



Perspectives

Exchange Traded Options

Richard A Bobb
Chartered Accountants



**BRINGING BUSINESS
TOGETHER**

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EDITORIAL



David Woo - Partner
Richard A Bobb
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In this edition of *Perspectives* we explore some of the issues relating to Australian Stock Exchange (ASX) exchange traded options (ETOs). This is a particular security that is in standard form and can be traded by buyers and sellers on the Australian Stock Exchange.

The characteristics of an ETO are not widely known and this issue of *Perspectives* hopes to provide readers with a better understanding of some of the characteristics of an ETO and the way that they can be deployed as part of an existing share portfolio or the establishment of a new share portfolio.

We also look at the Australian accounting and tax treatment of options. Moreover, we look at options traded on overseas exchanges. In this respect, we are fortunate to have an article written by Michael Gross and James Cordier of *Liberty Trading Group*. Their article is most insightful, since it replicates some of the strategies contained in the latest edition of their book [*The Complete Guide to Option Selling*](#) (McGraw-Hill 2009).

In today's turbulent times, in the aftermath of the *Global Financial Crisis*, savvy investors are looking at all of their options (no pun intended) in order to preserve and enhance their wealth.

David Woo
Editor

An Understanding of ASX Exchange Traded Options



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The Australian Stock Exchange (ASX) Exchange Traded Options (ETO) market has been operating since 1976. Since the market commenced operating, volumes have increased significantly¹.

There are now over 100 different companies and several indices to choose from. A list of companies and indices over which ETOs are traded can be found on the ASX website, www.asx.com.au/options (under Option Stocks in the "Trading Information" section).

This short article explains some basic concepts of options, how they work and what they can be used for. Most importantly, it should be noted ETOs over listed shares and indices, are not company issued options.

Option sellers are referred to as 'writers' because they underwrite (or willingly accept) the obligation to deliver or accept the shares covered by an option. Similarly, buyers are referred to as the 'takers' of an option as they take up the right to buy or sell a parcel of shares.

Every option contract has both a taker (buyer) and a writer (seller). ETOs can provide protection for a share portfolio, additional income or trading profits. Both the purchase and sale of options, however, involve risk. Transactions should only be entered into by investors who understand the nature and extent of their rights, obligations and risks

There are two types of options traded on ASX, call options and put options. *Call options* give the taker the right, but not the obligation, to buy the underlying shares, while put options give the taker the right, but not the obligation, to sell the underlying shares.

¹ In October 2008 the ASX issued a consultation paper on a recent review it conducted of ETO market in Australia. The ASX intends to phase in a range of changes designed to improve the standard and quality of market making and make product and other market adjustments that will provide a better environment for further growth in the ETO market in Australia.

There are four (4) components in a standard option contract. These can be summarised as:

1. The underlying securities.
2. The contract size.
3. Exercise price.
4. Expiry date.

As stated above, ETOs may be listed over the shares in a company listed on the ASX or over a share price index. The usual standard contract size involves 1,000 underlying securities. This will usually be the case unless there has been an adjustment to the terms of the contract (e.g. a share split, rights issue or a takeover or merger during the option period). In the case of index options the contract value is currently fixed at \$10.00 per index point. The exercise price is the price at which an investor either buys or sells the underlying securities if a party is exercised. Finally, the expiry date is the day on which all unexercised options in a particular series expire.

Options can be used for a variety of purposes depending on an investor's goals and risk tolerance. For example, some investors utilise put options to protect some part or all of their share portfolio, while others might use their share portfolio to generate additional income (over and above the dividends received by holding the underlying securities). In other cases, some sophisticated investors might generate income by writing options on the security of cash, bank guarantees or other acceptable collateral to the Australian Clearing House (a subsidiary of the ASX) rather than covering an obligation with specifically held shares.

