The documents in this package contain important information regarding the risks and characteristics of the securities, commodities and other investment products that may be traded in your account. Please read all these documents carefully.

This package contains:

- Options Clearing Corporation Characteristics and Risks of Standardized Options
- NFA/FINRA Disclosure for Security Futures Trading
- Australian Futures Risk Disclosure
- Euronext Derivatives Explanatory Memorandum
- Euronext Liffe Risk Disclosure
- French Risk Disclosure
- German Risk Disclosure
- Swiss Franc Denominated Account Risk Disclosure-Futures
- Swiss Franc Denominated Account Risk Disclosure-Options
INTRODUCTION

This booklet relates solely to options issued by the Chicago Board Options Exchange Corporation ("CBOE") and all references to "options" in this booklet are applicable only to such options. As of the date of this booklet, options are traded on the United States markets listed on the inside front cover page and on the European Options Exchange in Amsterdam, The Netherlands. In the future, options may be traded on other markets within or outside the United States. The markets on which options are traded at any given time are referred to in this booklet as the "options markets."

CCC is a registered clearing agency, and each U.S. options market is a national securities exchange that is subject to regulation by the Securities and Exchange Commission ("SEC") under the Securities Exchange Act of 1934. Foreign options markets, and their members, are not generally subject to regulation by the SEC or the requirements of the securities or other laws of the U.S. and may not be subject to the jurisdiction of U.S. courts.

What is an option? An option is the right either to buy or to sell a specified amount or value of a particular underlying interest at a stated exercise price by exercising the option before its stated expiration date. An option which gives the right to buy is a call option, and an option which gives the right to sell is a put option. Calls and puts are distinct types of options, and the buying or selling of one type does not involve the other.

EXAMPLE: An option to buy 100 shares of common stock of the XYZ Corporation at a stated exercise price would be an XYZ call option. An option to sell 100 shares of common stock of the XYZ Corporation at a stated exercise price would be an XYZ put option.

There are two different kinds of options—physical delivery options and cash-settled options. A physical delivery option gives the owner the right to receive physical delivery (if it is a call) or to make physical delivery (if it is a put) of the underlying interest when the option is exercised. A cash-settled option gives the owner the right to receive a cash payment based on
the difference between a determined value of the underlying interest at the time the option is exercised and the fixed exercise price of the option. A cash-settled call option conveys the right to receive a cash payment if the determined value of the underlying interest at exercise time (also known as the exercise settlement value) exceeds the exercise price of the option, and a cash-settled put conveys the right to receive a cash payment if the exercise settlement value is less than the exercise price of the option.

Each options market sets the underlying interests on which options are traded and the exercise prices for those options. Options are currently available covering four types of underlying interests: equity securities, stock index, government debt securities, and foreign currencies. Options on other types of underlying interests may become available in the future.

Most options have standardized terms—such as the nature and amount of the underlying interest, the expiration date, the exercise price, whether the option is a call or put, whether the option is physical delivery or cash-settled, the manner in which the cash payment and the exercise settlement value of a cash-settled option are determined, the multiplier of a cash-settled option, the style of the option, whether the option has automatic exercise provisions, and adjustment provisions. These standardized terms are generally described in Chapter II. Each U.S. options market publishes specification sheets setting forth the particular standardized terms of the options traded on that options market. (These options markets may also provide for trading in options whose terms are not fixed in advance. Rather, subject to certain limitations, the parties to transactions in these options may design certain of the terms. These flexibly structured options are discussed in Chapter VI of this booklet.)

Options having the same standardized terms are identical and constitute an options series. The standardized terms of all options in a series must be the same as the terms of the series of the same name as the one that was bought, or by buying an option of the same series as the one he wishes, an investor can close out the position in the same series at any time if there is a functioning secondary options market in options of that series.

In some instances, options of the same series may be traded on more than one options market at the same time. Options that are so traded are called multi-market options. Options traded on a U.S. options market may also be traded on a foreign options market. These options are referred to as multi-market options. Multi-market and international options can be traded on separate or the same options exchange. International options can be traded on options exchanges outside the United States. Options that are so traded may be traded on the same exchange as the option's underlying interest is traded, or on one or more of the exchanges on which an option's underlying interest is traded.

Options trading is subject to no longer make it feasible for a series of options to be traded on an exchange, an investor may choose to trade in options on another exchange. Options that are so traded may be traded on the same exchange as the option's underlying interest is traded, or on one or more of the exchanges on which an option's underlying interest is traded.

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Options generally are traded on U.S. options markets during normal day-to-day business hours of U.S. securities exchanges and for a short period afterward. However, trading in options may not be continued on those hours. Trading in evening and night trading sessions occurs in options on foreign currencies and may in the future occur in other types of options. Moreover, when there are unusual market conditions, options markets may authorize trading to continue for a substantially longer period than under normal conditions. Trading in the evening option may close at an earlier time than trading in other options. Trading hours for options are also fixed to change from time to time. Options should ascertain the trading hours of the particular options they are interested in trading from the options markets where those options are traded. Readers should be aware that trading in options on underlying interests is not confined to normal exchange trading hours. For example, underlying foreign currencies and debt securities are traded in international markets on virtually, an around-the-clock basis. The trading of underlying equity securities may be traded in foreign markets when U.S. markets are closed and in some U.S. markets after the close of their normal trading hours.

CHAPTER II

OPTIONS NOMENCLATURE

This chapter contains a description of the standardized terms, and of some of the special vocabulary applicable to options. Most of the nomenclature is the same for options on the four types of underlying interests. Differences that are applicable to options on a particular underlying interest to enhance that interest will be described in the chapter devoted to that underlying interest.

Certain terms—options, options markets, call options, put options, physical delivery options, cash-settled options, options series, multi-market options, and internationally traded options—have been defined in Chapter I. Readers interested in these definitions should consult that chapter.

OPTION HOLDER; OPTION WRITER—The option holder is the person who buys the right conveyed by the option.

EXAMPLE: The holder of a physical delivery XYZ call option has the right to purchase shares of XYZ Corporation at the specified exercise price upon exercise prior to the expiration of the option. The holder of a physical delivery option has the right to sell shares of XYZ Corporation at the specified exercise price upon exercise prior to the expiration of the option. The holder of a cash-settled option has the right to receive an amount of cash equal to the exercise settlement value of the option upon exercise prior to the expiration of the option.

The option writer is obligated—i.e., if assigned an exercise—to perform according to the terms of the option. The option writer is sometimes referred to as the option seller. An option writer who has been assigned an exercise is known as an obligated writer.

EXAMPLE: If a physical delivery XYZ call option is exercised by the holder of the option, the assigned writer must deliver the specified number of shares of XYZ common stock. He will be paid for the shares at the specified exercise price regardless of their current market price.
If a physical delivery but option is exercised, the assigned writer must purchase the required number of shares at the specified exercise price regardless of their current market price. If a cash-settled option is exercised, the assigned writer may pay the cash settlement amount.

The exercise price of a cash-settled option is the basis for the determination of the amount of cash, if any, that the option holder is entitled to receive upon exercise (see the discussion of "Cash Settlement Amount and Exercise Settlement Value" below).

Exercise prices for each option series are established by the options market on which that series is listed. The series start date is the time trading in the series is introduced, and is generally set at least above and below the then-nascent value of the underlying interest. The options market generally then establishes the exercise price for the option series. The exercise price for each option series is fixed by the options market on which the series is traded. In the case of exercise, the holder must purchase the specified number of shares of the underlying interest at the exercise price stated in the contract for the option series.

Example: A physical delivery option XYZ 40 call option gives the option holder the right to purchase 100 shares of XYZ stock at an exercise price of $40 per share. A cash-settled option on a portfolio of 100 shares of XYZ stock at an exercise price of $40 per share.

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and the exercising holder would be entitled to receive, a cash settlement amount of $500 ($50 minus $50 multiplied by 10 = $500).

The currency in which the cash settlement amount is payable is called the settlement currency. The settlement currency for all cash-settled options with standard terms that are trading at the date of this book is U.S. dollars. It is possible that another currency will be the settlement currency for some options introduced in the future.

The manner of determining the exercise settlement value for a particular option series is fixed by the options market on which the series is traded. The exercise settlement values for options on a particular underlying interest traded in one options market will not necessarily be determined in the same manner as the exercise settlement values for options on futures on the same underlying interest that may be traded in other markets.

Options markets may change the method of determining exercise settlement values for particular option series on specified days or all days. These changes may be made applicable to series outstanding at the time the changes become effective. Alternatively, an options market might phase in a change in the method of determining exercise settlement values by opening new series of options identical to outstanding series in all respects other than the method for calculating exercise settlement values. Such new series would trade alongside the old series until both series expire, but the two series would not be interchangeable. In the future, options markets may subject to regulatory approval, introduce options whose exercise settlement values may not exceed a specified maximum amount.

**ADJUSTMENT and ADJUSTMENT PANEL**—Adjustments may be made to some of the standardized terms of outstanding options upon the occurrence of certain events. Adjustments that may be made to a particular type of options are discussed in the chapter relating to that type.

The determination of whether to adjust outstanding options in response to a particular event, and, if so, what the adjustment should be, is made by a majority vote of an adjustment panel. An adjustment panel for an options series consists of two representatives of each U.S. options market on which the series is traded and one representative of OCC, who votes only to break a tie. Every determination by an adjustment panel is within its sole discretion and is binding on all investors.

**PREMIUM**—The premium is that price that the holder of an option pays and the writer of an option receives for the rights conveyed by the option. It is the price set by the holder and writer, or their brokers, in a transaction in an options market where the option is traded. It is a standardized term of the option. The premium does not constitute a "down payment." It is simply and entirely a nonrefundable payment of two forms to the option holder for the rights conveyed by the option.

The premium is not fixed by the options markets or by OCC. Premiums are subject to competitive change in response to market and economic forces, including changes in the financing conditions on the market on the price of the underlying interest. The ratio between the value of the underlying interest and the relationship between that value and the premium price, the current price of the underlying interest, and a number of factors affecting the prices of volatility of options, exercise prices, and interest rates, the individual estimates of market participants of future volatility of the underlying interest, the historical volatility of the underlying interest, the amount of time remaining until expiration, dividend payments on the underlying stock (in the case of stock and stock index options), current interest rates, current currency exchange rates (in the case of foreign currency options), and options whose premiums or cash settlement amounts are payable in a foreign currency (e.g., the depth of the market for the option), the effect of supply and demand in the options markets as well as in the markets for the underlying interest, and the information available about current prices and operations in the markets for the underlying interest and related interests, the individual estimates of market participants of future developments that might affect any of the foregoing, and other factors generally affecting the process of volatility of options, exercise prices, related interests or securities, or both generally. Also see the discussion below of "Intrinsic Value and Time Value." Readers should also assume that options premiums will not necessarily conform or correlate with any theoretical options pricing.

**COMBINATIONS; SPREADS and STRADDLES**—Combination positions are positions in more than one option at the same time. Spreads and straddles are two types of combination positions. A spread involves buying both the longer-term and shorter-term options of the same type of option (puts or calls) on the same underlying interest, with the options having different exercise prices and/or expiration dates. A straddle involves purchasing or writing both a put and a call on the same underlying instrument, with the options having the same exercise price and expiration dates.

**LONG and SHORT**—The word "long" refers to a person's position as the holder of an option, and the word "short" refers to a person's position as the writer of an option.

**COVERED CALL WRITER**—The writer of a physical delivery call option owns and does not have the amount of underlying interest that is deliverable upon exercise of the call. The writer is said to be a covered call writer.

**EXAMPLE:** An individual owns 160 shares of XYZ common stock. He writes one physical delivery call option, giving the call holder the right to purchase 160 shares of the stock at a specified exercise price. This would be a covered call. If he writes two such XYZ calls, one would be covered and one would be uncovered.

The distinction between covered and uncovered call writing positions is important since uncapped call writing can involve substantially greater exposure to risk than covered call writing. A call option writer who is not a covered writer may hold another option in a different position and thereby offset some or all of the risk of the option he has written. However, the spread may not offset all of the risk of the uncovered writing position. For example, if the long portion of the spread has a
higher exercise price than the exercise price of the short, or if the long has an earlier expiration date than the expiration date of the short, then the writer may be required to pay a significant amount of the uncovered writing position.

AT THE MONEY—This term means that the current market value of the underlying interest is the same as the exercise price of the option.

IN THE MONEY—A call option is said to be in the money if the current market value of the underlying interest is above the exercise price of the option. A put option is said to be in the money if the current market value of the underlying interest is below the exercise price of the option.

EXAMPLE: If the current market price of XYZ stock is $43, an XYZ 40 call would be in the money by $3.

OUT OF THE MONEY—If the exercise price of a call is above the current market value of the underlying interest, or if the exercise price of a put is below the current market value of the underlying interest, the option is said to be out of the money by that amount.

EXAMPLE: With the current market price of XYZ stock at $35, and a call with an exercise price of $45 would be out of the money by $10; a put with an exercise price of $35.

INTRINSIC VALUE and TIME VALUE—It is sometimes useful to consider the premium of an option into two components: the intrinsic value and the time value. Intrinsic value reflects the amount, if any, by which an option is in the money. Time value is the amount that the option is not in the money. Because American-style and capped options are not exercisable at all times, they are more likely to have American-style options to trade at less than their intrinsic value when they are not exercisable.

EXAMPLE OF A CALL WITH INTRINSIC VALUE: At a time when the current market price of XYZ stock is $45 a share, an XYZ 40 call would have an intrinsic value of $5 a share. If the market price of the stock were to decline to $44, the intrinsic value of the call would be only $4. Should the price of the stock drop to $40 or below, the call would no longer have any intrinsic value.

EXAMPLE OF A PUT WITH INTRINSIC VALUE: At a time when the current market price of XYZ stock is $46 a share, an XYZ 45 put would have an intrinsic value of $1 a share. Were the market price of XYZ stock to increase to $50 or above, the put would no longer have any intrinsic value.

EXAMPLE OF TIME VALUE: At a time when the market price of XYZ stock is $45 a share, an XYZ 40 call may have a current market price of, say, $2 a share. This is entirely time value.

An option with intrinsic value may often have some time value as well—this is, the market price of the option may be greater than its intrinsic value. This could occur with an option of any style.

EXAMPLE: With the market price of XYZ stock at $46 a share, an XYZ 40 call may be a current market price of $5 a share, reflecting an intrinsic value of $1 a share and a time value of $4 a share.

An option’s time value is influenced by several factors (as discussed in the “Premium” section), including the length of time remaining until expiration. The option is a “wasting” asset, it is not sold or exercised prior to its expiration, it will become worthless. As a consequence, all else remaining the same, the time value of an option usually decreases as the option approaches expiration, and this decrease accelerates as the time to expiration shortens. However, there may be occasions when the market price of an option may be below the intrinsic value of another option that has less time remaining to expiration but that is similar in all other respects.

An American-style option’s time value is also influenced by the amount of time remaining in the money or out of the money. An option normally has very little time value if it is substantially out of the money. Although an option that is substantially out of the money has no time value, the amount of that time value is normally less than the time value of an option having the same underlying interest and expiration that is at the money. Another factor influencing the time value of an option is the volatility of the underlying interest. As the volatility increases, the option’s time value increases.

CAP INTERVAL—The cap interval is a constant established by the options market on which a series of capped options is traded. The exercise price for a capped-style option is the cap interval (in the case of a call, or minus the cap interval in the case of a put), equal to the cap price of the option. For example, if a capped call option with an exercise price of $50 has a cap interval of 10, then the cap price at which the option will be automatically exercised would be $40.

CAP PRICE—The cap price is the level at which the automatic exercise of a capped option must occur in order to be automatically exercised. The cap price of a call option is above, and of a put option below, the exercise price of the option.

EXAMPLE: A 360 ABC capped call index option has an exercise price of 360 and a cap interval of 30. The call option has a cap price of $390.

EXAMPLE: A 310 XYZ capped put index option has an exercise price of 310 and a cap interval of 10. The put option has a cap price of $290.

AUTOMATIC EXERCISE VALUE—The automatic exercise value of a capped option is the price or level of the underlying interest determined in a manner fixed by the options market on which the option is traded for each trading day as of a specified time of that day.

EXAMPLE: A 310 XYZ capped put index option has a cap interval of 10, and therefore has a cap price of $290. Assume that the options market on which the option is traded has specified the time of exercising on each trading day as the time for determining the automatic exercise value on the XYZ index, and that the index level reaches a low of 289 during a particular trading day, but is at 291 at the close. The automatic exercise value has not reached the cap price, and the automatic exercise feature of the option is not triggered, because the index level was at or below the cap price at the time of any specified by the option time for determining the automatic exercise feature.

CASH SETTLEMENT AMOUNT—This is the cash amount that the holder of a cash settled capped option is entitled to receive upon the exercise of the option. In the case of a capped option that has been automatically exercised, the cash settlement amount is equal to the cap price times the multiplier for the option, even if the automatic exercise feature is triggered on this trading day in the case of a call or is less than the strike price in the case of a put. In the case of any option that is not exercised, the cash settlement amount is determined in the same manner as for other styles of cash settled options.

EXAMPLE: A 360 ABC capped call index option has a cap interval of 30 and a multiplier of 100. The automatic exercise value of the ABC index is 250 on a particular trading day. The call option is automatically exercised, and the cash settlement amount is $2500 (equal to the cap price of 350, times the multiplier of 100).

