

OPTIONS FUNDAMENTALS

THE BASICS

HOW OPTIONS WORK

An option is a contract to buy or sell a specific financial product. In the case of equity options, for example, the option’s underlying instrument or interest is a stock, exchange-traded fund (ETF), or in this case a U.S. Treasury product.

The contract establishes a specific price, called the strike price, at which the contract may be exercised, or acted on. It also has an expiration date. When an option expires, it no longer exists or has value.

There are two types of options – calls and puts – and both can be bought or sold. The purchase of a call gives the owner the right, but not the obligation, to buy the underlying security at the strike price on or before the expiration date. In turn, the seller of the call is required to sell the security at the strike price at the buyer’s request.

Conversely, the purchase of a put gives the owner the right, but not the obligation, to sell the underlying security at the strike price on or before the expiration date. In this case the seller is required to buy the security at the strike price at the buyer’s request. The type of option utilized, and whether it is purchased or sold, depends upon what the investor seeks to achieve.

BUYING AND SELLING OPTIONS

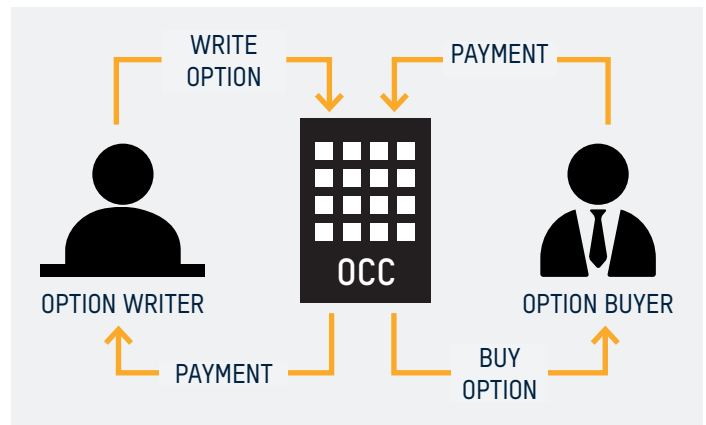
The buyer of a call or put has the right to sell the option to another buyer during its term or let the option expire worthless. The situation is different, however, for the writer or seller of the option contract who must fulfill the contract if the holder wishes to exercise the contract on the options expiration date. The writer has no control over whether or not a contract is exercised, and must recognize that exercise is possible on the expiration date. Treasury options are European style options that cannot be exercised until the expiration date. As stated previously they can be bought or sold in the market to offset their open position.

But just as the buyer can sell an option back into the a writer or seller of the option contract can purchase an offsetting contract. By offsetting the short option position, the writer ends the obligation to meet the terms of the contract.

ROLE OF OCC

In addition to the seller and buyer, The Options Clearing Corporation (OCC) is a participant in every options transaction, serving as an intermediary between the two parties.

OCC issues, guarantees, and clears all option trades placed on U.S. options exchanges. It ensures that all of the rules involved in the sales transactions will be followed and that each side will perform as promised.



OPTIONS PRICING

The purchase price of an option is called the premium. An option’s price is comprised of two major components, intrinsic value and time value.

Intrinsic value is the amount that the option is “in-the-money.” A call option is in-the-money if the current market value of the underlying is above the exercise price of the option, and out-of-the-money if the underlying is below the exercise price. A put option is in-the-money if the current market value of the underlying is below the exercise price and out-of-the-money if it is above it. If an option is not in-the-money at expiration, the option is assumed to be worthless but it still may be exercised and assigned.

Time value is the difference between the intrinsic value and the premium. The longer the amount of time for market conditions to work to benefit the investor, the greater the time value. Five major factors influence option premiums: value of the underlying security price, strike price, length of time until expiration, market volatility and cost to carry.

THE THREE MOST WIDELY-USED OPTIONS STRATEGIES

| | SELL COVERED CALLS | BUY PROTECTIVE PUTS | ZERO-COST COLLARS |
|-----------------|---|--|--|
| DESCRIPTION | Write (or sell) a call option against a Treasury position already owned by the investor | Purchase a put option to protect a Treasury position already owned by the investor | Simultaneously write (or sell) a call option AND purchase a put option against a Treasury position already owned by the investor |
| OBJECTIVE | Generate income on an existing Treasury position | Protect unrealized gains or to limit additional losses in the existing Treasury position | To hedge a Treasury position by buying a put option and to help offset the premium for the put option by selling a call option |
| MARKET FORECAST | Neutral to moderately bullish | Neutral to moderately bearish | Neutral or moderately bullish or moderately bearish |
| RISK | Limited | Limited | Limited |
| RETURN | 1) Call option premium received and 2) potential Treasury price appreciate up to the call strike price | Potential Treasury price appreciation less put option premium paid | Protection of unrealized gains |

ADDITIONAL RESOURCES

Visit WWW.NASDAQ.COM/INVESTING/OPTIONS.ASPX and WWW.NASDAQOMXTRADER.COM/OPTIONS for resources and information on options.

+ [OPTIONS ARTICLES AND OTHER USEFUL RESOURCES](#)

+ [WEB SEMINARS ARE AVAILABLE ONLINE](#)

+ [OPTIONS NEWS, MARKET DATA AND QUOTES](#)

MORE INFORMATION

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