All in all, ETOs can be a way of mitigating against "correlation risk". This is the risk that the correlation between two (2) asset classes will differ to what is expected. During the *Global Financial Crisis* ("GFC"), most asset classes (whether in Australia or outside) were completely synchronised in a downward spiral thus eroding substantial wealth that had been generated over time. Falls in the value of equities, property and the Australian dollar all seemed to be completely synchronised during this period of the GFC. Whilst this has changed, to some degree in the recent past, there can be no guarantee that there will be no repeat performance. Diversification, to mitigate correlation risk, through a judicious use of ETOs will be part of an investor's armoury when it comes to wealth protection.

Finally, there are some accounting and taxation issues which should also be considered and these are covered elsewhere.

Accounting for ASX Exchange Traded Options



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In 2005, Australia adopted the international accounting standards (IASs) which are collectively referred to as International Financial Reporting Standards (IFRSs) and are issued by the International Accounting Standards Board (IASB) based in the United Kingdom.

AABS 139 *Financial Instruments: Recognition and Measurement* is the primary Australian accounting standard that provides guidance on accounting for exchange traded options and is equivalent to IAS 39 *Financial Instruments: Recognition and Measurement* as issued by the IASB.

The first step in understanding the accounting treatment of exchange traded options is to understand that such options are defined as *derivatives* for the purposes of the accounting standards. Therefore, the accounting treatment applicable to exchange traded options follows the accounting treatment applicable to derivatives.

Generally speaking derivatives, such as exchange traded options, are recognised in the balance sheet when an entity becomes a party to a contract. At this time, the derivative is required to be measured and recorded in the balance sheet at fair value, which is normally the transaction price.

After the derivative is initially recognised and recorded at fair value, the standard requires that the derivative continue to be measured and recorded at fair value in the balance sheet and that any changes in the fair value from period to period to be taken to profit or loss. This requirement to 'mark to market' the exchange traded options can result in volatility in the financial statements.

The fair value at each balance sheet date is usually the quoted market price, which is ordinarily the current bid price. In instances where the market in which the option is traded becomes inactive, it would generally be more appropriate to use a valuation technique. When applying a valuation technique, it is important that the valuation model uses relevant observable inputs (such as a risk free rate) and minimises the use of unobservable inputs.

Furthermore, the technique should be consistent with accepted market pricing for exchange traded options.

Where exchange traded options form part of an overall hedge strategy, you may wish to apply hedge accounting in order to manage the volatility resulting from the mark to market requirements. However, in order to qualify for hedge accounting the stringent requirements outlined in the accounting standards need to be met. These requirements are in place to ensure consistent application of hedge accounting by all who chose to apply them.

Limited-risk option strategies

Trading options is about risk management.



James Ramsay
Bell Potter

Is volatility friend or foe? With market volatility hitting record highs we need to look at ways to capitalise on it and options are one way of doing so. As option traders know, volatility increases the price of option premiums and this is the time to focus on selling options and receiving high premiums.

Although certain option strategies have unlimited or unmanaged risk profiles, others offer known risk and known profit returns. As traders we need to first know how much we are risking before we enter a strategy. For this reason I will only focus on option strategies that have a known risk when opening the position.

The goal is to generate a monthly income by selling credit spreads each month. As the name suggests, a credit spread allows us to open an option spread for a credit. The first spread we will use is a bearish to neutral strategy called a bear call credit spread.

How it works

The bear call credit spread is a bearish to neutral strategy that takes advantage of time decay and decreases in volatility. The spread is opened for a credit and has a limited risk, limited profit profile.

It is constructed by using two call options with the same expiry month but different strike prices. The lower strike price is sold and the higher strike price is bought.

When to use it

Look to open spreads the day after option expiry. As our maximum profit is received at expiry we want to benefit from the time decay over the full month. By opening a spread on the day after expiry we can benefit from the full time value of the written option.

The strategy can be used in numerous situations but I will focus on opening the spread with a view to leaving it to run to expiry. We want to open the spread with at least an 80 per cent probability it will expire worthless. I use one of two ways to determine the probability of expiring worthless:

Method 1 - Using the delta of the option

If we look at a call option that is trading at the money (ATM) i.e. the strike price and share price is the same, it will have a delta of ~0.50

As we know, an ATM option at expiry can expire above or below the strike price. So the delta is saying we have a 50 per cent chance of being above the strike price and a 50 per cent chance of being below the strike price.