EXAMPLE: A 380 ABC capped call index option has a cap interval of 30 and a multiplier of 100. The automatic exercise value of the ABC index never reached the cap price of 350 during the life of the option, and the exercise settlement value of the option is 250 on the final trading day. Upon exercise of the option, the holder is entitled to receive a cash settlement amount of $250 (equal to the multiplier of 100 times the difference between the exercise settlement value of 267 and the exercise price of 360).
CHAPTER III
OPTIONS ON EQUITY SECURITIES

The term "stock options" is used broadly to include calls, which give the buyer of the option the right to purchase shares of stock at a specified price or strike price, and also puts, which give the buyer of the put the right to sell shares of stock at a specified price or strike price. Stock options are traded on organized exchanges such as the American Stock Exchange, the New York Stock Exchange, and the Chicago Board of Trade. They are also traded on the OTC market, where they are quoted and traded on a more informal basis.

FEATURES OF STOCK OPTIONS

Each option gives its holder the right, but not the obligation, to buy or sell shares of stock at a specified price or strike price on or before a specified date or expiration date. The holder of a call has the right to buy the underlying stock at the strike price, while the holder of a put has the right to sell the underlying stock at the strike price. The strike price is the price at which the holder of the option can buy or sell the underlying stock.

As a general rule, stock dividends, stock distributions, and stock splits can result in an adjustment in the number of underlying shares or the exercise price, or both.

EXAMPLE: An investor bought 100 shares of XYZ Company at $50 per share. After a 2-for-1 split, the stock price is $25 per share. The investor now has 200 shares of XYZ stock. If XYZ Company announces a 1-for-2 reverse split, the investor now has 100 shares of XYZ stock at $50 per share.

However, in the case of a stock dividend, the number of underlying shares and the exercise price remain unchanged. For example, if XYZ Company announces a 2-for-1 stock dividend, the investor now has 200 shares of XYZ stock at $50 per share.

Adjustments may be made to the exercise price of an option in the event of a stock split or stock dividend. The exercise price of an option is calculated by dividing the strike price by the ratio of the stock split or stock dividend.

EXAMPLE: An XYZ 400 stock gives the buyer the right to purchase 100 shares of XYZ stock at a price of $40 per share, or a total price of $4,000. In the future, stock options may, with regulatory approval, be introduced that have exercise prices in a foreign currency.

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As a general rule, adjustments will not be made to reflect changes in the capital structure of the issuer where all of the underlying securities outstanding in the hands of the public (other than short sale shares) are not charged into another security, cash or other property.

As a general rule, an adjustment that is made in an option will become effective on the six-days established by the primary market for trading in the underlying security.

Chapter IV
INDEX OPTIONS

About Indexes

As referred to in this booklet, an index is a measure of the price of a group of securities or other interests. Although indexes have been developed to cover a variety of securities, such as stocks and other equity securities, debt securities and foreign currencies, and even to measure the cost of living, indexes on equity securities (which are called PPI, CPPI and others) are among the most familiar, and they are the only indexes that underlie options trading at the date of this booklet. The following discussion refers only to stock indexes and stock index options.

Stock indexes are compiled and published by various sources, including securities markets. An index may be designed to be representative of the stock market as a whole, of securities traded in a particular market, of a broad market sector (e.g., industrial), or of a particular industry (e.g., electronics). An index may be based on the prices of all, or a sample, of the securities whose prices it is intended to represent. Indexes may be based on securities traded primarily in U.S. markets, securities traded primarily in a foreign market, or a combination of securities whose primary markets are in various countries.

A stock index, like a cost of living index, is ordinarily increased in relation to a base established when the index was originated.

Example: On the starting or "base" date for a new value-weighted index, the total market values of the component securities (market price times number of shares outstanding) is $50 billion. The publisher of the index will assign an arbitrary index level—say 100—to the base value. If the total market value of the component securities represents by 3% the next day (i.e., to $61 billion), the index level would rise to 121 (121% of the base level of 100).

Stock indexes reflect values of companies, rather than securities, by taking into account both the prices of constituent securities and the number of those securities outstanding.

Different stock indexes are calculated in different ways. Accordingly, even though indexes are based on identical securities, they may measure the relevant market differently because of differences in methods of calculation. Often the market prices of the securities in the index group are "capitalization-weighted." That is, in calculating the index value, the market price of each constituent security is multiplied by the number of shares outstanding. Because of this method of calculation, changes in the price of the securities of larger corporations will generally have a greater influence on the level of a capitalization-weighted index than price changes affecting smaller corporations.

Other methods may be used to calculate stock indexes. For example, in one method known as "relative dollar weighting," the index is established by assigning an aggregate market value to each constituent security of the index and then determining the number of shares of each security by dividing the market price by the current market price of the security. The base level of the index is established by dividing the total market value of all constituent securities by a fixed index divisor. Thereafter, the number of shares of the constituent securities and the index divisor are adjusted at periodic intervals in order to have each constituent security continue to represent an approximately equal dollar value in the index without distorting the level of the index.

Another method of calculation is simply to add up the prices of the securities in the index and divide by the number of securities in the index, disregarding numbers of shares outstanding. Another method measures daily percentage movements of prices by averaging the percentage price changes of all securities included in the index.

Investors should keep in mind that an index cannot respond to reported price movements in its constituent securities. An index will thereby reflect the stock market as a whole, or particular market segments, only to the extent that the securities in the index are being traded, the prices of those trading being promptly reported, and the market prices of those securities, as measured by the index, reflect price movements in the relevant market. The index level will be affected by all of the factors that may at the time affect prices in the relevant market for the constituent securities of the index, including, among other things, applicable laws, regulations and trading rules, the market-making and order-processing systems of those markets, the liquidity and efficiency of those markets, and the prices and price behavior of futures contracts on that index or a related index.

Certain trading strategies involving purchases and sales of index options, index futures, options on index futures or combinations of certain of the securities in the index, can affect the value of the index, the price of the index futures, and, therefore, the price of index options. These transactions and the resulting impact may occur at any time and may not be significant changes in the prices of individual stocks or the broader markets including at or shortly before an expiration. For example, traders holding positions in acquiring index options or futures contracts hedged by positions in index futures included in the index may attempt to liquidate these contracts by increasing the price of the option or futures contracts by the amount they desire to receive for the contracts. The resulting orders to liquidate these securities might result in significant changes in the level of the index. Index options investors should be aware of the potential impact that these trading strategies can have on index levels at or near expiration, and the possibility that the values of index options positions will be affected accordingly.
Readers who intend to trade index options should familiarize themselves with the basic features of the underlying indexes, including the general methods of calculation. Readers who are attempting to follow a precise and substantial guide involving index options may wish to inform themselves of the exact method for calculating each index involved. Information regarding the method of calculation of any index on which options are traded including information concerning the standards used in adjusting the index, setting or deleting securities, and making similar changes, is generally available from the options exchange where the options are traded.

The value level of every index underlying an option—indicating the exercise settlement value—is the value of the index as reported by the reporting authority designated by the options exchange where the option is listed, as the official price for determining that index’s value. United DGC stocks, however, every value as most recently reported by the reporting authority is conclusively presumed to be accurate and deemed to be final for the purpose of calculating the cash settlement amount, even if the value is substantially revised or determined to have been inaccurate.

Most indexes on which options are traded are updated during the trading day, and actual index values are disseminated at frequent intervals. Investors may determine current index levels from their brokerage firms. In addition, the closing levels of many underlying stocks are published in daily newspapers such as the "Wall Street Journal." However, an index option may be traded in the options markets at a time when, even on a substantially, all of the constituent securities of the underlying index are trade or when there is a lag between reporting of prices in some of the constituent securities. In those circumstances, the current reported index level will be based on non-current information, since its calculation will be based on the last reported prices on all constituent securities. Trading prices may fluctuate above or below the index's value, and the price of any index option contract will be determined by the market demand of the option.

FEATURES OF INDEX OPTIONS

All index options that are traded at the date of this book are cash-settled. Cash-settled index options do not relate to a particular number of shares. Rather, the "price" of a cash-settled index option contract is determined by the multiplier of the option. If the option price on an index option is traded should be interpreted in the context of the index and the multiplier for that index. In the context of the index, the multiplier should be considered as the multiplier for that index. The multiplier for an index option is expressed in points and decimals of points. Each point of premium of the options traded at the date of this book represents an amount equal to one U.S. dollar; in order to determine the aggregate premium for a single index option, the quoted premium must be multiplied by the multiplier.

EXAMPLE: An investor purchases a December 110 index call at 2 1/2. The multiplier for that option is $100. The aggregate dollar amount of the premium is $212.50 (2 1/2 x 100 = $212.50). Hedging the options market would have a multiplier of 200; a premium of 2 1/2 would have meant an aggregate premium of $425.00.

The exercise settlement values of stock index options are determined by their reporting authorities in a variety of ways. The exercise settlement values of some index options are based on the reported value of the index derived from the last reported prices of the constituent securities of the index at the close of the day. The exercise settlement values of other options are based on the reported level of the index derived from the opening price of the constituent securities on the day of exercise. If the option is exercised on a day that is not scheduled as a trading day for the constituent security of the index, the exercise settlement value is based on the highest level of the index derived from the opening price of the constituent securities on the last prior trading day that is a trading day for the constituent security. If a constituent security does not settle for trading on the day the exercise settlement value is determined, the last reported price of that security is used. Other methods for determining the exercise settlement values of some index options series have been, and may continue to be, established. For example, the exercise settlement values for options on an index of foreign securities may be fixed in relation to a value fixed by a foreign exchange.

CHAPTER V

DEBT OPTIONS

Two kinds of debt options have been approved for trading at the date of this book: One kind, called call option-based options, are options which give the holder the right either to purchase or sell a specific underlying debt security at a designated price. The price is based on the value of an underlying debt security (depending on whether the options are physical delivery or cash-settled options). The other kind, called yield-based options, are options that are cash-settled based on the difference between the exercise price and the value of the underlying debt security.

At the date of this book, only yield-based options are being traded. Although price-based options have been in the past and may be traded in the future, no price-based option is traded at the date of this book.

The principal risks of debt options are discussed in Chapter X. Readers interested in buying or selling debt options should not only read this chapter but should also carefully read Chapter X, particularly the discussion under the headings "Prices of Option Holders," "Prices of Option Buyers," "Other Risks," and "Special Risks of Debt Options."

RATES, YIELDS AND PRICES OF DEBT SECURITIES

To understand debt options, an investor should understand the relationship between the rates or yields, which are different ways of expressing return on debt securities, and prices of debt securities. Coupon interest rates of a bond are security expressed as a percentage of the principal amount (par value) of the security. Yield (expressed in percent) expresses return (or interest return) as a percentage of the amount invested. This relationship, simply stated, is that the price of debt securities move inversely to changes in yields, declining rates, whether...
TREASURY SECURITIES

The underlying debt securities of price-based options and the debt securities from which the underlying yields of yield-based options are derived are all Treasury securities—e.g., 30-year Treasury bonds, 10-year Treasury notes, 5-year Treasury notes and Treasury bills.

Treasury bonds and notes are direct obligations of the United States that pay a fixed rate of interest semi-annually. Bonds are issued for maturities of more than ten years (although many issues are callable prior to maturity), Notes are issued for maturities of one to ten years, and are non-callable. New issues of bonds and notes are sold periodically through the Treasury, usually on an auction basis. The auction price is established by bidding and may be above or below par value. Occasionally the Treasury will "reopen" an outstanding issue by auctioning additional principal amounts. Government securities dealers make secondary markets in virtually all outstanding issues, but market activity and liquidity tend to center on the most recently auctioned issues.

Unlike Treasury bonds and notes, Treasury bills do not pay interest. Instead, the Treasury sells bills at a discount from their principal amount (par value). The investment return consists of the difference between the basic issue price and the principal amount payable at maturity. Treasury bills are issued in maturities of 13, 26, or 52 weeks.

Return on Treasury bills is commonly expressed in terms of a discount rate which represents an annualization (based on a 360-day year) of the percentage discount at which the bills are sold.

EXAMPLE: At 13-week (91-day) Treasury bills, a discount price of $97,000, the actual discount would be $3,000 or 3%, and the discount rate would be approximately 15.5% (365/91 times 3%).

Bills are auctioned by the Treasury on a regular basis, typically on weekly intervals for 13-week and 26-week bills and every four weeks for 52-week bills. While dealers maintain secondary markets in all outstanding Treasury bills, activity tends to center on the most recently auctioned issues. These are commonly referred to as the "current" 13-week, 26-week, and 52-week bills, respectively.

YIELD-BASED OPTIONS

All yield-based options being tracked at the date of this booklet are so-called Euro-style options. The underlying yields of these options are the annualized yields to maturity of the most recently issued Treasury security of a designated maturity—e.g., 30-year, 10-year, 5-year, based upon quotations or prices determined in accordance with a method specified by the options market on which the option is traded. If such a security is a Treasury bill, the underlying yield is the annualized discount rate of the Treasury bill. (A discount represents a percentage of principal amount, rather than a return on investment, and is therefore not a true yield.) Underlying yield is stated in terms of a yield indicator, which is the percentage yield multiplied by 100. For example, if the yield is based on a Treasury bill having an annualized discount of 6.715%, the yield indicator would be 671.5.

The designated maturity of the Treasury security from which the underlying yield is determined is a standardized term of every yield-based option that is included in the options market. The specified Treasury security having that maturity is not listed; rather, the underlying yield is derived from the outstanding security of the designated maturity. Newly-issued securities having the longest remaining life are new issues securities having the longest remaining life. Newly-issued securities having the longest remaining life will replace such issues on the first trading day following their auction. Thus, the specific Treasury security from which the underlying yield is derived may change during the life of the option. Because yield-based options are European-style options, investors will not know prior to the time an option can be exercised the specific Treasury security from which its exercise settlement value will be determined. However, an option may often be traded for weeks or months before that specific security is auctioned by the Treasury. During this period the real interest rate will be based upon the yield for the Treasury security of the designated maturity that then has the longest remaining life.

EXAMPLE: Yield-based options whose yield is based on 5-year Treasury notes sliding in December
Because yield-based options are European-style options and the underlying yield is determined from the most recently auctioned Treasury security with the longest remaining life, a major factor affecting the pricing of such options is likely to be the estimates of market participants of the anticipated yield at expiration, and current yield may be a less significant pricing factor.

Settlement of exercise of yield-based options takes place on the business day immediately following the day of exercise. Investors may determine from their brokerage firms when and how settlement amounts will be credited or debited to their brokerage accounts.

If the U.S. Department of the Treasury ceases to issue, or changes the terms or the schedule of issuance of, Treasury securities, the adjustment panel has discretion to adjust the terms of the series by substituting other securities or to make such other adjustment as the adjustment panel may determine. If the options on the maturity are priced on a yield-based option is treated should decrease the multiplier for the option, the adjustment panel has discretion to adjust outstanding options affected by the change by proportionately substituting them or by taking other action.

Rules of the options market on which yield-based options are traded may permit or require suspension of trading in the options if current quotations for the last-auctioned Treasury securities of the designated maturity become unreliable or unrepresentative. For a discussion of the risks involved in trading this option, see the discussion in Chapter X under “Other Risks.”

**MARKET FOR FOREIGN CURRENCIES**

Understanding the risks inherent in foreign currency options requires familiarity with the characteristics of the markets for the underlying currencies. Let's consider the factors that may affect foreign currency options.

Foreign exchange rates can be free floating or may be subject to a variety of formal or informal government exchange rate control mechanisms. Exchange rates of most Western nations are permitted to fluctuate in value relative to the U.S. dollar and at other currencies. It must be kept in mind, however, that sovereign governments may voluntarily allow their currencies to float freely in response to economic forces. To the contrary, sovereign governments use a variety of mechanisms, such as intervention by a country's central bank or imposition of regulations to control access to the exchange rates of their currencies. Thus, a special risk in trading options on foreign currencies is that governmental actions might be instituted which could interfere with the relatively unrestricted determination of value even with movements of currencies across borders. These risks are specifically addressed under “Special Risks of Foreign Currency Options” in Chapter X.

The market in foreign currencies exists in every major financial center in the world, and primarily consists of trading by the world's international banks. In contrast to the stock market, the market for foreign currency is decentralized, essentially free from government regulation designed to protect investors (although, as noted above, governments may take various actions that affect their own currencies and the markets in which they trade), and almost always a spot trading. Trading is generally conducted in units equivalent to $1 million to $5 million, and the maximum amount of currency for trading or delivery of small amounts of currency. When a “retail market” for foreign currencies is available for individuals and others engaged in smaller transactions, the prices available in that market are generally determined from a variety of factors related to currency exchange rates and the prices of options on that underlying foreign currency can be summarized as follows:

1. The value of an underlying foreign currency in one or more of the fore-mentioned currencies is related to the trading currency, and the prices of options on that underlying foreign currency can be summarized as follows:

   **EXAMPLE:** Assume a dollar-denominated call option gives the holder the right to purchase British pounds at $1.35 each. At expiration, that option will have increase in value if the exchange rate of the British pound is above $1.35 at the same time. It will have no value if the price of the pound is equal to or below $1.35. The change in the value of British pounds may result from a change in the value of the U.S. dollar relative to other currencies (such as “strong” dollar, “weak” dollar), from changes in the behavior of the pound (strong” pound, “week” pound), or from a combination of the two. In any case, the relationship between the value of the pound and the value of the British pound relative to the U.S. dollar.

