, make comments and order publications via e-mail.

BASIC:
http://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 U.S. futures exchanges have supplied BASIC with information on CFTC registration, NFA membership, futures-related disciplinary history and non-disciplinary activities such as CFTC reparations and NFA arbitration.

Organizations and Agencies Referenced

Commodity Futures Trading Commission

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1155 21st Street, N.W.
Washington, DC 20581
202.418.5080
www.cftc.gov

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