Now if we scroll down the list of tradeable call options we see options with a delta of 0.2. This is where we want to look to sell options. A delta of 0.2 it is saying we have an 80 per cent chance of the option expiring out of the money.

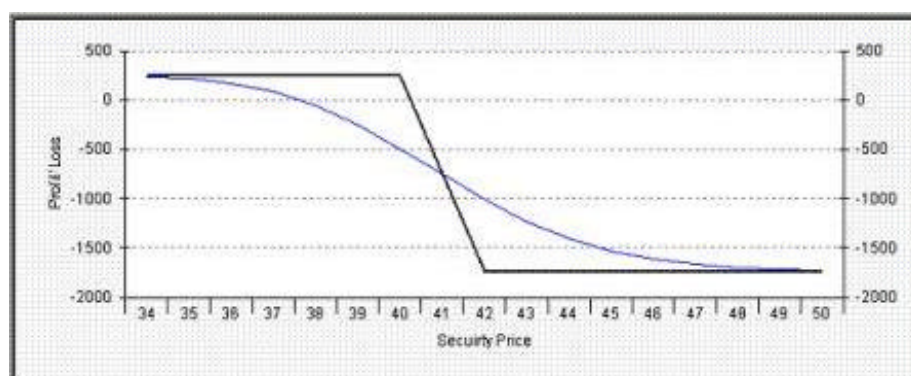
Method 2 - Using an options probability calculator

An options probability calculator allows you to enter the exact parameters of your option trade. Once your parameters are entered you can calculate the probability of the shares hitting or missing your strike price.

The results are based on the current underlying share price, days until expiry, your volatility estimate and your strike prices.

Pay-off diagram

The pay-off diagram below shows the risk reward of the Bear Call Credit Spread:



Source: OTrader Stock and Option Portfolio Management Software

This box below shows the key points of the strategy:

Construction Sell lower strike call option, buy higher strike call option. Both with the same expiry date.

Breakeven Lower strike price + credit received.

Maximum loss Difference between strike prices - credit received.

Maximum profit Initial credit received at expiry date

Time decay Time decay helps the spread. The maximum profit can only be realised at expiry. For this reason we look to open spreads the day after expiry to benefit from a full month of time value.

Volatility When the spread is opened we want to open it at a time of high volatility. Once opened a rise in volatility will hurt the spread while a decrease will help it.

Margins to be paid? Yes. As the spread is opened for a credit the position will be margined. The margins will be reduced though as we bought a higher strike price option as protection. Use the [ASX margin estimation tool](#) to determine your margin obligations.

Cons of the strategy

- The profit is limited to the credit received when opening the position.
- If a sold option strike price is penetrated you run the risk of being exercised.

Some points to remember

- The spread should be opened and closed as a spread.
- The maximum profit is only made at expiry.
- The maximum loss is known when opening the spread.
- The great thing about selling option credit spreads is the margin error it allows. Your analysis can be wrong to a certain extent but you can still end up in profit. You can win if the market moves in your favour, sideways, or even if it moves slightly against you.

About the author

If you do not have the time to analyse options, but would like exposure to them, feel free to call James Ramsay on 08 9326 7664 or email jramsay@bellpotter.com.au. James Ramsay is an advisor at Bell Potter with Level 1 and 2 Derivative Accreditation.

Pros of the strategy

- It is opened for a credit so your only outlay is margin obligations.
- The maximum risk is known when the spread is opened.
- The maximum profit is only made at expiry.