   **EXAMPLE:** Assume a cross-rate option gives the holder the right to purchase euros against British pounds at 2.50 German marks (DM) each. At expiration, the option will have increase in value if the exchange rate of the British pound is above 2.50 German marks (DM).
Intrinsic value if the price is equal to or below 0.9500 at that time. Changes in the exchange rate between German marks and British pounds may result in changes in the value of German marks relative to other currencies generally, from changes in the value of the British pound, or from fluctuation of the mark. In this case, the intrinsic value of the option will be determined by the value of the British pound relative to the German mark, and not to the U.S. dollar or any other currency. However, as noted in the following section, fluctuations in the value of the British pound to other currencies may significantly affect the intrinsic value of the option. Investors who intend to convert their gains or losses into one of those other currencies.

Readers should note that the various expiration dates for foreign currency options are different from the expiration dates for options on other underlying interests. Readers should determine the expiration date of each foreign currency option they wish to buy or sell.

**SPECIAL FEATURES OF DOLLAR-DENOMINATED FOREIGN CURRENCY OPTIONS**

The amount of the foreign currency underlying each foreign currency option (i.e., the unit of trading) is specified by the options market on which the option is traded.

Prices for currently available dollar-denominated options on foreign currencies other than the Japanese yen are stated in U.S. cents per unit of foreign currency. Exercise prices for dollar-denominated Japanese yen options are quoted in thousands of U.S. cents per unit. In order to determine the total exercise price per contract, it is necessary to multiply the strike exercise price by the unit of trading of the particular option.

**EXAMPLE:** A dollar-denominated call option covering 31,250 British pounds with an exercise price of $100 and a strike price of $1.25 will entitle the holder to buy the underlying pounds for an aggregate exercise price of $24,000 ($100 x 31,250).

**EXAMPLE:** A dollar-denominated call option covering 2,250,000 Japanese yen with an exercise price of 90 will entitle the holder to buy the underlying yen for an aggregate exercise price of $202,500 ($0.90 x 2,250,000).

Exercised options are settled through the facilities of OCC. The exercise price is paid to the holder or received from the holder if the holder exercised a call or put, respectively. The holder is then entitled to receive the underlying foreign currency on the fourth business day after exercise, provided that the contract is still outstanding.

For purposes of settlement between an investor and a broker-dealer, applicable rules require a broker exercising a physical delivery put option and an assigned writer of a physical delivery call option to arrange for the delivery of the requisite units of the underlying foreign currency into a designated bank account in the currency issuing country in which currency is not available through automatic clearing mechanisms. The designated bank account must be established by OCC in advance of exercise.

For purposes of settlement between an investor and a broker-dealer, applicable rules require a broker exercising a physical delivery call option and an assigned writer of a physical delivery put option to arrange for the receipt of the requisite units of the underlying foreign currency from the broker-dealer.

At the time of exercise, OCC distributes a delivery of the underlying foreign currency, with payment in U.S. dollars made at the current exchange rate. OCC pays the delivery charge in U.S. dollars. The delivery charge is determined by OCC and is based on the current exchange rate. The delivery charge is paid on the date of delivery of the underlying foreign currency.

**CROSS-RATE FOREIGN CURRENCY OPTIONS**

As noted at the beginning of this chapter, a cross-rate foreign currency option is an option to purchase or sell a foreign currency at an exercise price that is denominated in another foreign currency. An example of a cross-rate option is an option to purchase British pounds at an exercise price denominated in Japanese yen—that is, the trading currency would be the Japanese yen and the underlying currency would be the British pound. The exercise price would be expressed in a certain number of yen per pound. Premiums for cross-rate options are denominated in the trading currency. Thus, if the above example, premiums would be paid in yen.

The cross-rate options that have been approved for trading as of the date of this book are physical delivery European-style options. It is possible that other kinds of cross-rate options will be added in the future.

Investors in cross-rate options should bear in mind that the magnitude and direction of any change in the value of the underlying currency in relation to the foreign currency may be different from the magnitude and direction of any contemporaneous change in the value of either of those currencies in relation to a third currency, such as the U.S. dollar. For example, the British pound may appreciate in relation to the
example. If the yen-denominated option covering 300,000 British pounds is purchased at a premium of 2.63, the cost of the option will be JY 316,000 (JY2.63 times the unit of trading of 300,000).

Premium settlement of cross-rate options is effected in a trading currency other than U.S. dollars. Similarly, in the event of exercise, the exercise price is paid in the trading currency in general applies equally to cross-rate options except to the extent that it is specifically limited to the underlying currency. Certain special features of cross-rate options are discussed below.

special features of cross-rate options

The exercise price of a physical delivery cross-rate option is the price (denominated in the trading currency) at which the underlying currency may be purchased or sold upon exercise of the option. Exercise prices for cross-rate options are generally expressed in terms of units (or fractions of units) of the underlying currency per unit of the underlying currency. Therefore, in order to determine the total exercise price per contract, it is necessary to multiply the stated exercise price by the unit of trading of the particular option.

Example: The exercise prices of yen-denominated options covering underlying German marks are expressed in yen against the relevant mark rate. For example, an option covering 500,000 German marks with an exercise price of $2 Japanese yen ("JY") would entitle the holder to sell the underlying marks at the exchange rate, expressed in yen, of 200,000 marks (500,000 marks divided by 2.500 yen = 200,000 marks).

The discussion in this chapter relating to cash-denominated foreign currency options generally applies to cash-settled foreign currency options except insofar as such discussion specifically applies to physical delivery options.

The contract size of a cash-settled foreign currency option, like the size of other foreign currency options, is expressed in terms of the amount of the underlying currency covered by the option.

Example: If the exercise price of a cash-settled option on German marks is 50 (expressed as US cents per mark), the exercise settlement value of the underlying currency is 50 marks, and the unit of trading is 100,000 marks, then the cash settlement amount of the option will be 500 US dollars (50 marks multiplied by 0.500 yen = 50 marks).

A cash-settled foreign currency option that, based on its exercise settlement value, is in the money on the expiration date will be automatically exercised on the expiration date. In the future, cash-settled foreign currency options may arise that will be automatically exercised only if they are in the money by a specified amount on the expiration date.

As the date of this booklet, the exercise settlement value for cash-settled foreign currency options is based upon bid and offer quotations from a netting of participants in the Interbank London market for the underlying foreign currency. The exercise settlement value is an approximation and varies from time to time. At any time, the exercise settlement value may be applicable to options outstanding at the time of the change.

Another special feature of cash-settled foreign currency options is the expiration date of no more than two weeks following the initiation of trading is that option writers must deposit required margin with their brokerage firms within two business days of the expiration date. It should be noted that this is a shorter period than the normal period required for other options transactions.

flexibly structured options

Flexibly structured options, like the other options discussed in this booklet, are traded on the U.S. options markets and regulated by OCC. However, unlike other options, the terms of flexibly structured options are not standardized. When a flexibly structured option is purchased and sold in an opening transaction, the terms of the option agree on which the transaction occurs to fix the option's premiums. The terms of a flexibly structured option which may be fixed by the parties are called variable terms. The flexibility to fix these variable terms is what makes flexibly structured options different from other options.

The principal risks of holders and writers of flexibly structured options are those not standardized. It is less likely that there will be an active secondary market in which holders and writers of such options will be able to close out their positions by offsetting sales and purchases. See paragraph 1 under "Special Risks of Cross-rate Options" in Chapter X.

The trading procedures established by the options markets for transactions in flexibly structured options differ from the procedures for transactions in other options. Readers desiring information about the trading procedures should contact the marketplace for flexibly structured options or obtain information from that market.

The options markets may fix minimum size or minimum monetary values for transactions in flexibly structured options. Flexibly structured options may be useful to sophisticated investors seeking to manage particular positions and trading risks, however, as a result of these minimums, as well as the social trading procedures and reduced likelihood of there being a...
Chapter VIII

Exercise and Settlement

Although most option holders and writers close out their option positions by an off-market closing transaction, investors should nonetheless be familiar with the rules and procedures applicable to exercise. Such an understanding can help an option holder determine whether exercise might be more advantageous than an offering sale of the option. An option writer needs to understand exercise procedures because of the possibility of being assigned an exercise. Once an exercise of an option has been assigned to an option writer—even though she may not yet have been notified of the assignment—the writer can no longer affect a closing transaction in that option but must instead purchase or sell the underlying interest for the exercise price (or, in the case of a cash-settled option, pay the cash settlement amount).

HOW TO EXERCISE

The period during which an option is exercisable depends on the style of the option. This is discussed under “Style of Option” in Chapter II.

In order to exercise most options traded at the close of this booklet, action must be taken by the option holder prior to the expiration of the option. However, some options may be subject to automatic exercise. For example, capped options are subject to automatic exercise if the automatic exercise value of the underlying interest is less than the cap price for the option, and certain other options are subject to automatic exercise at expiration if they are then in the money (or, in the case of some options, in the money by a specified amount).

To exercise an option that is not subject to automatic exercise, the holder must direct the brokerage firm to give exercise instructions to OCC. In order to ensure that an option is exercised on a particular day, the holder must direct his brokerage firm to exercise before the firm's cut-off time for exercising exercising...
ASSIGNMENT

OCC assigns exercises in standardized lots to Clearing Member accounts that reflect the writing of options identical to the exercised options. A description of OCC’s assignment procedures is available from OCC on request at the address set forth in paragraph 1 of Chapter XI of these rules. Assignments are ordinarily made prior to the commencement of trading on the business day for the option following receipt by OCC of the exercise instruction. In the case of options traded in evening sessions, exercise instructions received by OCC on a business day are ordinarily assigned prior to the opening of trading on that day’s evening session.

If exercises are assigned by OCC to a Clearing Member’s customer account, the Clearing Member shall then assign them to customers maintaining positions as writers of the exercised options series. The rules of the options markets require that member firms allocate assignments to customers other than on a random selection basis or on a “first-come, first-served” basis and inform their customers which method is used and how it works. Regardless of the method used, option writers are subject to the risk each day their options are exercisable that someone of them may be assigned (see the discussion in Chapter X under “Risk of Option Writers.”)

It is possible that an option writer will not receive notification of the assignment until one or more days following the exercise. In the case of the initial assignment to the Clearing Member by OCC, this creates a special risk for uncovered writers of physical delivery call options, as discussed in paragraph 14 of Chapter X under “Risk of Option Writers” in Chapter X and under “Settlement” in this chapter.

SETTLEMENT

Settlements between brokerage firms or their agents on exchange and over-the-counter physical delivery stock options are routinely handled through stock clearing corporations in much the same way as ordinary purchases and sales of the underlying security. If, for any reason exercised and assignment of a physical delivery stock option to an agent who is not a member of OCC or a Clearing Member, OCC reports it to the designated stock clearing corporations of the Clearing Members representing the exercising holder and the assigned writer. If neither stock clearing corporation rejects the transaction by a time specified in their agreements, the settlement is effected pursuant to the rules of these clearing corporations, and OCC has no further responsibility to either the exercising holder or the assigned writer.

In several cases—which usually occur because an underlying security is no longer eligible for quotation through a stock clearing corporation—settlements calling for the delivery of the security are made directly between Clearing Members. OCC’s rules provide special procedures for such settlements made directly between Clearing Members that involve the delivery of securities which either have been called for redemption, due to default, or are subject to tender offer or other tender offer which is available, if the expiration time (as defined in chapter XI) is exercised, and the issuer is subject to the exercise settlement due for the option. Once these procedures, the Clearing Member entitled to receive the securities may give a notice in writing to the delivering Clearing Member by a specified cutoff time prior to the expiration time. If a notice is given and the securities are not delivered sufficiently in advance of the expiration time to permit the sale of the underlying Clearing Members to obtain their benefit, the delivering Clearing Member will be liable for any resulting damages. The failure to deliver was the fault of the Clearing Member’s customer, the Clearing Member may (depending on its own procedures) pass that liability on to the customer. Investors should be aware that correspondent clearing corporations may have specific procedures, in respect of the settlements made through them.

At the time of this booklet, the regular exercise settlement date for physical delivery stock options is the fifth business day after exercise, though the SEC has adopted a rule that requires the regular settlement date to be the third business day after exercise on an option that takes place on or after January 1, 1995. The regular exercise settlement date means for all other types of physical delivery options traded at the time of this booklet are described in the separate chapters of the booklet discussing those options.

At the time of this booklet, settlements of exercises of cash-settled options and foreign currency options are affected by Clearing Members through OCC. Settlement of exercises of cash-settled options—through the payment in cash of the cash settlement amount—ordinarily takes place on the business day immediately following the day of exercise. However, cash-settled options that have been automatically exercised on any trading day other than the one immediately prior to or following the expiration date are settled on the second business day after the automatic exercise is triggered. Prior to settlement with the Clearing Member representing the option writer, the realized amount of the underlying security, if any, is not delivered to the Clearing Member. If the writer of the cash-settled options has been provided with a safe account in which to deposit the amount of the underlying security, the option writer’s account will be credited with the amount of the security, if any, that has been delivered to the clearing member. The settlement of exercises of cash-settled options that have a written assignment that is not an OCC is discussed under “Settlement” in Chapter X.

OCC has authority to postpone settlement of any option on any type of underlying interest when OCC considers such action to be necessary in the public interest or to effect a desired result.

Each brokerage firm involved in an exercise or assignment settles with its own customers. Neither OCC nor any other member enjoys any responsibility to customers with respect to funds or securities that have been provided by the brokerage firm for its customers. Investors may determine from their brokerage firms when and how settlement amounts will be credited or debited to their brokerage accounts.

In certain unusual circumstances, it might not be possible for uncovered call writers of physical delivery stock and stock index options to obtain the underlying security interests in order to meet their settlement obligations following exercise. This could happen, for example, in the event of a successful tender offer for all or substantially all of the outstanding interest in an underlying security or if trading in an underlying security was suspended or suspended. In situations of that type, OCC may impose special exercise settlement procedures. These special procedures, applicable only to cash and only an assigned writer is unable to deliver the underlying security, may involve the suspension of the settlement obligations of the holder unlisted on the day of exercise settlement. The holder unlisted on the day of the exercise settlement must deliver the currency of cash settlement price in lieu of delivery of the underlying security. In such circumstances, OCC might also prohibit the exercise of write by holders who would be unable to deliver the underlying security on the exercise settlement date. When special exercise settlement procedures are imposed, OCC will announce the Clearing Members how settlements are to be handled. Investors may obtain that information from their brokerage firms.
CHAPTER IX
TAX CONSIDERATIONS, TRANSACTION COSTS AND MARGIN REQUIREMENTS

The tax consequences of options transactions depend, in part, on the tax status of the investor, and may differ depending upon the type of underlying interest involved. Taxable gains and losses from the exercise or assignment of options are subject to income tax as capital gains or losses, depending on the investor's holding period and the investor's tax bracket. Losses may also be deductible as a capital loss against capital gains, subject to certain limitations.

Options transactions are not tax free. The gain or loss on the exercise of an option is taxable as a capital gain or loss, and any cash received from the exercise of an option is taxable as ordinary income. The tax treatment of options transactions can be complex, and investors should consult a tax professional for advice on their specific situation.

TRANSACTION COSTS

Transaction costs of options investing consist primarily of commissions (which are imposed on opening, closing, exercising, and assignment transactions), but may also include margin and interest costs in particular transactions. The impact of transaction costs on profitability is often greater for options transactions than for transactions in underlying securities because the total cost is often greater in relation to option premium than in relation to price of underlying securities. Transaction costs are significant in option strategies calling for multiple purchases and sales of options, such as spread and straddle strategies. Transaction costs may be different for transactions affected in foreign option markets than for transactions affecting a U.S. market. Readers should always discuss transaction costs with their brokerage firms before engaging in options transactions.

MARGIN REQUIREMENTS

Options and other derivatives are subject to margin requirements. In the United States, margin requirements are imposed by the Securities and Exchange Commission (SEC). Margin requirements for options are based on the value of the underlying asset, volatility, time to expiration, and other factors. Margin requirements may vary from broker to broker, and from exchange to exchange.

It is important for options investors to have adequate funds available to meet margin requirements. Readers should consult their brokers for specific requirements and any changes in those requirements. Margin requirements are subject to change, and investors should always be aware of current requirements.

CHAPTER X
PRINCIPAL RISKS OF OPTIONS POSITIONS

The chapter discusses the principal risks of holding and writing options. The risks discussed are those that are unique in being an option holder or writer. Risks that relate to underlying market factors are covered in earlier chapters. The risks discussed in this chapter are specific to options and include:

- Volatility: Options are sensitive to changes in the price of the underlying asset. Large changes in the underlying asset price can lead to large changes in the value of the option.
- Time Value: Options have an intrinsic value and a time value. The time value of an option decreases as time passes, and this can affect the option's value.
- Leverage: Options can provide significant leverage, which can magnify gains and losses.
- Complexity: Options are complex financial instruments, and they can be challenging to understand and trade.

Readers should be aware of the risks associated with options trading and should consult with a financial advisor before making any trading decisions.
by sections discussing the special risks associated with options on the particular types of underlying interests.

RISKS OF OPTION HOLDERS

1. An option holder runs the risk of losing the entire amount paid for the option in a relatively short period of time. This risk reflects the nature of an option as a wasting asset which becomes worthless when it expires. An option holder who neither sells his option in the secondary market nor exercises it prior to its expiration will necessarily lose his entire investment in the option. (As noted in Chapter VIII, many brokerage firms have procedures for the exercise of options at expiration that are then in the money by a specified amount.)