THE TAXATION OF PREMIUMS RECEIVED

(FROM WRITING ASX EXCHANGE TRADED OPTIONS OVER AUSTRALIAN LISTED EQUITIES)

By **Richard Bobb**

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1. Introduction
 - General issues
 - Scope of the paper
 - Derivation
2. What is an exchange traded option (“ETO”)?
3. What are option premiums?
4. What services does a writer of an ETO perform?
5. Is a writer carrying on a business?
6. Derivation of premium income
 - Div 16e
 - Income in advance
7. Special issues relating to non-resident taxpayers
8. Conclusion

1. INTRODUCTION

- General Issues

There is very little literature on the taxation aspects of quantifying assessable income when an option writer (particularly one carrying on a business) opens a sold position.

The concept of “derivation” is the cornerstone of the Australian tax system dealing with the assessment of income.

A glossary, at the end of this paper, sets out the meaning of all acronyms used on this paper.

- Scope of the Paper

This paper will only concentrate on assessable income. When a taxpayer is required to work out taxable income there is usually a calculation

requiring the determination of assessable income² in the first instance, and subtracting there-from allowable deductions to arrive at taxable income. Allowable deductions, which might otherwise be subtracted from assessable income, are outside the scope of this paper.

Also, other taxes, such as goods and services tax, stamp duty, capital gains tax etc. are, likewise, outside the scope of this paper.

Finally, the scope will not be extended to include the complex aspects of the new accruals regime to financial arrangements³, set out in Division 230 of ITAA97. Generally, individuals are excluded from the rules, as are other entities that meet certain thresholds; that is superannuation entities or MIS with less than \$100 million in assets, financial sector entities with less than \$20 million aggregated turnover or other entities with:

- aggregated turnover of less than \$100 million
- financial assets less than \$100 million, and
- total assets of less than \$300 million.

- Derivation

It will be assumed for the purposes of this paper that the hypothetical taxpayer, is operating a business in writing exchange traded options, such that the income derived there-from is on revenue account. Any relevant CGT events will not be relevant⁴.

Section 65 of the ITAA97 concisely states the assessable income of a resident taxpayer includes income according to ordinary concepts⁵ and if the taxpayer is a resident then the ordinary income will include income derived either directly or indirectly from all sources whether in or out of Australia during the income year. A non-resident of Australia is only required to include ordinary income derived either directly or indirectly from Australian sources during the income year.

Apart from income, according to ordinary concepts, there is also the notion of statutory income set out in Section 610 of ITAA97. Items of statutory income are provided for in Division 15 of ITAA97. For example, in Section 15-30 of ITAA97 the assessable income of a taxpayer will include

² Assessable income is made up of ordinary income and statutory income and excludes exempt income.

³ A “financial arrangement” for these purposes is defined as a cash settleable right to receive, or an obligation to provide, a financial benefit which exists under an arrangement. The right or obligation will be cash settleable where the financial benefit is money or a money equivalent.

⁴ Section 118-20 of ITAA97 excludes the double counting of capital gain when the same item gives rise to ordinary income under an assessing provision.

⁵ This means according to common law principles.

amounts received by way of insurance or indemnity for loss.

2. WHAT IS AN EXCHANGE TRADED OPTION (“ETO”)?

As this paper is devoted to ETOs, written over Australian equities listed on the ASX, it will be useful to note that, in this case, equity option contracts convey on holders the right, but not the obligation, to buy (in the case of a call) or sell (in the case of a put) shares of the underlying security at a specified price (the strike price) on or before a given date (expiration day). After this given date, the option ceases to exist. The writer of an option is, in turn, obliged to sell (in the case of a call) or buy (in the case of a put) the shares to (or from) the buyer of the option at the specified price upon the buyer's request.

Equity option contracts usually represent 1,000 shares of the underlying stock. For example, a single equity option contract in *BHP* will usually represent 1,000 shares of the underlying stock in *BHP*.

3. WHAT ARE OPTION PREMIUMS?

Premium is the term used for the price for agreeing to grant an option. It varies as the underlying security's price fluctuates as well as with the passage of time. The premium is dependant on other factors including the volatility of the underlying security, dividends and interest rates.

Option premiums are calculated based on models that take these factors into account and take the guesswork out of valuing options. The most common models are the *Black Scholes* and the *Binomial* option pricing models. Often, the market price will vary from the theoretical price determined by a model. Factors, causing such divergence between fair value and market price are outside the scope of this paper.

4. WHAT SERVICES DOES A WRITER OF AN ETO PERFORM?

In essence a writer provides insurance for the holder of a put option and profit making opportunity for the holder of a call option. The reward for assuming these risks (of potential assignment) is called a premium.

The risk assumed, depending on the fluctuation of market prices of the underlying securities, may mean that the holder will be able to call upon the writer to sell shares to a holder in the underlying securities or (put options) to buy shares held by the holder.

A writer will not be permitted to open a position unless there is significant collateral provided to an ASX Participant to offset the Participant's exposure to the Exchange. Collateral can usually take the form of cash, listed ASX securities or bank guarantees.

5. IS A WRITER CARRYING ON A BUSINESS?

The concept of “carrying on a business” has been determined, over the years, by reference to decided cases. For example, see *Thomas*⁶. See also *Ferguson*⁷.

In *Ferguson's* case *Bowen* CJ and *Franki* J had this to say at pages 4264 and 4265:

“Section 6 of the *Income Tax Assessment Act* defines “business” stating that it includes any profession, trade, employment, vocation or calling, but does not include occupation as an employee. This does not afford much assistance in the present case. It is necessary to turn to the cases. There are many elements to be considered. The nature of the activities, particularly whether they have the purpose of profit-making, may be important. However, an immediate purpose of profit-making in a particular income year does not appear to be essential. Certainly it may be held a person is carrying on business notwithstanding his profit is small or even where he is making a loss. Repetition and regularity of the activities is also important. However, every business has to begin and even isolated activities may in the circumstances be held to be the commencement of carrying on business. Again, organization of activities in a business-like manner, the keeping of books, records and the use of system may all serve to indicate that a business is being carried on. The fact that, concurrently with the activities in question, the taxpayer carries on the practice of a profession or another business, does not preclude a finding that his additional activities constitute the carrying on of a business. The volume of his operations and the amount of capital employed by him may be significant. However, if what he is doing is more properly described as the pursuit of a hobby or recreation or an addiction to a sport, he will not be held to be carrying on a business even though his operations are fairly substantial. See generally, *Trautwein v. F.C. of T. (No. 2)* (1936) 56 C.L.R. 196; *Tweddle v. F.C. of T. (1942)* 7 A.T.D. 186; *Fairway Estates Pty. Ltd. v. F.C. of T.* 70 ATC 4061; (1970) 123 C.L.R. 153; *Thomas*

⁶ 72 ATC 4094; (1972) 3 ATR 365.

⁷ 79 ATC 4261; (1979) 9 ATR 873.

v. F.C. of T. 72 ATC_4094; (1972) 46 A.L.J.R. 397 especially at pp. 4098-4100; 399-401, in all of which cases it was held the taxpayer was carrying on business; and Martin v. F.C. of T. (1953) 90 C.L.R. 470 in which it was held the taxpayer was not carrying on business”.

In *FCT v Murry*⁸ the High Court said, in a majority decision:

"A business is not a thing or things. It is a course of conduct carried on for the purpose of profit and involves notions of continuity and repetition of actions."

The cases seem to suggest that features or characteristics of a business will usually include some or all of the following:

- Regularity and recurrence of business transactions;
- An intention to make a profit;
- Maintenance of Systems;
- Record keeping.

It should be noted that Division 35 of ITAA97 limits the extent to which non-commercial losses⁹ from a taxpayer's business activities are used as tax deductions to reduce the tax paid on other income. Division 35, dealing with such non-commercial losses is outside the scope of this paper.

6. DERIVATION OF PREMIUM INCOME

The premium payable by the holder to the writer is paid on a T + 1 basis. That is to say, the premium is received by the writer on the day after the transaction is entered into.