The fact that options become valueless upon expiration means that an option holder must. decide quickly about the disposition of an anticipated price change in the underlying interest, but he must also be right about when the price change will occur. If the price of the underlying interest does not change in the anticipated direction before the option expires to an extent sufficient to cover the cost of the option, the option holder may lose all or a significant part of his investment in the option. This contrasts with an investor who purchases the underlying interest directly and may continue to hold the investment, notwithstanding its failure to change in price as anticipated. In the hope of waiting out an adverse price move and eventually realizing a profit.

The significance of this risk to an option holder depends in large part upon the extent to which he elects to diversify his investments to avoid a large percentage of the underlying interest than he would have purchased directly with the same investment amount. This is illustrated in the following example, which compares the consequences of three different approaches to investing the same amount of money in stocks or options, with each approach involving a different degree of leverage.

EXAMPLE: Assume that Investors A, B, and C, each have $5,000 to invest and that each anticipates an increase in the market price of XYZ stock, which is currently $50 a share. Investor A invests his $5,000 in 100 shares of XYZ. Investor B invests $500 in the purchase of an XYZ 50 call (covering 100 shares of

XYZ at a premium of 85 9/16 shares) and invests the remaining $4,500 in a relatively riskless investment such as Treasury bills. (For purposes of this example, it is assumed that all of the calls are purchased when they have six months remaining until expiration, and that the strike price increases at an annual rate of, say, 3.5%—which means that a $5,000 investment will earn approximately $170 in interest over six months.) Investor C invests his entire $5,000 in 100 XYZ 50 calls.

If each option is held for six months and, if it is profitable, is either sold or exercised immediately before expiration, the following table illustrates the dollar and percentage profit or loss that each investor would realize on his $5,000 investment, depending upon the price of XYZ stock when the option expires:

<table>
<thead>
<tr>
<th>Price of XYZ Stock When the Option Expires</th>
<th>Investor A</th>
<th>Investor B</th>
<th>Investor C</th>
</tr>
</thead>
<tbody>
<tr>
<td>$55</td>
<td>+$2,500</td>
<td>+$2,500</td>
<td>+$2,500</td>
</tr>
<tr>
<td>$51</td>
<td>+$1,100</td>
<td>+$1,100</td>
<td>+$1,100</td>
</tr>
<tr>
<td>$47</td>
<td>+$600</td>
<td>+$600</td>
<td>+$600</td>
</tr>
<tr>
<td>$43</td>
<td>+$100</td>
<td>+$100</td>
<td>+$100</td>
</tr>
<tr>
<td>$40</td>
<td>+$0</td>
<td>+$0</td>
<td>-$200</td>
</tr>
<tr>
<td>$37</td>
<td>-$100</td>
<td>-$100</td>
<td>-$1,100</td>
</tr>
<tr>
<td>$33</td>
<td>-$200</td>
<td>-$200</td>
<td>-$2,500</td>
</tr>
</tbody>
</table>

The table demonstrates how increased leverage results in greater profit potential on the upside and greater risk of loss on the downside. Investor C, as the most leveraged investor, would realize the highest percentage return if the price of XYZ increased to $55 (assuming he did not sell his options while they had significant remaining time value), and would lose all of his investment if the price of XYZ decreased to $33. For the investor who relies on option prices to increase or decrease significantly before the option expires, it is critical that the option holder will take all or part of his investment in the option.

The greater the price movement of the underlying interest necessary for the option to become profitable is, the more the option is the money when purchased and the greater the cost of the option and the shorter the time within which the price movement must occur the greater the likelihood that the option holder will realize a loss. This lack of necessity means that an option must be worthless to exercise in order for a holder to realize a profit.

Instead, it may be possible for the holder to realize a profit by selling an option prior to its expiration.

OCC and the options markets have authority to restrict the exercise of options at certain times in specified circumstances. The options markets often exercise such authority with respect to an option in which trading has been halted. If a restriction on exercise is imposed at a time when trading in the option has also been halted, holders of that option will be locked into their positions unless the exercise restriction is lifted or the trading that has been halted.

Exercise restrictions imposed by OCC and the options markets affect cash-settled options generally cannot be continued in effect beyond the opening of business on the next trading day before their expiration. Such exercise restrictions affecting physical delivery options generally cannot be continued beyond the opening of business on the last trading day before their expiration, but only if important exceptions. OCC determines that the available supply of a security underlying a physical delivery option appears to be insufficient to permit delivery of the security by the writers of all outstanding calls in the event of exercise, or that foreign government regulations would prevent or greatly hinder the orderly settlement of exercise of all foreign currency options. OCC may indefinitely prohibb the exercise of all or some of the options which is necessary to prevent the sale of the option. The holder of such a put could lose the entire investment in the option if the prohibition remained in effect until the put’s expiration and the holder was unable to exercise the underlying interest or to sell his put in the market. The put holder might be unable to do either because the event which caused OCC to impose the exercise restriction—which, e.g., a suspension of trading in an underlying stock—might not only make it difficult or impossible to obtain the underlying interest, but might also impair the market in options on that interest.

It is also possible that a court, the SEC, or another regulatory agency may impose exercise restrictions. While an American-style option can normally be exercised at any time prior to its expiration,
RISKS OF OPTION WRITERS

1. An option writer may be exposed to an expense at any time up to the expiration of the option. Starting with the day it is purchased, an American-style option is subject to being exercised by the option holder at any time until the option expires. This means that the option writer may be required to make an exercise at any time after he has written the option until the option expires or until he has disposed of his position in a closing transaction. By contrast, the writer of a European-style or capped option is subject to assignment only when the option is exercised or in the case of a capped option when the automatic exercise feature of the underlying interest hits the cap price.

An assigned writer may not receive notice of the assignment until one or more days after the assignment has been made by OCC. Once an exercise has been assigned to a writer, the writer may not close out the assigned position in a closing purchase transaction, whether or not he has received notice of the assignment. In that circumstance, an attempted closing purchase would be treated as an opening purchase transaction.

If an option that is exercisable in the money, the option writer can anticipate that the option will be executed, especially if expiration approaches. Once he is assigned an exercise, the assigned writer must deliver the option at the exercise price or pay the cash settlement amount in the option at the exercise price or pay cash settlement amount in the option at the exercise price. The consequences of being assigned an exercise depend upon whether the writer of the call is covered or uncovered, as discussed below.

2. The writer of a covered call benefits from the opportunity to benefit from an increase in the value of the underlying interest provided that put interest rate, and strike rates, are near the exercise price and that the value of the underlying interest is above the exercise price. The writer of a covered call benefits if the exercise price is near the strike rate and if the value of the underlying interest is above the exercise price. The writer of a covered call benefits if the exercise price is near the strike rate and if the value of the underlying interest is below the exercise price.

The writer of a covered call benefits from the opportunity to benefit from an increase in the value of the underlying interest. If the exercise price is near the strike rate and if the value of the underlying interest is above the exercise price, the writer of a covered call benefits from the opportunity to benefit from an increase in the value of the underlying interest.

Example:

When XYZ stock was $50, the investor purchased a $400 put option by writing an XYZ call. As the call approached, the stock price dropped to $40. The put option was then exercised, and the investor purchased the stock at $40. The investor then had to sell the stock at $40, which resulted in a loss of $100. The investor had to pay a margin of $500 to purchase the stock, so the investor lost $600, or 120% of the investment. The investor had to pay a margin of $500 to purchase the stock, so the investor lost $600, or 120% of the investment.
interest to be manifested in the price of the option. A writer of an option that is unsecured and unfunded may have a significantly greater risk than a short seller of the underlying interest. The table set forth in paragraph 2 under "Risks of Option Holders" above, if all investors had sold short 100 shares of XYZ to Investor A that sale to receive $5,000, the investor would have lost $1,000 if the market price of XYZ had increased to 62. On the other hand, in order to receive $2,000 in proceeds, the insurer had written 10 XYZ 40 uncovered calls, he would have lost $9,000 if the market price of XYZ had increased to 62.

A. The fact that an option writer may not receive immediate notification of an assignment in an extreme case this risk may be overcome by physical delivery call stock options that are exercised at the close of business when the assignment security is the subject of a tender offer, exchange offer, or similar event. An investor who refuses to purchase the underlying security on or before the expiration date for the offer may remain after the expiration date that he has been assigned exercisable shares of option stock will enable the assigned writer to deliver the security on the assignment date or for the option exercise (see "Settlement" in Chapter VIII). If the assigned writer fails to make timely settlement, he may be liable for, among other things, the value of the security (because he does not maintain the option may have lost the entire holder from making timely delivery of the security to the option). This risk can be avoided by purchasing the underlying security in connection with the option expiration date for the option. Occasionally, an offer will require that the holders deliver the security in the holder's settlement time for exchange transactions after the offer's expiration date. In those cases, the writer will need to purchase the underlying equity security at an earlier point in time, at least the number of days required to the normal settlement time before the delivery deadline—necessary to extend settlement times in order to protect themselves.

B. Although the rules of the options markets establish specific rules that do not exist in the options markets to the exclusion of one side of the trade while the other side of the trade remains outstanding. Also, the transaction costs (of writing options) can be significantly higher, since the cost is incurred on each component of the combination. This can have the effect of requiring a substantial favoring of the underlying instrument prior to the option's initial risk is reduced and should never create the writer's risk position.

The writer of a straddle enters both a call and a put in the same underlying interest at the same expiration date in exchange for a combined premium on the two underlying options. The straddle is unfunded (in the case of capped options) in the intent that the price of the underlying interest is either above the exercise price by more than the combined premium, or above the exercise price by more than the combined premium, the writer of a straddle will incur a loss when the price of one of the options is exercised. Indeed, if the writer of a straddle is an option on one instrument and fails to close out the other position, subsequent fluctuations in the price of the underlying instrument could cause the option to be exercised as well, causing losses on both option positions.

Combinations involving different styles of options present additional complexities. For example, the writer of an American-style option would be unable to cover by purchasing a European-style or capped-style of option that he holds unless the assignment occurred during the exercise period of the option. Combination transactions involving call and put options also bear the same risks that are discussed for index options under "Special Risks of Index Options" below.

A. If a market is in a market of options, a writer of options would lose no value in the underlying instrument. The market may not have a significant impact on the value of the options. The writer of an option on a market or 40 new series of options on that market may not be affected by the expiration or assignment.

B. When the proceeds in paragraphs 1 and 3 under "Other Risks" below.

A. Capped options may cause a drop upward or downward in the value of the underlying instrument depending on the value of the underlying instrument. The option may not take place until after the expiration date of the option. The writer of a writer's risk is not a true risk. While this is not to suggest that this combination strategy should not be considered, it is advisable to consider the risks associated with the risk and the risks associated with the underlying instrument. In the absence of such considerations, the writer of an option on a market or 40 new series of options on that market may not be affected by the expiration or assignment.

C. The investor considering strategies involving combination strategies should recognize several other risks associated with combination strategies in addition to those already mentioned. When it is not possible to execute simultaneously or sequentially transactions in all of the options involved in the combination, the difficulty may be in the process of incurring losses or making losses. Therefore, the possibility that a loss could be incurred on
Similarly, in the event an options specialist is a significant group of options market makers should fail to have a significant reduction in capital, the market in the particular option or in which the specialist or market makers traded could be adversely affected. The suspension by OCC of any Clearing Member that maintains significant positions in any particular option series in its accounts could also disrupt the market for that option series.

An options market could also become unavailable because of its own operational problems. For example, if an options market were to be declared bankrupt or in the event it were to take possession of its principal trading systems, it might be unable to continue to operate as an options market.

If a secondary market in a particular option were to become unavailable, a holder of that option would be able to realize his or her rights or losses only by exercising the option to purchase the underlying security at a price reflecting the market value of the security.

5. Restrictions on trading under certain circumstances could result in the loss of options exposure. Each of the options markets has discretion to halt trading in an option in certain circumstances—such as when the market determines that the halt would be advisable in maintaining a fair and orderly market in the option. If trading is halted or suspended, no one or more of the markets for an underlying interest, the trading of options on that interest may also be halted. Similarly, if the trading value of an underlying interest is interrupted, or if trading is interrupted in stocks accounting for a substantial portion of the value of an index, the trading of options on that index may also be halted. In addition, the rules of the options markets may require them to halt trading in particular types of options in certain circumstances. At the date of this book, the U.S. options markets are required (1) to halt trading in all stock options and index options when trading in all stocks on the New York Stock Exchange ("NYSE") has been halted by the activation of "circuit breakers" by the NYSE, and (2) to halt trading in all stock options and index options for a specified period of time if the Dow Jones Industrial Average ("Average") is calculated at a value of 250.00 points below its closing value on the previous trading day, or for at least two hours if the Average is substantially calculated on the same day at a value of 400 or more above such closing value. These requirements may be changed from time to time.

When trading in an option is halted or suspended, holders and writers of that option will be unable to close out their positions until trading resumes, and they may be faced with substantial losses if the value of the underlying interest moves adversely during that time. For example, if a trading halt in an underlying stock is followed by the announcement of a tender offer at a substantial premium, and this stock recovers at a price reflecting the offer, uncovered call writers may sustain large losses.

Even if options trading is halted, holders of American-style options would still be able to exercise unless exercise was deferred. However, OCC is an options market may restrict the exercise of an option while trading in the option has been halted, and the restriction may remain in effect until shortly before expiration (See paragraphs 5 under "Rights of Options Holders" above.) If an option is exercisable while trading has been halted in the underlying interest, option holders may have to determine whether to exercise without knowing the current market value of the underlying interest. This risk can become especially important if an option is close to expiration, and failure to exercise will mean that the option will expire worthless. Exercise does occur when trading of the underlying interest is halted, the party required to deliver the underlying interest may be unable to obtain it, which may necessitate a postponed settlement and the loss of all settlement decisions (see Chapter VIII).

All cash-settled options have certain special risks. These risks, as they apply to cash-settled index options, are discussed under "Special Risks of Index Options" below. This discussion is also applicable to other types of cash-settled options.

If a cash-settled option has a settlement currency other than U.S. dollars, holders and writers will be subject to the same kinds of risks with respect to the foreign currency and the settlement of an exercise as are discussed in paragraphs 1 through 5 under "Special Risks of Foreign Currency Options" below.

6. Holders and writers of a capped option face the risk that an automatic exercise feature will be elected.
neither be able to satisfy his assignment obligations by delivering those securities against payment of the exercise price. Instead, he will be required to pay cash in an amount based on the exercise settlement value on the exercise date, and by the time he heard that he has been assigned, the index may have declined, with a corresponding decline in the value of the securities underlying. This "marginal" is an inherent limitation on the ability of writers of cash-settled calls to cover their risk exposure by holding positions in the underlying index. This risk applies only to American-style options. The writer of a European-style capped call that is exercisable only on the expiration date runs the risk of assignment only with respect to exercisable options held on that day. If the call is more than marginally in the money on the underlying index, the writer can reasonably assume that it will be exercised and take market action to protect himself against an unexpected decline in the value of his position in the underlying interval.

3. The limiting risk exposure in the underlying portfolio involves spread positions and particular multiple option strategies involving cash-settled American-style index options significantly lower than similar strategies in physical delivery options. With physical delivery options, a person in a spread position can ordinarily satisfy his settlement obligations by holding a short leg of the spread position on the short side. With cash-settled index options, however, an investor in a spread position runs the risk that by the time he receives notice of an exercise assignment on the option he has written, the index value will have changed such that exercising the long leg of the spread will not yield sufficient cash to satisfy his obligation on the exercise assignment. Thus, an investor who writes a spread position in cash-settled index options and then exercises an underlying index in this manner is exposed to the risk of adverse movement in the underlying index. In the event the exercise settlement value of the assigned short is greater than the exercise settlement value of the short leg of the position, in time to take action to satisfy exercise settlement value options. Other multiple option strategies involving cash-settled options may present similar risks.

5. Just as holders and writers of stock options take the risk that exercise in the underlying securities may be erroneously reported, holders and writers of index options face the risk that reported current index levels may be in error. A person who buys or sells an index option at a premium based on an erroneously reported index level is bound by the trade and has to remedy the result of the option's trades.
activity tends to center on recently issued securities. Liquidity is generally greater and quotations are generally tighter on recent issues than on older issues.

There are numerous dealers in all of the Treasury issues from which the yield on the options is readily calculated. But at the date of the book, there is no comprehensive consideration of bids and offers or public reporting of transaction prices in those securities such as exists for the market for stocks. While there is some dissemination of representative bids and offers, prices in the same manner as the broker interest in buying or selling a Treasury security usually must have a knowledge firm or some contact on one or more dealers individually to learn their current quotations.

The possession of fast reliable information and the limited availability of quotations for near-term instruments can make it difficult for many investors to determine accurate data about the state of the market for the underlying debt securities. At the same time, dealers in the underlying securities have access to private quotation networks that give actual current bids and offers of other dealers. This information is not available to most investors. As a result, these dealers may have a significant advantage over other participants in the debt options market.

2. Another important difference between the stock market and the market for Treasury securities is that stock quotations are generally reported to a 160th of a point while the basis unit of trading in the debt securities market is the $1,000,000 or principal amount. On Treasury bills it can be larger. Most dealers are oriented toward doing business with large institutional customers or other dealers. As a result, investors buying or selling debt securities in amounts larger than round lots can expect to pay more and receive less than dealer quotations for round lot transactions.

The lack of trading for price-based debt options is likely to produce larger option prices of the underlying debt security than is the case with stock options. In general, this means that: (a) premiums for such an option will be higher for a round lot option; and (b) the increase or decrease in the price of an option that is associated with any given change in the price of the underlying security will tend to be larger for many such debt options.
SPECIAL RISKS OF FOREIGN CURRENCY OPTIONS

1. The value of any currency, including U.S. dollars, as well as foreign currencies, may be affected by complex political and economic factors applicable to the country issuing that currency. The price of a foreign currency option is dependent upon the value of the underlying foreign currency relative to the trading currency as well as the price of both currencies relative to other currencies generally. Fluctuations in the value of the trading currency—whether it is the U.S. dollar in the case of a dollar-denominated option or a foreign currency in the case of a cross-rate option—will affect the strike rate and the price of foreign currency options, even in the case of otherwise stable underlying foreign currencies. Consequently, fluctuations in the value of an underlying foreign currency will affect exchange rates and the prices of foreign currency options even if the value of the trading currency remains relatively constant. Investors should consider factors affecting the economies and currency values of both the currency of origin for the trading currency and the country of origin for the underlying currency. Although these same considerations apply to dollar-denominated options and cross-rate options, corporate option plans involve factors affecting the economies of at least two foreign countries and may involve considerations by U.S. investors of factors affecting the U.S. economy as well. Accordingly, a U.S. investor in cross-rate options may need to consider a broader range of economic developments than a U.S. investor in dollar-denominated foreign currency options.

2. Even though the intrinsic value of an option is determined by the value of the underlying currency relative to the trading currency, investors who wish to convert gains or losses into U.S. dollars or other currencies must be particularly affected by changes in the exchange rates between two currencies and the changes in the currency value of the underlying asset. The example of the dollar-denominated foreign currency option given above indicates that changes in one currency value can also have an impact on the value of the other currency.

3. Because foreign currency transactions occurring in the interbank market involve substantial, larger amounts than those likely to be involved in the exercise of individual foreign currency option contracts, investors who want to enter foreign currency option may be disadvantaged by having to deal in an odd lot market for the underlying foreign currency instead of at prices that are more favorable than those available in the interbank market. Because the price differential may be the same, however, it should be evaluated in light of the market forces operating in the interbank market, the availability of liquidity and the probable adverse effect of adverse movements in the underlying currency. In any event, the market forces in the interbank market can be a barometer of the speculative demand for forward contracts.

4. In addition, the concept of a single currency option transaction can be complicated by the presence of the foreign currency exchange market for the underlying currency. The price of a foreign currency option is determined by the exchange rate at the settlement date. Because the exchange rate at the settlement date is determined by market forces operating in the interbank market, the price of a foreign currency option will be influenced by the market forces operating in the interbank market. The exchange rate at the settlement date will be determined by the prevailing market forces operating in the interbank market.

5. It is thus clear that the price of a foreign currency option may be influenced by factors affecting the economies of the relevant currencies. The price of a foreign currency option may be influenced by factors affecting the currencies of the relevant countries and may involve considerations by U.S. investors of factors affecting the U.S. economy as well. Accordingly, a U.S. investor in cross-rate options may need to consider a broader range of economic developments than a U.S. investor in dollar-denominated foreign currency options.

6. The exchange rate at the settlement date is determined by the prevailing market forces operating in the interbank market. The price of a foreign currency option is determined by the exchange rate at the settlement date. Because the exchange rate at the settlement date is determined by market forces operating in the interbank market, the price of a foreign currency option will be influenced by the market forces operating in the interbank market.
disposing of foreign currencies. OCC determines that such restrictions or taxes would not prevent the orderly settlement of delivery foreign currency option exercises or would impose undue burdens on parties to exercise settlements, it has authority to impose special exercise settlement procedures, which could adversely affect some investors.

7. The interbank market in foreign currencies is a global, around-the-clock market. Therefore, the hours of trading for foreign currency options do not conform to the hours during which the underlying currencies are traded. To the extent that the options markets are closed while the market for the underlying currencies remains open, significant price and value movements may take place in the underlying market that cannot be reflected in the options markets. The possibility of such movements should be taken into account in referring closing prices in the options market to those in the underlying markets. In addition, this creates a risk that foreign currency options may be exercised on the basis of price movements in the underlying currency after the close of trading in the options market, when writers are no longer able to close out their short positions.

8. Since exercise settlement of physical delivery foreign currency options—whether they are cash-settled or settled in kind—may not be made on the same date that the underlying foreign currencies through their brokerage firms in conformity with any U.S. or foreign restrictions or regulations governing the maintenance of foreign-exchange amounts by U.S. residents, and may be required to pay any fees, taxes, or charges associated with such deliveries.

9. Exercise settlement of physical delivery foreign currency options—whether they are cash-settled or settled in kind—may not be made on the same date that the underlying foreign currencies through their brokerage firms in conformity with any U.S. or foreign restrictions or regulations governing the maintenance of foreign-exchange amounts by U.S. residents, and may be required to pay any fees, taxes, or charges associated with such deliveries.

10. As in the case of other cash-settled options, writers of cash-settled foreign currency options cannot fully provide in advance for their potential settlement obligations by acquiring and holding the underlying interest. Although a call writer may hold the quantity of the currency underlying the option, there is no assurance that he will be able to sell such currency at the exercise settlement value.

11. If a cash-settled foreign currency option is exercised based upon a reported exercise settlement value that is in error, the holder and the writer will be obligated to make settlement based on the exercise settlement value as originally reported, even if the value is subsequently revised or determined to have been inaccurate. In extraordinary circumstances (e.g., where the value as initially reported is obviously wrong and inconsistent with other available price information and a corrected value is promptly announced), OCC has discretion to direct that the exercise settlement be based on the corrected value.

12. If a cash-settled foreign currency options options on a trading day—as is the case with the cash-settled options traded at the date of this booklet—there will be no execution of an over- and under-trading transaction in those options on the morning of their expiration date. If the opening of the options market should be delayed for any reason on that day, there may be no trading at all that day in those options. Accordingly, holders and writers who wait until the last trading day to close out their positions in closing transactions in those options run a risk that they may be unable to do so.

13. If OCC determines that the exercise settlement value for any cash-settled foreign currency option is unreasonable for purposes of calculating the cash settlement amount, OCC has the authority to suspend the settlement obligations of the exercising holder and assigning writer of such option or to limit the cash settlement amount based on the best information available to OCC, or to do both. Accordingly, there is a risk to both holders and writers that the settlement of exercisability cash-settled foreign currency options may be postponed and may be based on a determination by OCC rather than by the procedures specified by the options market on which the options are traded.

**SPECIAL RISKS OF FLEXIBLY STRUCTURED OPTIONS**

In addition to the risks discussed above, the following special risks are applicable to flexibly structured options.

1. Because flexibly structured options have variable terms that are fixed by the parties, there are no pre

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**CHAPTER XI**

**SCOPE AND LIMITATIONS OF THIS BOOKLET**

Readers should be aware of the scope and limitations of this booklet set forth below.

1. This booklet has been prepared by the U.S. options markets for distribution pursuant to the requirements of SEC Rule 15b-1 under the Securities Exchange Act of 1934 and the rules of the U.S. options markets. This booklet is not intended to meet all requirements which may be of concern to any jurisdiction and should not be relied upon for that purpose.

2. Under the applicable SEC regulatory scheme for options, this booklet is not a prophylactic. Nothing in this booklet should be construed as furnishing enlightenment or advice as to the suitability of any investment strategy. A prospective buyer of any option is advised to consult with an investment professional. Any statement or offer to buy or sell any option is not an offer of any security under the Act.

3. Only the U.S. options markets on which an option is authorized to be traded are responsible for the statements in this booklet concerning that option.

4. The options markets do not furnish this booklet to be incorporated by reference into the OCC's prospectus or into any other publication that may be purchased or distributed by OCC, an options market, or any other person (other than a document that has been specifically designated to be a supplement to this booklet and that has been filed with the SEC pursuant to Rule 40-1). The fact that another document states that this
of buy and sell orders that impose special requirements with respect to approved of customers for options trading and recommendations of particular option transactions. This booklet does not attempt to describe these requirements, the rules and regulations governing brokerage firms and other securities professionals, or the agreements between the two, nor does this booklet cover the handling of options. However, the handling of options may be subject to the Securities and Exchange Commission's rules regarding the handling of options. This booklet should be used in conjunction with the booklet concerning such matters.

7. This booklet does not attempt to describe the risks to investors that may be associated with the additional fees in the conduct of any particular option transactions. The reader should not assume that the primary markets of the market for underlying related contracts will be efficient, liquid, and transparent in all circumstances or that their prices will be or remain at all times.

8. This booklet does not attempt to describe risks that may be inherent in an investment in the underlying index. It is advisable that the investor evaluate the risks associated with the purchase of an options contract on the contract's performance. The investor should not assume that the primary markets of the market for underlying related contracts will be efficient, liquid, and transparent in all circumstances or that their prices will be or remain at all times.

9. This booklet does not attempt to describe the risks associated with the purchase of an options contract on the contract's performance. The investor should not assume that the primary markets of the market for underlying related contracts will be efficient, liquid, and transparent in all circumstances or that their prices will be or remain at all times.

10. This booklet does not attempt to describe the risks associated with the purchase of an options contract on the contract's performance. The investor should not assume that the primary markets of the market for underlying related contracts will be efficient, liquid, and transparent in all circumstances or that their prices will be or remain at all times.

11. This booklet does not attempt to describe the risks associated with the purchase of an options contract on the contract's performance. The investor should not assume that the primary markets of the market for underlying related contracts will be efficient, liquid, and transparent in all circumstances or that their prices will be or remain at all times.
DECEMBER 1997
SUPPLEMENT

To accommodate the introduction of trading in cash-settled options on indexes of mutual funds, the February 1994 edition of the booklet entitled Characteristics and Risks of Standardized Options is amended by adding the following disclosure to Chapter IV, Index Options, following the third full paragraph on p. 26:

Index options may be traded on underlying indexes designed to reflect the net asset values of selected mutual funds in specified categories. For example, an underlying index may be designed to reflect the net asset value of a selected group of growth funds, or a selected group of growth and income funds. These indexes are calculated and disseminated based on the reported net asset values of the mutual funds included in the index. Mutual funds typically report their net asset values only once per day following the close of trading in the primary markets for the securities held in the funds’ investment portfolios. Mutual fund indexes are based on these closing values and are not updated during the trading day. Mutual fund indexes as reported during the trading day will thus be based on non-current information, not only because the funds’ portfolios may have changed since the previous day’s close, but also because the values of the funds’ portfolios securities during the trading day may vary from their values at the previous day’s close. Therefore, reported fund index values should not be relied upon as indicative of the current values of the mutual funds included in the indexes. In this respect, mutual fund indexes are comparable to other indexes that are not updated during the trading day, including certain foreign stock indexes. These other indexes are not updated because their component stocks may not be traded in their primary home country markets during all or part of the options trading day.

This supplement supersedes the October 1996 supplement to the options booklet.
that some or all of his short position may be assigned
(See the discussion in Chapter X under "Roles of Option Writers.") However, if less than all of the open
interest in an option series is exercised, OCC's proce-
dures for assigning exercises to Clearing Members
and brokers' procedures for allocating assignments to
customers may affect the likelihood that a customer's
position will be assigned and the potential size of
the assignment.

To address special considerations with respect to
the deadlines for the exercise of certain options that
cannot be exercised on a day when an options market is
closed for trading, the fourth paragraph under the caption "How to Exercise" in Chapter V of the Booklet is amended to read as follows:

A brokerage firm's cutoff time for accepting exer-
cise instructions becomes critical on the last trading
day before an option expires. An option that expires
unexercised becomes worthless. An option holder
who intends to exercise an option before expiration
must send written instructions to his broker at least
three business days before the firm's cutoff time for accepting exercise instructions on the last trading
day before expiration. If the expiration date of an option falls on a day on which
an options market is open for trading in that option, a brokerage firm's last cutoff time for accepting exercise
instructions prior to the option's expiration may be
on the expiration day. Investors should be aware of their
brokerage firm's policies in this regard. Many brok-
erage firms accept electronic instructions to exercise, or
have procedures for the exercise of, every option
which is on the money by a specified amount at expira-
tion. These procedures often incorporate other reference
OCC's administrative procedures that provide for the exercise of every option that is in the money by a
specified amount at expiration unless the Clearing
Firm carrying the option in its accounts instructs OCC
not to exercise the option. Investors should determine from their brokerage firm the applicable cut-off times,
the firm's procedures for submitting exercise instruc-
tions, and whether any of their options are subject to
automatic exercise. Investors should also determine
whether the exercise of their options is subject to
standing instructions of their brokerage firm, and if so,
their obligations with the spirit of the potential conse-
quences of such instructions.

foreign currency. For example, at the date of the booklet,
premiums for currently available dollar-denominated Swiss
franc options are expressed in U.S. cents, and premiums
for currently available dollar-denominated Japanese yen
options are expressed in hundreds of U.S. cents.

On page 38, the following is deleted: the sen-
tence immediately following the first "EXAMPLE," to the
d second "EXAMPLE," and the sentence immediately
following the second "EXAMPLE."

On page 39, the following is inserted immediately
before the last paragraph:

Readers should note, however, that certain
 exchanges may express premiums in other uncustom-
ary ways. Readers need to be sure they fully under-
stand the various conventions used by the exchanges on
which they trade in currency options.

The first paragraph under the heading "Cash Settled
Foreign Currency Options," which is the last paragraph
on page 43, is deleted and the following sentence is
added at the beginning of the first paragraph on page 44:

At the date of this booklet, dollar-denominated
cash-settled foreign currency options have been
approved for trading.

The last paragraph on page 44 is deleted and
replaced with the following:

EXAMPLE: If the exercise price of a cash-settled,
dollar-denominated call option on Swiss francs is $1.2500
per franc, the exercise settlement value of the option is
determined to be $1,2507, and the premium covers 10,000
francs, the cash settlement amount for the option will be
(12,507 - 1.2500) x 10,000 = 970.00.

Cash-settled foreign currency options may be auto-
matically exercised on the expiration date if the money
in the account is paid in a customer account. See the discus-
sion in Chapter VIII under "How to Exercise."

The exercise settlement value for cash-settled foreign
currency options will be based on an exchange rate for
the underlying foreign currency from a source selected by
the market participant which the options trade as an asset
in exchange rates. In the case of non-modified foreign
currency options, the options market on which the
options are traded would calculate and disseminate the underly-
ing rate. In either case, the rate would be based on the
market on which the options trade as an asset in exchange
rates. In the case of non-modified foreign
currency options, the options market on which the
options are traded would calculate and disseminate the underly-
ing rate. In either case, this rate would be based on the
market on which the options trade as an asset in exchange
rates.
other widely-available rates. The time at which the exercise settlement value is calculated and the method of calculation are determined by the options market on which the options are traded and may be changed by it at any time. Any such change may be more adverse to you than to options outstanding at the time of the change.

If OCC determines that the exercise settlement value of the underlying foreign currency option is unexpected, unreasonable, unreliable, unavailable, or inappropriate for purposes of calculating the exercise settlement amount of such series, OCC has the authority to suspend the exercise settlement obligations of the exercising and assigned Owning Member's options of such series or to fix the exercise settlement amount for exercised options of such series or to do both. In the event of such a suspension, OCC will fix a new exercise settlement date after OCC determines that the exercise settlement value is available or after OCC fixes the cash settlement amount.

If OCC determines to fix the cash settlement amount, it will act through an adjustment panel that will use its judgment as to what is appropriate for the protection of investors and the public interest. For a description of adjustment panels, see "Adjustment and Adjustment Panels" in Chapter 5. The panel may fix the cash settlement amount using the reported price or value of the underlying foreign currency at such time, or representing a combination or average of prices or values at such time or times, and reported in such manner, as the panel deems appropriate.

If an adjustment panel dictates fixing a cash settlement amount for a series of cash settled foreign currency options past the last trading day before expiration of that series, normal expiration exercise procedures will not apply to the affected series. Instead, exercise settlement will be postponed until the next business day following the day when the adjustment panel fixes the cash settlement amount, and each long position in the affected series will be treated as having been exercised if the cash settlement amount per contract for that series is $1.00 or more, or if the cash settlement amount per contract is less than $1.00, the option will be treated as having expired unexercised. As a result of these procedures, holders of existing cash settled foreign currency options may not know whether their options have been exercised, and writers of such options may not know whether they have been assigned an exercise, until after the expiration date. An adjustment panel's determinations shall be conclusive, binding on all investors, and not subject to review.

underlying rate-modified value = 112.7 x 109 = 122.4
The option is therefore in-the-money.
Exercise settlement value of the option is (122.4 - 120) x $100 = $2,400.
Do not confuse the rate-modified with the multiplier.
They serve different purposes and may or may not have the same numeric value.

EXAMPLE: Assume that the exchange rate underlying a rate-modified call option on the exchange rate between the Japanese Yen and the U.S. Dollar is 80.00 on May 1st. The stated rate for the option is 1.10, which means that the option is rate-modified. If the exercise premium is 1.00, the exercise settlement value is (110 - 110) x $100 = $0.

Note that, as in the case of index options, the multiplier determines the cash value of an option just as in the money by a specified amount, like index options, and unlike other cash settled currency options, a rate-modified currency option does not usually trade at its exercise price, and it is not considered an underlying currency.