In the event that the option contract is later closed before expiry (there is no such thing as buying back a contract that has been previously sold) then depending on the option price paid to close out the contract the writer will make either a profit or a loss.

In the event that the option contract is held to expiry and there is no exercise of the option then the writer still retains all of the premium income and his obligations will come to an end.

The writer will usually retain all of the income regardless of whether the option is closed out or not. This is an essential feature for assisting one to determine whether premium income, which is

received in advance of the performance of the obligation, should be treated as assessable in full upon receipt or whether there should be some form of accounting to amortise the receipt over the life of the contract (whether the life is to the date of expiry or whether it is cut short by closing out earlier). Moreover, what happens when the option period straddles two (2) income tax years?

As stated above, the literature on dealing with such transactions is scarce.

- Division 16E

Division 16E of the ITAA36 deals with the accrual accounting of “qualifying securities”. An option is not a “qualifying security” and, therefore, Division 16E has no application.

Furthermore, the Commissioner has previously stated in Taxation Ruling TR 96/14, that the Division 16E of definition of 'security' contained in subsection 159GP(1) of the ITAA36 applies only to debt securities or contracts that create debt-like obligations

- Income in advance

It is, perhaps, useful at this point to quote from the ATO's IDs¹⁰.

In ATO ID 2009/57 the facts encompassed an individual who was carrying on a business of trading in ETOs. The question posed was whether the premiums receivable were assessable upon the registration of the ETO with the ACH. The ATO held that the premiums receivable are assessable upon receipt as the premiums receivable are non-refundable. In the ID, the ATO made no reference to the classic decision of *Arthur Murray (NSW) Pty Ltd v FC of T*¹¹ where it was held that the fees paid in advance to the taxpayer company for dancing lessons was not assessable until the service had been rendered.

What is distinguishable from the facts in *Arthur Murray* and those in the ID, is that the fees received in advance in *Arthur Murray* were refundable if the services were not provided; whereas under the ASX's Market Rules for ETOs no such refund can apply. Thus, in the words of Dixon J (as he then was) in *Carden's case*¹² to determine the appropriate method to return income

⁸ 98 ATC 4585; (1998) 193 CLR 605.

⁹ Individual taxpayers, carrying on a business activity either alone or in partnership, are denied any losses from such business activities where they do not satisfy prescribed tests. Such losses are deferred until a later year of income where any of the tests are, or might be, satisfied.

¹⁰ An ID is a publication of a private ruling, in response to a request for an opinion from the ATO on the tax implications of a particular transaction, with deletions made to the taxpayer's identity to preserve the ATO's obligations to maintain secrecy over the affairs of taxpayers.

¹¹ (1965) 114 CLR 314

¹² *Commissioner of Taxes (SA) v Executor Trustee and Agency Company of South Australia Limited* [1938] HCA 69; (1938) 63 CLR 108 (23 December 1938)

“the inquiry should be whether in the circumstances of the case it is calculated to give a substantially correct reflex of the taxpayer's true income”.

Can the market value of the options at year end, which have not been closed out, be taken into account as an offset? The answer to this question must take into account whether options can be considered to be “trading stock” for taxation purposes. Section 70-10 of the ITAA97 defines trading stock to include “anything produced, manufactured or acquired which is held for the purposes of manufacture, sale or exchange in the ordinary course of business”. In the case of an ETO, the writer or holder does not sell or exchange their options in the event of a decision to close out. Closing out extinguishes a right or contingent obligation consequent upon entering into a separate transaction opposite to the position previously taken. There has been no sale or exchange. Similarly, allowing an option to lapse does not involve any element of sale or exchange. The exercise of an option results in the taxpayer buying or selling the underlying security at a pre-agreed price but does not involve any sale or exchange of an ETO. In ATO ID 2004/526 the ATO affirms the view that ETOs are not trading stock for taxation purposes.

What of the payment or refund of cash to the OCH to cover margin obligations?¹³ These payments are typically refundable when a sold position is either closed out or expires. The payments do not constitute losses or outgoings within the meaning of section 81 of ITAA97 and thus the payments are not allowable deductions. Likewise, the refund of cash does not give rise to such amounts constituting assessable income under section 6-5 of ITAA97.