The multiplier is also used in determining the total premium for a rate-modified currency option. For example, if the premium is priced at $0.60 and the multiplier is $120, the total premium for a single option is $72.

The paragraph numbered 12 on page 87 is deleted.

MAY 2000 SUPPLEMENT

The February 1998 edition of the booklet entitled "Derivatives (Foreign Options and Security Futures)" is amended as follows to reflect certain changes in foreign exchange rules as well as the rules of certain options markets.

The changes in Part I reflect modifications made to the definition of "optionary cash dividend or distribution" (cash dividends and distributions for which no adjustment is made). The changes in Part I reflect changes made to eliminate the need to round adjusted exercise prices in certain circumstances and to provide more precise conversion for fractional shares eliminated by rounding.

Parts II to V of this Supplement are unsuperseded and reproduce the February 2000 Supplement to the Booklet.

For further details on options on interests in investment companies and similar entities, Part VI begins to explain exercise settlement procedures or restrictions that may be imposed upon the exercise of certain extraordinary shares. Part VI discusses that a cancellation statement and prospects for the options covered by the booklet are no longer available.

Part VI pertains to an expansion of OCC's authority to adjust the multiplier for predetermined Treasury options and to the cash settlement amount for such options in certain circumstances. Part VII redefines theagination of certain options that may be used where certain extraordinary shares are held. Part VIII, which supersedes paragraph 1 of the March 2000 Supplement to the Booklet, permits the conversion of the expiration date for options on equity securities in certain circumstances.

Part I: Definition of Ordinary Cash Dividend, Dividend or Distribution.

The fourth paragraph on page 19 is amended to read as follows:

At a general rule, no adjustment is made for dividend payments in cash settlements. Cash dividends and distributions announced prior to February 1, 2000, will generally be considered "ordinary" unless they exceed 10% of the aggregate market value of the underlying security outstanding at the close of trading on the declaration date. The same rule will apply to options and after that.
**Stock Options with Exercise Prices Stated in Fractions**

As of the date of this Supplement, exercise prices for stock options are always stated in dollars and fractions of a dollar. However, the table in the fourth paragraph of the first section of this Supplement lists all stock options whose exercise prices are stated in dollars and fractions of a dollar.

A general rule is that any stock option with an exercise price of $2 or less will be exercised at a price of $2 or less. Similarly, any stock option with an exercise price of $3 or less will be exercised at a price of $3 or less.

**EXAMPLE:** An investor holds a call option covering 100 shares of XYZ stock with an exercise price of $2. If this investor exercises the option, he or she will receive 100 shares of XYZ stock at an exercise price of $2.

**Procedure and Restrictions:**

The procedures and restrictions for exercising stock options are detailed in the first section of this Supplement. These procedures include the following:

1. **Exercise Date:** The exercise date is the date on which the option holder must exercise the option to purchase the underlying stock.
2. **Exercise Price:** The exercise price is the price at which the option holder must purchase the underlying stock.
3. **Expiration Date:** The expiration date is the date on which the option ceases to be exercisable.
4. **Settlement:** The settlement occurs after the option is exercised and the underlying stock is delivered.
5. **Repayment:** If the investor exercises the option and the underlying stock is not available, the option holder may be required to repay the exercise price.

These procedures and restrictions are designed to ensure that all stock options are exercised in a fair and efficient manner.
If an adjustment panel delays paying an exercise settlement value for a series of tender option bonds past the last trading day before expiration of that series, normal expiration exercise procedures will not apply to the affected series.

An adjustment panel may delay an exercise settlement value for a series of tender option bonds past the last trading day before expiration of that series for any reason. Normal expiration exercise procedures will not apply to the affected series.

An adjustment panel may delay an exercise settlement value for a series of tender option bonds past the last trading day before expiration of that series for any reason. Normal expiration exercise procedures will not apply to the affected series.

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An adjustment panel may delay an exercise settlement value for a series of tender option bonds past the last trading day before expiration of that series for any reason. Normal expiration exercise procedures will not apply to the affected series.
JUNE SUPPLEMENT 2007

The February 2000 edition of the booklet entitled Charateristics and Risks of Standardized Options and Theoretical Value of a Security (the "Booklet") is further amended as provided below. The changes pertain to the definition of credit default options.

Credit default options, including credit default basket options, have characteristics that are different from those of other options described in the booklet and the present Supplement. Accordingly, some of the statements and terms in Chapters 1 and 2 of the Booklet are inappropriate to discuss default options. For example, as further described in this amendement, the option owner at the expiration date of a credit default option does not necessarily receive a cash payment if the credit default obligation has not occurred. The definitions of credit default options in this Supplement supersede materials in the Booklet applicable to other standardized options to the extent such material is inconsistent with statements in this Supplement. Credit default options are described by amendment in Chapter 1 of the Booklet as follows:

The title of Chapter 1 (the page 29 of the booklet) is changed to "DEBT OPTIONS: IS THERE A CREDIT DEFAULT OPTON?"

On page 30, the second and fifth paragraphs are deleted and replaced with the following paragraphs:

A credit default option, also known as a credit default option, is a credit default option under which the purchase of a particular credit default option is made by the owner of a credit default option, who will be paid a cash payment on the expiration date of the credit default option if the underlying credit default obligation has occurred. Credit default options are not standardized options as defined in the Booklet. Credit default options are not traded on any organized exchange.

The principal risks of holders and writers of credit default options and credit default options are discussed in Chapter 3 of the Booklet. The discussion of the risks of holders and writers of credit default options is included in the Booklet, although the risk of loss on credit default options is not discussed in the Booklet. The risk of loss on credit default options is not discussed in the Booklet, although the risk of loss on credit default options is not discussed in the Booklet.

Credit default options are not standardized options as defined in the Booklet. Credit default options are not traded on any organized exchange.

ADJUSTMENT OF CREDIT DEFAULT OPTIONS

Adjustments can be made to the standardized terms of credit default options. Credit default options may be adjusted on the expiration date if the underlying credit default obligation occurs. The adjustment of credit default options is not discussed in the Booklet. Credit default options are not traded on any organized exchange.

A credit default basket option is an aggregation of individual credit default options, each based on the same reference entity or a group of reference entities. Credit default basket options may be traded on any organized exchange. Credit default basket options are not traded on any organized exchange.

The effect of the reference entity's credit default will be removed from the credit default basket option. Premiums for credit default basket options and credit default options are expressed in points and decimals to obtain the aggregate premium for a specific option, multiplied by a premium multiplier specified by the listing options market.

ADJUSTMENT OF CREDIT DEFAULT OPTIONS

Adjustments can be made to the standardized terms of credit default options. Credit default options may be adjusted on the expiration date if the underlying credit default obligation occurs. The adjustment of credit default options is not discussed in the Booklet. Credit default options are not traded on any organized exchange.

A credit default basket option is an aggregation of individual credit default options, each based on the same reference entity or a group of reference entities. Credit default basket options may be traded on any organized exchange. Credit default basket options are not traded on any organized exchange.
that the listing options market demands to be suitable for specifying as successor reference obligations. The option will be exercised on the third business day after the expiration date. If no credit event occurs in time for the third business day, the option will expire worthless.

Adjustment of credit default basket options for a composite statistic in the case of a single or multiple credit default basket options is an adjustment to the risk unless one of the reference entities in the basket and for credit default basket options is determined, pursuant to the rules of the listing options market, to have occurred prior to the effective date of such adjustment event. The adjustment will be made by all market participants to the basket reference entities as of the date of the adjustment event. The adjustment will be made by all market participants to the basket reference entities as of the date of the adjustment event. The adjustment will be made by all market participants to the basket reference entities as of the date of the adjustment event. The adjustment will be made by all market participants to the basket reference entities as of the date of the adjustment event. The adjustment will be made by all market participants to the basket reference entities as of the date of the adjustment event.

Example: Company XYZ is a member of the Reference Entities Group. The Reference Entities Group consists of five entities, namely ABC, DEF, GHI, JKL, and MNO. Each entity has a credit default basket option contract tied to the creditworthiness of the other four entities. When one of the entities defaults, the credit default basket option contracts for the other entities must be adjusted accordingly.

In the example shown, Company XYZ’s credit default basket option contract for entity JKL is triggered. As a result, the credit default basket option contracts for entities ABC, DEF, GHI, and MNO must be adjusted. The adjustment will be made by all market participants to the basket reference entities as of the date of the adjustment event. The adjustment will be made by all market participants to the basket reference entities as of the date of the adjustment event. The adjustment will be made by all market participants to the basket reference entities as of the date of the adjustment event. The adjustment will be made by all market participants to the basket reference entities as of the date of the adjustment event. The adjustment will be made by all market participants to the basket reference entities as of the date of the adjustment event.

Adjustment of credit default basket options after a succession event. The succession event that occurs in respect of a reference entity that is a successor to another reference entity may be treated in the same manner as if it was a new credit default basket option contract for the successor entity.

Example: Company XYZ is a member of the Reference Entities Group. Company XYZ’s credit default basket option contract is tied to the creditworthiness of entities ABC, DEF, GHI, and JKL. When entity JKL defaults, Company XYZ’s credit default basket option contract for entity JKL will be adjusted to reflect the creditworthiness of entity KLM, which is the successor to entity JKL.

2. The sources of price information used to price credit default options are subject to a level of transparency and, at times, liquidity. The specific sources used may be subject to other factors, such as the period of time during which the underlying securities are traded, the volume of transactions, the level of information available about the underlying securities, and the level of information available about the reference entities. The price information used to price credit default options may be obtained from a variety of sources, including financial markets, government agencies, and private companies. The price information may be obtained through the use of computerized systems, such as electronic trading platforms, or through the use of human intermediaries, such as dealers.

Example: Company XYZ is a member of the Reference Entities Group. Company XYZ’s credit default basket option contract is tied to the creditworthiness of entities ABC, DEF, GHI, and JKL. The price information used to price Company XYZ’s credit default basket option contract is obtained from the financial markets, government agencies, and private companies. The price information is obtained through the use of electronic trading platforms and computerized systems.

SPECIAL RISKS OF CREDIT DEFAULT OPTIONS

1. Pricing of credit default options is complex. Accurate comparisons of the creditworthiness of different reference entities is necessary to determine the price of credit default options. Different sources may use different methodologies to determine the creditworthiness of reference entities, which can lead to differences in the prices of credit default options.

Example: Company XYZ is a member of the Reference Entities Group. Company XYZ’s credit default basket option contract is tied to the creditworthiness of entities ABC, DEF, GHI, and JKL. Different sources may use different methodologies to determine the creditworthiness of entities ABC, DEF, GHI, and JKL, which can lead to differences in the prices of Company XYZ’s credit default basket option contract.

2. The price of credit default options may be affected by changes in the market conditions. Changes in market conditions, such as changes in economic conditions, political conditions, and the level of volatility in the credit markets, can affect the prices of credit default options.

Example: Company XYZ is a member of the Reference Entities Group. Company XYZ’s credit default basket option contract is tied to the creditworthiness of entities ABC, DEF, GHI, and JKL. Changes in market conditions, such as changes in economic conditions, political conditions, and the level of volatility in the credit markets, can affect the price of Company XYZ’s credit default basket option contract.

3. The price of credit default options may be affected by the level of information available about the underlying securities. The level of information available about the underlying securities can affect the price of credit default options.

Example: Company XYZ is a member of the Reference Entities Group. Company XYZ’s credit default basket option contract is tied to the creditworthiness of entities ABC, DEF, GHI, and JKL. The level of information available about the underlying securities can affect the price of Company XYZ’s credit default basket option contract.

4. The price of credit default options may be affected by the level of information available about the reference entities. The level of information available about the reference entities can affect the price of credit default options.

Example: Company XYZ is a member of the Reference Entities Group. Company XYZ’s credit default basket option contract is tied to the creditworthiness of entities ABC, DEF, GHI, and JKL. The level of information available about the reference entities can affect the price of Company XYZ’s credit default basket option contract.

5. The price of credit default options may be affected by the level of information available about the underlying securities and the reference entities. The level of information available about the underlying securities and the reference entities can affect the price of credit default options.

Example: Company XYZ is a member of the Reference Entities Group. Company XYZ’s credit default basket option contract is tied to the creditworthiness of entities ABC, DEF, GHI, and JKL. The level of information available about the underlying securities and the reference entities can affect the price of Company XYZ’s credit default basket option contract.

6. The price of credit default options may be affected by the level of information available about the underlying securities and the reference entities. The level of information available about the underlying securities and the reference entities can affect the price of credit default options.

Example: Company XYZ is a member of the Reference Entities Group. Company XYZ’s credit default basket option contract is tied to the creditworthiness of entities ABC, DEF, GHI, and JKL. The level of information available about the underlying securities and the reference entities can affect the price of Company XYZ’s credit default basket option contract.

7. The price of credit default options may be affected by the level of information available about the underlying securities and the reference entities. The level of information available about the underlying securities and the reference entities can affect the price of credit default options.

Example: Company XYZ is a member of the Reference Entities Group. Company XYZ’s credit default basket option contract is tied to the creditworthiness of entities ABC, DEF, GHI, and JKL. The level of information available about the underlying securities and the reference entities can affect the price of Company XYZ’s credit default basket option contract.

8. The price of credit default options may be affected by the level of information available about the underlying securities and the reference entities. The level of information available about the underlying securities and the reference entities can affect the price of credit default options.

Example: Company XYZ is a member of the Reference Entities Group. Company XYZ’s credit default basket option contract is tied to the creditworthiness of entities ABC, DEF, GHI, and JKL. The level of information available about the underlying securities and the reference entities can affect the price of Company XYZ’s credit default basket option contract.

9. The price of credit default options may be affected by the level of information available about the underlying securities and the reference entities. The level of information available about the underlying securities and the reference entities can affect the price of credit default options.

Example: Company XYZ is a member of the Reference Entities Group. Company XYZ’s credit default basket option contract is tied to the creditworthiness of entities ABC, DEF, GHI, and JKL. The level of information available about the underlying securities and the reference entities can affect the price of Company XYZ’s credit default basket option contract.

10. The price of credit default options may be affected by the level of information available about the underlying securities and the reference entities. The level of information available about the underlying securities and the reference entities can affect the price of credit default options.

Example: Company XYZ is a member of the Reference Entities Group. Company XYZ’s credit default basket option contract is tied to the creditworthiness of entities ABC, DEF, GHI, and JKL. The level of information available about the underlying securities and the reference entities can affect the price of Company XYZ’s credit default basket option contract.
JUNE 2008 SUPPLEMENT

This supplement supercedes and replaces the April 2008 Supplement to the booklet entitled Characteristics and Allied Standards (collectively the “Bookeet”). This supplement adds information relating the following new options products to the series of cash settled options, binary options, binary options, binary options, and range options.

The third paragraph of page 1 of the bookeet is replaced with the following paragraph:

What is an option? An option is the right to buy or sell a specified asset or value at a specified underlying interest rate at a fixed exercise price by exercising the option in accordance with its expiration date. An option which gives the right to sell is an option, and an option which gives the right to buy is a call option. Calls and puts are distinct types of options, and buying or selling of one type does not involve the other. Certain special kinds of options may give the right to receive a cash payment if certain criteria are met.

The last paragraph on page 1 of the bookeet, which contains on the tail of page 2, is replaced with the following paragraph:

There are two different kinds of options: physical delivery options, and cash-settled options. A physical delivery option gives the holder the right to receive physical delivery of a call or put at the exercise price. A cash-settled option gives the holder the right to receive a cash payment. A cash-settled option is either a binary option, or an option on a physical delivery option. A cash-settled option may be exercised by requiring the holder to receive a cash payment based on the difference between the exercise price and the option price. The exercise price of a call is the same as its strike price, and the exercise price of a put is the strike price of the option. The exercise price of an American-style option on a physical delivery option is the strike price of the option. The exercise price of an American-style option on a cash-settled option is the strike price of the option. The exercise price of a European-style option on a cash-settled option is the strike price of the option. The exercise price of a binary option is the strike price of the option. The exercise price of a range option is the range of values.

The fourth paragraph of page 2 of the bookeet is replaced with the following paragraph:

The exercise price of a cash-settled option (either a binary option or a range option) is the strike price of the option. The exercise price of a binary option is the strike price of the option. The exercise price of a range option is the range of values.

The fifth paragraph of page 2 of the bookeet is replaced with the following paragraph:

The exercise price of a binary option is the strike price of the option. The exercise price of a range option is the range of values.

The sixth paragraph of page 2 of the bookeet is replaced with the following paragraph:

The exercise price of a binary option is the strike price of the option. The exercise price of a range option is the range of values.

The seventh paragraph of page 2 of the bookeet is replaced with the following paragraph:

The exercise price of a binary option is the strike price of the option. The exercise price of a range option is the range of values.

The eighth paragraph of page 2 of the bookeet is replaced with the following paragraph:

The exercise price of a binary option is the strike price of the option. The exercise price of a range option is the range of values.

The ninth paragraph of page 2 of the bookeet is replaced with the following paragraph:

The exercise price of a binary option is the strike price of the option. The exercise price of a range option is the range of values.

The tenth paragraph of page 2 of the bookeet is replaced with the following paragraph:

The exercise price of a binary option is the strike price of the option. The exercise price of a range option is the range of values.

The eleventh paragraph of page 2 of the bookeet is replaced with the following paragraph:

The exercise price of a binary option is the strike price of the option. The exercise price of a range option is the range of values.

The twelfth paragraph of page 2 of the bookeet is replaced with the following paragraph:

The exercise price of a binary option is the strike price of the option. The exercise price of a range option is the range of values.

The thirteenth paragraph of page 2 of the bookeet is replaced with the following paragraph:

The exercise price of a binary option is the strike price of the option. The exercise price of a range option is the range of values.

The fourteenth paragraph of page 2 of the bookeet is replaced with the following paragraph:

The exercise price of a binary option is the strike price of the option. The exercise price of a range option is the range of values.

The fifteenth paragraph of page 2 of the bookeet is replaced with the following paragraph:

The exercise price of a binary option is the strike price of the option. The exercise price of a range option is the range of values.

The sixteenth paragraph of page 2 of the bookeet is replaced with the following paragraph:

The exercise price of a binary option is the strike price of the option. The exercise price of a range option is the range of values.

The seventeenth paragraph of page 2 of the bookeet is replaced with the following paragraph:

The exercise price of a binary option is the strike price of the option. The exercise price of a range option is the range of values.

The eighteenth paragraph of page 2 of the bookeet is replaced with the following paragraph:

The exercise price of a binary option is the strike price of the option. The exercise price of a range option is the range of values.

The nineteenth paragraph of page 2 of the bookeet is replaced with the following paragraph:

The exercise price of a binary option is the strike price of the option. The exercise price of a range option is the range of values.

The twentieth paragraph of page 2 of the bookeet is replaced with the following paragraph:

The exercise price of a binary option is the strike price of the option. The exercise price of a range option is the range of values.

The twenty-first paragraph of page 2 of the bookeet is replaced with the following paragraph:

The exercise price of a binary option is the strike price of the option. The exercise price of a range option is the range of values.
The following paragraphs are inserted following the carry-over paragraph at the top of page 12 of the booklet:

In the case of a binary option, the cash settlement amount is determined by the underlying options market and, whether or not it is established through use of a multiplier, is fixed and does not vary (except in the case of certain adjustments described below) regardless of the amounts by which the exercising settlement value is increased (in the case of a binary call option) or is less than (in the case of a binary put option) the exercise price.

**EXAMPLE:** An investor holds a binary call option on XYZ security that has an exercise price of $80, and a fixed cash settlement amount of $100. If the exercise settlement value of XYZ is $120 at expiration, the investor will receive $100. If the exercise settlement value of XYZ is $60, the investor will receive $0. In the other case, the exercise settlement value of XYZ at expiration is below $80; the investor will receive nothing, and the option will expire worthless.

It is very important to note that the condition under which a binary option returns a cash settlement amount may vary depending upon the rules of the listing options market. Specifically, the listing options market may, at its own option, return cash settlement amounts if it deems the exercise settlement value is above a certain amount (a binary call) or below a certain amount (a binary put). In addition, certain binary call options return a cash settlement amount if the exercise settlement value of the underlying is exactly equal to the exercise price.

**EXAMPLE:** Assume XYZ stock is the underlying security for a binary stock option with an exercise price of $85, and the exercise settlement value of XYZ at expiration is exactly $85. If the listing options market specifies that the option would return a cash settlement amount if the exercise settlement value was above the exercise price, the option would immediately expire (all) if the exercise settlement value of XYZ was either $80 or $90. If the exercise settlement value of XYZ was anything else, the option would be automatically exercised and a cash settlement amount would be paid to the holder.

In the case of a range option, the cash settlement amount varies depending on whether the exercise settlement value of the underlying is above or below the range (at expiration). At the time of expiration of this option, the holder of the call option is entitled to receive a cash settlement amount that is:

**EXAMPLE:** Assume that XYZ range options have a specified range length from 1000 to 1005, a range interval of 10, a maximum exercise price of 105, and a multiplier of $100. The range therefore has a maximum cash settlement amount of $10,000 (multiplier times maximum range exercise value), a low range from 1000 to 1005, a mid-range from 1005 to 1006, and a high range from 1010 to 1100. The table below summarizes the variations in cash settlement amount based on the range of the underlying:

**INTRINSIC VALUE AND TIME VALUE:** It is sometimes useful to consider the premium of an option as consisting of two components: intrinsic value and time value.

In the case of an option other than a binary option, the intrinsic value is equal to the amount, if any, by which the current market value of the underlying is above (below if a put) the exercise price of the option. A range option, which is a simple option that can be classified as either a call or a put, is said to be at-the-money if the current market value of the underlying is at the top or bottom of the range length.

**EXAMPLE:** Assume a series of XYZ range options has a specified range length from 1000 to 1005, a range interval of 10, a maximum exercise price of 105, and a multiplier of $100. The range therefore has a maximum cash settlement amount of $10,000 (multiplier times maximum range exercise value), a low range from 1000 to 1005, a mid-range from 1005 to 1006, and a high range from 1010 to 1100. The table below summarizes the variations in cash settlement amount based on the range of the underlying:

**OUT-OF-THE-MONEY:** The exercise price of a call is above the current market value of the underlying interest; or the exercise price of a put is below the current market value of the underlying interest. In either case, the holder of an option to buy or sell the underlying is out of the money.

**EXAMPLE:** Assume the current market price of XYZ stock is $115, and the exercise price of the option is $120. The holder of the option is out of the money by $5.

**IN-THE-MONEY:** The exercise price of a call is below the current market value of the underlying interest; or the exercise price of a put is above the current market value of the underlying interest. In either case, the holder of an option to buy or sell the underlying is in the money.

**EXAMPLE:** Assume the current market price of XYZ stock is $95, and the exercise price of the option is $100. The holder of the option is in the money by $5.
EXERCISE PRICE SETTING DATE — The exercise price setting date for a series of delayed start options is the date on which the options market on which the series is traded will set the exercise price for the series. The exercise price setting date is specified in the announcement of trading of the series of delayed start options. Specific information regarding exercise price setting dates may be obtained from the listing option manual.

EXERCISE PRICE SETTING FORMULA — The exercise price setting formula for a series of delayed start options is the formula used by the options market on which the series is traded to calculate the exercise price for the series on the exercise price setting date. The exercise price setting formula is specified in the announcement of trading of each series of delayed start option. The formula for a particular option series may provide that the exercise price will be the money by a specified amount, or the money by a specified amount. Exercise prices may be rounded as specified by the listing option market.

EXAMPLE: In January, an American-style delayed start option on the ABC index is opened for trading with an exercise price setting date of the third Friday in September and an exercise price setting formula specifying that the exercise price will be the closing value of the ABC index on the exercise price setting date, rounded to the nearest whole number. The option may not be exercised at all until after the third Friday in September because it will not have an exercise price until that date. At the close of trading on the third Friday in September, the ABC index closed at 1000. The exercise price setting date is the third Friday in September, and the exercise price setting formula is the formula used by the options market on which the delayed start option is traded to set the exercise price. The exercise price setting date will determine the closing value of the ABC index and the exercise price based on that value. For example, if the options market determines that the ABC index closed at 1000 on the exercise price setting date, the exercise price setting formula would round that value to 1000, and that value would be the exercise price for the option. The exercise price setting formula would be a regular American-style option with an exercise price of 1000.

The following paragraph is inserted immediately following the subsection “Features of Stock Options” on page 135 of the Booklet:

The following discussion relates primarily to stock options other than binary option contracts. A separate description of the features of binary option contracts may be found at the end of this chapter.

than a whole number of shares, of the underlying security is issued. The adjustment panel has discretion to make exceptions to the general rules described above.

EXAMPLE: Suppose a 2-for-1 stock split, an investor holds one ABC binary stock option with an exercise price of $500. If the exercise settlement value of ABC is 1000 at expiration, the exercise price will be $500. If the exercise settlement value of ABC is 1500 at expiration, the exercise price will be $750. This is because the investor will receive 100 additional shares for each share held.

An investor holds one XYZ binary stock option with an exercise price of $100 that pays a cash settlement amount of $100 if the exercise settlement value of XYZ stock is above the exercise price. XYZ stock is $60 at expiration. For the investor to be able to exercise the option, it must have an exercise price of $100. The exercise price will be adjusted to $60. For example, if the exercise settlement value of XYZ stock is $120 at expiration, the investor will receive $120. Exercise prices of binary stock options will be rounded, as described above.

An investor holds two ABC binary stock options with an exercise price of $50 and pays a cash settlement amount of $100 if the exercise settlement value of ABC stock is above the exercise price. XYZ stock is $60 at expiration. The exercise price will be adjusted to $60. For example, if the exercise settlement value of XYZ stock is $120 at expiration, the investor will receive $240. Exercise prices of binary stock options will be rounded, as described above.

In the event of a reverse stock split or combination of shares, the exercise price will be proportionately increased.

Distributions of property other than the underlying security may result in adjustments to the terms of binary stock options. For example, the exercise settlement value might be adjusted to include the value of the distributed property.

EXAMPLE: XYZ “pops off” its subsidiary ABC by distributing to its stockholders two shares in ABC for each share of XYZ. The exercise settlement value of XYZ binary stock options may be adjusted to include the value of two shares of ABC, as well as one share of XYZ.

Alternatively, the option might be adjusted by reducing the exercise price by an amount equal to the value of the property distributed, resulting in a cash settlement that is a cash settlement in the option in the exercise price. As in the exercise price, the exercise price will be adjusted to the average exercise price by an amount equal to the value of the property distribution. The exercise price will be adjusted to a cash settlement that is a cash settlement in the exercise price.

As in the case of other stock options, adjustments to the terms of binary stock options may result from events other than dividends, distributions, and splits. If all outstanding shares of an underlying security are acquired in

A merger or consolidation, binary stock options may be adjusted so that the cash securities or other property received by stockholders is, with respect to each share of the underlying security, the exercise price. Alternatively, an adjustment panel may determine to adjust to a cash settlement of $100 or the number of the non-cash property received.

While holders of an underlying security receive only cash for an option on the underlying security, the option may receive a cash settlement for a cash value for all non-cash property received. For example, the option may receive $100 if the exercise price is $100. The exercise price will be adjusted to $50. For example, if the exercise settlement value of XYZ stock is $120 at expiration, the investor will receive $120. Exercise prices of binary stock options will be rounded, as described above.

In the event of a reverse stock split, any adjustment decision with respect to binary stock options will be made by an adjustment panel as described above. The adjustment panel has discretion to make exceptions to the general rules described above.

As in the case of other stock options, any adjustment decision with respect to binary stock options will be made by an adjustment panel as described above. The adjustment panel has discretion to make exceptions to the general rules described above.

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As in the case of other stock options, any adjustment decision with respect to binary stock options will be made by an adjustment panel as described above. The adjustment panel has discretion to make exceptions to the general rules described above.
The second paragraph following the caption "How to Exercise" on page 69 of the Booklet is replaced with the following paragraph:

In order to exercise most options traded at the date of this booklet, action must be taken by the option holder prior to the expiration date of the option. However, some options may be exercised in automatic exercise. For example, capped options are subject to automatic exercise if the strike price is lower than the exercise price of the underlying instrument. As a result, the exercise price may be lower than the exercise price of the underlying instrument. For example, capped options are subject to automatic exercise if the strike price is lower than the exercise price of the underlying instrument. As a result, the exercise price may be lower than the exercise price of the underlying instrument. The exercise price may be lower than the exercise price of the underlying instrument. For example, capped options are subject to automatic exercise if the strike price is lower than the exercise price of the underlying instrument.
The following example is inserted immediately following the example at the bottom of page 63 of the Booklet:

**EXAMPLE:** An investor receives a premium of $4 for writing a binary call option on XYZ security that has an exercise price of $50 and a fixed cash settlement amount of $100. If the underlying security value of XYZ is $51 at expiration, the investor will receive $101 paid to the holder of the call option less the $4 premium received when the option was written.

The paragraph beginning at the bottom of page 63 of the Booklet is replaced with the following paragraph:

The investor is aware of the underlying asset's value at expiration, and the investor may then exercise the option to either sell the underlying asset for $51 or retain ownership of the underlying asset. The investor will receive $101 paid to the holder of the call option less the $4 premium received when the option was written.

The paragraph numbered 1 on page 64 of the Booklet is replaced with the following paragraph:

4. As with writing covered calls, the risk of writing put options is substantial. The writer of a put option incurs a loss if the put is exercised, which would lead to the following events:

- The underlying asset's value at expiration is less than the exercise price.
- The writer receives a premium for writing the put option.
- The writer is obligated to sell the underlying asset for the exercise price, regardless of its market value.

The risk involved in writing put options is substantial, and the writer should consider the underlying asset's market value before writing put options.

**EXAMPLE:** An investor receives a premium of $4 for writing a binary put option on XYZ security with an exercise price of $40 and a fixed cash settlement amount of $100. If the underlying security value of XYZ is $39 at expiration, the investor will receive $101 paid to the holder of the put option less the $4 premium received when the option was written.

The first full paragraph on the top of page 65 of the Booklet is replaced with the following paragraph:

In the case of a put option, if the investor writes a put option, the investor's exposure to the underlying asset's value is limited. If the underlying asset's value is less than the exercise price, the investor will receive the exercise price plus the premium received when the option was written. However, if the underlying asset's value is equal to or greater than the exercise price, the investor will experience a loss.

The paragraph numbered 4 on page 71 of the Booklet is replaced with the following paragraph:

4. Cash-settled options have certain special risks.

The special risks applicable to cash-settled options are discussed under "Special Risks of Options." Below, the special risks applicable to range options are discussed under "Special Risks of Range Options." The special risks applicable to binary options are discussed under "Special Risks of Binary Options." The special risks applicable to credit default options are discussed under "Special Risks of Credit Default Options."
amount or incurring worthwhile. References herein to index values ‘as initially reported’ refer to the values initially reported by the Index Operator of the index as definitive, and not to any tentative or preliminary values that may be announced at an earlier time subject to adjustment. In extraordinary circumstances (e.g., where an exercise settlement value as initially reported is obviously wrong and incorrect values have been previously reported, and the corrected value is promptly announced), OTC has discretion to defer an exercise settlement based on corrected exercise settlement value. Ordinarily, however, a revised exercise settlement value as initially reported by the official source of the Index will be conclusive for exercise settlement purposes.

The paragraphs numbered 7 and 8 beginning on page 78 of the booklet are repeated with the following paragraphs:

7. Casually settled index options whose exercise settlement values, based on the opening prices of the constituent securities, are not then current at the last sale shall, subject to the prior agreement of the parties, trade at a discount for those securities prior to the option settlement date. An option holder will be able to receive value from his option on that day only if the option is in the money and is exercised. A writer of this type of option who has not previously closed out his position will be unable to do so on that last trading day for the constituent securities and will be at risk of being assigned an exercise.

8. Current index levels will not ordinarily continue to be reported even when trading is delayed or cancelled in some or all of the constituent securities of the index when the reporting of quotations in those securities has been delayed. In that event, the reported index levels will be based on the most recent reported prices of the constituent securities—whether or not those securities are being currently reported. As a result, reported index levels may at times be based on non-current price information with respect to some or even all of the constituent securities of the index. If this condition existed at the time of determining the exercise settlement value of an expired option, that exercise would be settled on the basis of an index level that reflected non-current price information and would not reflect the most recent trading of the constituent securities which may be subject to significant price fluctuations for a significant portion of the index value. Indeed, as noted in Chapter IV, an exercise settlement value that is based on the most recent trading of the constituent securities may not coincide with, and may diverge substantially from, the index values that are reported at the time of the opening. Moreover, the index underlying a capped index option or a binary index option, that option would not be automatically exercisable based on an index level that might reflect the true state of the market at the time.

The paragraph numbered 10 beginning on page 78 of the booklet is repeated with the following paragraph:

10. The purchase and sale of index options in foreign markets at times when U.S. markets are closed may present special risks. Although an underlying index may be based on securities primarily traded in U.S. markets, the index levels reported in foreign markets at such times may be based on the trading of some or all of the constituent securities in foreign markets, and, in any case, option premiums in the foreign markets will not reflect current prices of the constituent securities in U.S. markets. In addition, a cash settled index option or a binary index option, which are exercised through the foreign office of a book-certificated option in a U.S. market, are closed, the exercise settlement value of the option will not be known until after the closing prices for determining exercise settlement values on the next day on which U.S. markets are open. The corresponding rules would apply to the trading in U.S. markets of options based on an index of securities primarily traded in foreign markets.

The following new paragraph is inserted on page 79 of the booklet immediately before the section in Chapter II titled “Special Risks of Capped Options”:

11. Holders and writers of delayed start options bear the risk that the index level used to calculate the exercise price on the exercise date may not reflect the underlying price level appropriately or in any way that the market may subsequently decline below the exercise price. The section discusses some of the risks of an erroneously reported index level to a portion holding, selling, or exercising an option, or who is otherwise adversely affected by the delayed start exercise, based on the erroneous index level. Similarly, persons who are holders or writers of delayed start options on the exercise price setting date bear the risk that an erroneously reported index level will be used to determine the exercise price. Once a certain delayed start option is closed out for trading on the day after the exercise price setting date, even if a corrected index level is later reported, or if it is later discovered that an exercise price was incorrectly used, the situation will not be corrected for accounts for such errors.

The following new section is inserted at the end of Chapter II of the booklet following the section expanded:...
opportunities for manipulation may be greater when the underlying interest is in individual security than when it is an index. Volume-weighted average price is used to determine the actual settlement value of binary options in order to reduce the likelihood of such manipulation. While market manipulation may be unlawful under the federal securities laws and SEC regulations, there can be no assurance that manipulation affecting binary options will not occur. If manipulation does occur, exercise settlement values may be based on the manipulated price and may fall below the prevailing price that a buyer might reasonably expect.