7. SPECIAL ISSUES RELATING TO NON-RESIDENT TAXPAYERS

As stated above, a non-resident will derive income only if there is a source of that income in Australia. In the case of ETOs traded on an exchange located in Australia, then the source of those profits will be the place where the ETOs are traded¹⁴.

However, where the non-resident resides in a country which has entered into double tax treaty with Australia source will not be the relevant issue. There will usually be a more important issue to

¹³ Margins (comprising the “premium margin” and “risk margin” are calculated at the end of each day by the Exchange. The revised amount to cover margins means that an options writer will have to cover any shortfall or will receive any excess on the next working day by the payment or receipt of cash.

¹⁴ *Commissioner of Inland Revenue v Hang Seng Bank* [1991] 1 AC 306

consider, and that is whether or not the non-resident has a PE in Australia such that income derived by that PE (usually from world-wide sources) is attributable to it.

In an Australian AAT decision¹⁵, it was held that a New Zealand couple who carried on a business of share trading in New Zealand had a PE in Australia as the share trading was conducted through an authorised representative, albeit he was employed by a broker. The authorised representative was deemed to constitute the PE of the non-resident husband and wife and this meant that their share trading profits made in Australia were assessable to Australian income tax.

Importantly, if a taxpayer resides in a country which has entered into a double tax treaty with Australia, and the non-resident taxpayer does not have either an actual or deemed PE in Australia then, the non-resident will not have a *prima facie* liability to tax on profits made on the AOM.

8. CONCLUSION

It is to be hoped that readers will now have a better understanding in the way that premiums received are brought to account, in Australia, for income tax purposes.

However, given the application of the current rules, and the ineligibility for most taxpayers to apply the accruals regime set out in Division 230 of ITAA97, taxpayers may feel there is a lack of fairness when they are obliged to pay tax on income received, yet for accounting purposes are under an obligation to mark-to-market the value of the option at year end, thus reducing accounting income by reference to the amount that has been marked-to-market.

GLOSSARY

AAT	Administrative Appeals Tribunal
ACH	Australian Clearing House Pty Ltd
AOM	Australian Options Market
ASX	Australian Securities Exchange
ATO	The Australian Taxation Office
BHP	BHP Billiton Ltd
ETO	Exchange Traded Options
ID	Interpretive Decision
ITAA36	Income Tax Assessment Act, 1936
ITAA97	Income Tax Assessment Act, 1997
MIS	Managed Investment Scheme
OCH	Options Clearing House
PE	Permanent Establishment
TR	Taxation Ruling (issued by the ATO)

¹⁵ *Re Taxation Appeals* [1993] AATA 178 (11 June 1993)



THE OPTION SELLER

OPTION SELLER SEMINAR

Stock Options vs. Commodity Options - The Futures Advantage

*Why Equity Option traders should consider adding
Futures Options to their Portfolios*

*By James Cordier, Michael
Gross, Portfolio Managers,
Liberty Trading
Group/OptionSellers.com*



James Cordier
Founder, OptionSellers.com

If you are reading this seminar, I am about to make several assumptions about you. I am assuming you are somewhat of an experienced investor who has already "paid some dues" on the market battlefield. I am assuming that you are experienced enough that you have already discovered on your own the inherent logic of writing option premium and have possibly already joined the somewhat elite investor circle that actively employ the strategy. I am assuming that you are somewhat comfortable with a certain degree of risk, as long as you understand it and know how to manage it. I am assuming that you either currently sell equity options for profit or are considering it. Finally, I am assuming that you are seeking an investment that can offer consistent returns in 2008's (and probably 2009's) lackluster and/or volatile investment sectors.

If I have made any incorrect assumptions, please

don't feel left out. This information may benefit you as well. However, if you are already taking advantage of the large percentage of options that expire worthless in the equities arena, you might find the advantages of applying this same strategy to futures can be an awakening of sorts. Think of selling options on futures contracts like the S&P, Euro, Coffee or Crude Oil to be just like selling equity options, on steroids. Higher risk? It depends. Higher returns? You be the judge. Lets take a look at the benefits and drawbacks of selling premium in the futures market.

If you're already selling options on equities, you already know the game. The majority expire worthless. Time is always on your side. Entry and exit points don't have to be precise. You don't have to guess short term market direction. The same remains true in futures, with a few key differences.

1. **Lower Margins:** A key factor that attracts many stock option traders to futures. Margins posted to hold short stock options can be 10 to 20 times the premium collected for the option. With the SPAN margin system used in futures, options can be sold with out of pocket margin requirements* for as little as 1 to 1 ½ times premium collected. For instance, you sell an option for \$600 and post a margin of \$900*. * Total margin requirement minus premium collected.

2. **Attractive premiums can be collected for far out of the money strikes.** Unlike equities, where to collect any worthwhile premium, options must be sold 1-3 strike prices out of the money, futures options can often be sold at strike prices far out of the money where adverse short term market moves will not adversely affect the position, yet time value erosion may be allowed to work less impeded by short term volatility. How far out of the money? In some cases, strikes can be sold and more than double or even triple the existing price of the underlying contract.

3. **Liquidity.** Many equity option traders complain of poor liquidity hampering their efforts to enter or liquidate positions. While some futures contracts have higher open interest than others, most of the major contracts like Financials, Sugar, Coffee, Grains, Energies, etc. have substantial volume and open interest offering several thousand open contracts per strike price.

4. **It's not equities.** In the current state of the financial markets, it can be beneficial to be using a flexible strategy that can profit from the long or short side of the market. In addition, commodities contracts offer an alternative to trading the sometimes nonsensical equities markets. Commodities offer physical products that will always have a demand and therefore always carry some kind of value. Regardless of how the economy is doing, people will still drink coffee, eat bread and burn fuel to keep their house warm. While this does not mean that prices will not experience bear markets, it does mean that there are a decipherable set of supply/demand fundamentals that will ultimately dictate price.

We are not bashing equity options. Quite the contrary. Many investors have achieved substantial returns with a properly managed option selling approach in equities. Our point is to make equity traders aware that there is another vehicle with similar (in some cases, more desirable) properties that is available for diversification. Gaining higher leverage can carry increased risk in some situations, but at the same time provide for higher returns in an option portfolio.

Like writing equity options, futures options selling can be approached in an aggressive or conservative manner. Trading plans can range from an aggressive, more leveraged approach to a conservative, lower risk approach. On the whole, however, futures option investors are in it for a higher return than those sought by the average equity option trader.

SUMMARY

Volatility may offer opportunities to sell out of the money stock options. But not at the extreme, out of the money distances available in commodities, and not with as high of return on equity.

One does not need to be an equity options trader to invest in futures options or a managed futures options portfolio. However, if you are already familiar with stock options, you may want to consider the benefits of diversifying into commodities options. A commodities option portfolio can not only offer diversification but also substantially lower margins and offer far out of the money strikes for the investor seeking to add a

lightly more aggressive edge to his overall holdings.

Seasonal Positioning Update

As we've stated in past newsletters, holidays can often offer option writers a beneficial set of circumstances. Often during major holidays and the days surrounding long weekends, traders take time off. This will generally result in trading volumes, electronic and floor, to drop. This can translate into a "quiet time" in the markets. To option writers, this can mean "free" days of time decay. The last two weeks of December are probably the pinnacle of this phenomenon and many traders (professional and amateur alike) take some or all of this time off. Traders selling options ahead of this time period can often get two weeks of time decay with little movement in the markets. We are advising clients to position slightly more aggressively over the next week in order to take advantage of this time period.

For more information on Liberty Trading Group managed option selling portfolios, feel free to call us at **800-346-1949** or visit us at www.OptionSellers.com

-LTG

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