4. A writer of a binary option has risks similar to those of writers of other options. European-style options except that the writer may be required to pay any excess at an exercise price if it is limited to the fixed settlement amount. Even though the potential loss is limited, writers of binary options must have sufficient liquidity to pay the fixed cash settlement amount and the financial capacity to bear that risk.

5. A writer of a binary option will be obligated to pay the investor the fixed cash settlement amount, even if the exercise settlement value is only partially in the investor's favor. In the case of certain binary options, all the money invested should be aware of the possibility for automatic execution of the binary options that they purchase or write. Binary option contracts may be offered in this regard from binary option providers, and binary options listed on one exchange market may have different terms from those listed on other option markets.

6. A binary option that has an exercise price at or near the current price or level of the underlying asset is riskier than others with options with lower exercise prices or levels, and therefore involves more risk than a non-binary option.

The following new section is inserted at the end of Chapter 4 on page 4 of the Book.

DECEMBER 2009 SUPPLEMENT

1. SPECIAL RISKS OF RANGE OPTIONS

Options contracts have a unique payout structure. Whereas other cash-settled options (other than binary options) provide an increasingly greater return to the option holder as the difference between the exercise price and the level of the underlying interest increases, a range option’s potential provides a linear increase through the lower range, a linear decrease through the upper range, and a combination of the two in between. Therefore, a range option holder must be sure that the option at an anticipated change in the level of the underlying index, but he must also be aware about the degree of the change in the level of the underlying index, thereby reducing the risk associated with the position.

2. The writer of a range option, if he writes on other option contracts, must run the risk that the option will expire expiring before the exercise is exercised in the exercise of the option. The writer of an option contract is required to pay the exercise price at the exercise price value.

3. A writer of a binary option, if he writes on other option contracts, must run the risk that the option will expire before the exercise price is exercised in the exercise of the option. The writer of an option contract is required to pay the exercise price at the exercise price value.

EXAMPLE: An investor receives a premium of $10 for writing a range option on XYZ that has a maximum payoff amount of $100. Assume that the option has a range from 100 to 105, with a premium of $10 paid by the investor to the writer of the option. The investor will earn a loss of $10 (the $100 paid to the holder of the option less the $10 premium received when the option was written). If the level of the XYZ index is below 100, the investor will earn a loss of $10 (the $100 paid to the holder of the option minus the $10 premium received when the option was written). If the index level falls expiring before the exercise price is exercised in the exercise of the option. The writer of an option contract is required to pay the exercise price at the exercise price value.

4. A writer of a binary option, if he writes on other option contracts, must run the risk that the option will expire after the exercise price is exercised in the exercise of the option. The writer of an option contract is required to pay the exercise price at the exercise price value.

The following new section is inserted at the end of Chapter 4 on page 4 of the Book.

DECEMBER 2009 SUPPLEMENT

The December 2009 version of the book, titled "Characteristics and Risks of Standardized Options" (the "Booklet") is amended as provided below. Part I of this Supplement contains information regarding options on asset indices including (1) (the booklets financial statement of a company or the booklets implied volatility) or realized volatility of the daily returns of a stock index; (2) the return to a strategy for hedging, and the level of the underlying interest; and (3) the difference between the exercise price and the level of the underlying interest. A range option’s potential provides a linear increase through the lower range, a linear decrease through the upper range, and a combination of the two in between. Therefore, a range option holder must be sure that the option at an anticipated change in the level of the underlying index, but he must also be aware about the degree of the change in the level of the underlying index, thereby reducing the risk associated with the position.

2. The writer of a range option, if he writes on other option contracts, must run the risk that the option will expire before the exercise price is exercised in the exercise of the option. The writer of an option contract is required to pay the exercise price at the exercise price value.

3. A writer of a binary option, if he writes on other option contracts, must run the risk that the option will expire after the exercise price is exercised in the exercise of the option. The writer of an option contract is required to pay the exercise price at the exercise price value.

EXAMPLE: An investor receives a premium of $10 for writing a range option on XYZ that has a maximum payoff amount of $100. Assume that the option has a range from 100 to 105, with a premium of $10 paid by the investor to the writer of the option. The investor will earn a loss of $10 (the $100 paid to the holder of the option less the $10 premium paid when the option was written). If the level of the XYZ index is below 100, the investor will earn a loss of $10 (the $100 paid to the holder of the option minus the $10 premium received when the option was written). If the index level falls expiring before the exercise price is exercised in the exercise of the option. The writer of an option contract is required to pay the exercise price at the exercise price value.
Underlying indexes are in various categories. A stock index may be based on the price of all, or only a sample, of the securities whose prices it is intended to represent. Like stock indices, commodity indices, currency indices, and dividend indices are securities indexes. However, volatility indexes may measure the implied volatility of an index, using the premiums for options on the index, or may measure the historical volatility or variance in the returns of an index over a certain period assuming a mean daily return of zero. Standardized indexes measure the return of a portfolio strategy involving the composition securities of an index selected on that index. The performance of these indexes is used to reflect the price movements of the components of the strategy or strategy-based diversification. The selection of diversified indexes is based on their specific characteristics.

**STOCK INDEXES**

4. The example in the second full paragraph on page 25 is amended as follows:

Investors should keep in mind that a stock index can vary in response to reported price movements in its component securities.

5. The paragraph that was removed following the second full paragraph on page 26 in the December 1997 Supplement to this book is revised so that it follows the second full paragraph on page 25 since this paragraph relates to stock indexes and not to volatility indexes or strategy-based indexes.

6. The following paragraph and captions are added on page 25 following the relocated paragraph referred to in point 3 immediately above:

**DIVIDEND INDEXES**

Dividend indexes measure the stock price changes of the component securities of underlying indexes that result solely from the distribution of ordinary cash dividends as calculated on a per-share basis for shares of each underlying index.

The information set forth on pages 26 through 28 of the booklet under the caption "Funds of Index Options" is generally applicable to volatility indexes. However, the method of determining the exercise settlement price is different between volatility indexes and strategy-based indexes. Therefore, the exercise settlement price is different between volatility indexes and strategy-based indexes.

7. As of the date of the Supplement, options are approved for trading on three different types of volatility indexes representing three different ways of measuring volatility. A realized variance index measures variance on a specified trinomial or trinomial triangular basis, over a specified period of time. The volatility index represents the variance of the same index over the same time period. It refers to the standard deviation of the absolute value of the historical returns of the index.

An implied volatility index is a measure of the implied future variance of the reference index over a specified time period. The implied volatility index measures the implied standard deviation of the future price of the index over the specified future time period. An implied volatility index reflects future expectations about the future volatility of the reference index, as implied by the market price of options on the index. Implied volatility indexes are calculated using the midpoints of the bid and ask premium quotes, which have index values on a specified time period. Implied volatility indexes are calculated using the midpoints of the bid and ask premium quotes of the options series that generates the index. These index values are based on quotations; they are sometimes referred to as "implied values." Because different indexes may be used in calculating the implied volatility, the exercise settlement values for implied volatility options, there is no direct relationship between the exercise settlement values for implied volatility options and index values calculated at the option's settlement date.

Investors should keep in mind that the volatility index of an implied volatility index is calculated using the implied volatility of the index, as measured by the index value of the index. The volatility index is based on the volatility of the index over a specified period of time. An implied volatility index is calculated using the market price of options on the index at the option's settlement date.
value will be based on non-current information. The quality of the information reflected in the value of the index is not implied. Variability index should be evaluated in light of the depth and liquidity of the market for the securities in the reference index and the option or options that are the components of the index.

The realized variability index (RVII) is the component variability index approved for trading as of the date of this Supplement. The RVII measures the actual variability or variance of the price of the index over the fixed period ending on the last trading day before the expiration date of the RVII option. The index of a component security is published once per trading day during the fixed period, but values published early in the period, which are based on a small number of observations, may be substantially from the actual settlement value. The exercise settlement amount for a realized variability index is equal to the difference between the realized variability index and the exercise price of the option, times the multiplier.

Realized variability options that are described in this Supplement are European-style and "A-Melle." The strike and exercise prices of a realized variability index is equal to the exercise price of the option, times the multiplier.

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[Image -1x4 to 614x788]
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10. In certain circumstances, the use of realized variability indexes is preferred over other methods of calculating the exercise settlement values for realized variability options described in this Supplement. They are calculated from the actual settlement values of the reference index in the preceding period. A component security does not open for trading, the last recorded price in the reference index may be used. OCIO's rules for other methods of calculating the exercise settlement values of realized variability indexes are described in the Supplement. They are calculated from the actual settlement values of the reference index in the preceding period.

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[Image -1x4 to 614x788]
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11. The last paragraph on page 27 is replaced with the following paragraph:

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The exercise settlement values of index options are determined by Essar and the exchanges. The exercise settlement value is equal to the exercise price of the option multiplied by the multiplier on the index. The exercise settlement value is based on the reported level of the underlying index on the last trading day that is not scheduled as a trading day. If a particular security does not open for trading on the last trading day, its exercise settlement value is determined by Essar and Essar exchanges. Such last reported price of that security is used. For determining the exercise settlement values of index options, the exchanges may use a divisor value for determining the exercise settlement values of index options.
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12. The following paragraph is inserted on page 73, immediately following the reference "Special Rules of Index Options," and immediately before the paragraph immediately after the last paragraph:

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The rules described in paragraph 14 through 16 on pages 73 through 75 of the Supplement include primary rules to options on index options. The rules described in paragraph 14 through 16 include options on realized variability index options. The rules described in paragraph 15 relate to dividend options, and the rules described in paragraph 16 relate to realized variability index options.
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11. The following paragraphs are inserted on page 78 immediately following paragraph number 75, as amended by the June 2003 Supplement:

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Because different values may be used in calculating indicative values and exercise settlement values of
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the volatility index underlying implied volatility options, there is a risk that there may be a divergence between the expected settlement value and the actual settlement value.

12. The settlement value is calculated based on the expected settlement value and the actual volatility index calculated at the time of the trade on the same date as the opening time for each of the options series that is used to calculate the expected settlement value.

13. Strategies involving the purchase and sale of options on a volatility index can be complex and require a thorough understanding of the concepts that underlie these instruments. Investors should thoroughly research the methods used to calculate the index to ensure they understand the risks involved.

14. As in the case of all other index options, written and naked options on the volatility index cannot provide a substitute for holding or investing in stocks or other securities of the same issuer.

15. The expected value of dividend payments may be affected by factors other than the issuer's dividend policy, such as market conditions and the issuer's financial situation.

Part II: Definition of Ordinary Cash Dividends

The following replaces Part I of the May 2007 Supplement:

The fourth paragraph on page 19 of the booklet is amended to read as follows:

As a general rule, no adjustment is made for ordinary cash dividends or cash distributions. A cash dividend or distribution announced prior to February 1, 2009, will generally be considered "ordinary" unless it exceeds 10% of the aggregate market value of the underlying security outstanding at the close of trading on the declaration date. The same rule will apply on and after that date with respect to options series designed by OCC as "grandfathered" for purposes of this rule (i.e., series opened prior to publication of the May 2007 Supplement that remain outstanding on February 1, 2009) in the case of all other options series, a cash dividend or distribution announced on or after February 1, 2009, will generally be considered "ordinary," regardless of size. OCC believes that it was designed to avoid the adverse impact of a particular dividend or distribution on the holder of an option contract. The return from a particular strategy may depend on the strategy-type-based index, which may differ from the actual returns that an investor following that strategy achieves, because assumptions regarding transactions and the failure to take into account significant factors such as taxes and transaction costs.

13. Persons who exercise volatility options or strategy-based index options or are assigned derivatives based on an anonymous index that will be required to make settlement based on the expected settlement value as finally reported by the designated reporting authority for the relevant index, even if the connection value is subsequently announced by an independent third party. To help investors understand the implied and actual settlement value, OCC has distributed to officers that exercise settlements are based on a calculated average settlement value. Ordinarily, however, the implied settlement value as finally reported by the designated reporting authority for the underlying index will be considered as the settlement value for all exercise settlement purposes. As described in paragraph 1, page 19, if the index is reported by a regulated reporting authority for the underlying index, it will be consistent for all exercise settlement purposes. A strategy-based index may be based on non-constant information. This may occur in a period of volatility in the market for the component securities of the underlying index or the reference index (which are the same in the case of real-time volatility indexes).

14. As in the case of all other index options, written and naked options on strategy-based index options cannot provide a substitute for their potential settlement value or by acquiring the underlying securities. Instead, the risk of writing these option is greater than the risk of writing other index options. Even when some offsetting risk is possible, there are risks and other risks, respectively, and options discussed in paragraphs 3 and 4, pages 74 and 75 of the booklet, may be subject to conditions varying transactions in volatility or strategy-based index options and transactions in stocks or options, future contracts or other investments in stocks.

15. The following paragraph is inserted on page 29 immediately following the paragraph on May 2006:

The reported value of dividend payments may be affected by factors other than the financial stability of the issuer of the component securities of a dividend index or cash dividends. For example, the issuer's dividend policy may affect the amount of cash dividends in lieu of cash dividends or to foreign payment or cash dividends notwithstanding its ability to do so may affect the level of a dividend index.
performance of a "reference asset" which may, for example, consist of a securities or commodities index, a futures index, a physical commodity, a foreign currency, a similar debt security, or some combination of the above. The term "index" in the context of an index-linked security has a broader meaning than that set forth in Chapter IV since, in the context of an index-linked security, the term is synonymous with the term "reference asset" and is not limited to securities indices.

A third kind of options, called yield-based options, or options are also described in this Chapter. Credit default options are also described that are related to the creditworthiness of issuers or guarantors of debt securities, and are intended upon termination of a credit event affecting an underlying debt security or securities.

The principal risks of holders of credit default options are also described in this Chapter. Credit default options are also described that are related to the creditworthiness of issuers or guarantors of debt securities, and are intended upon termination of a credit event affecting an underlying debt security or securities.

The underlying debt securities of one kind of price-based option that have been approved for trading as of the date of this booklet, and the debt securities from which the underlying yields of price-based options are derived, are Treasury securities — e.g., 30-year Treasury bonds, 10-year Treasury notes, 5-year Treasury notes, and Treasury bills.

An adjustment may be made to certain of the standardized terms of outstanding options on index-linked securities if a particular event occurs that is deemed by an adjustment panel to warrant the adjustment. As in the case of stock options, an adjustment panel for index-linked securities would be composed of representatives of at least one of the U.S. equity markets and of representatives of CFTC, as described above in Chapter II.

Index-linked securities may return less than the principal originally invested, regardless of the performance of the index. The index is usually defined to be the price of a specified index, typically of a stock index, at a specified time, usually the end of the day. An index-linked security is a security that is linked to the performance of the index, and the return on the security is determined by the performance of the index over a specified period of time. An index-linked security may be an attractive investment for investors who believe that the performance of a particular index will be strong over the period of time for which the index-linked security is designed.

Index-linked securities are debt securities that are issued by financial institutions such as banks and may have the form of notes, certificates, units, or some other interest. An index-linked security provides a return based on the performance of an index-linked security, which may, for example, consist of a securities or commodities index, a futures index, a physical commodity, a foreign currency, another debt security, or some combination of the above. References in this booklet to "uninsured" of underlying index-linked securities include these various forms of interest. The term "index" is used in the context of an index-linked security has a broader meaning than that set forth in Chapter IV since, in the context of an index-linked security, the term is synonymous with the term "reference asset" and is not limited to securities indices. As of the date of this booklet, options are approved to be traded on conventional index-linked securities, but not on leveraged or inverse index-linked securities.

As a general rule, a single index-linked security option covers 100 units of the underlying security. However, it is possible that the number of underlying units covered by an index-linked security option would be adjusted after the option is issued if an adjustment panel determines, as described above, that it is appropriate to make such an adjustment.

The exercise prices of options on index-linked securities that are approved for trading as of the date of this booklet are stated in U.S. dollars per unit. As with stock options, the exercise price of an index-linked security option would be modified by the number of units underlying the option in order to determine the aggregate exercise price and aggregate premium of the option.

Index-linked securities generally have a term of at least one year but not greater than 30 years. Index-linked securities may be redeemable at certain intervals at the option of the holder through the issuer at a price related to the applicable underlying reference asset, there is no assurance that the exercise settlement date for an index-linked security option will coincide with the date on which the payment to the holder of the underlying security becomes available from the issuer. Covered writers of an index-linked option may therefore be required to pay the cash amount in part of the option before they receive the cash payment on the underlying security.

In contrast to a situation in which the exercise date is an event of a specific date, an event of a continuing nature, or an event that occurs over a period of time, there is a single exercise date. As a general rule, no adjustment will be made to the terms of options on index-linked securities for any interest payment on the securities.

As is the case with equity options, an adjustment panel with respect to options on index-linked securities has discretion to make exceptions to the general rules described above.

The value of an option is affected by the value of the underlying interest. It is beyond the scope of this booklet to discuss all of the factors that affect the value of an option. However, the most important factors are the price of the underlying security, the time to expiration, the volatility of the underlying security, and the interest rate.

The value of an option is also affected by the value of the underlying security. The underlying security is the security whose price is the basis for the value of the option. If the price of the underlying security decreases, the value of the option decreases, and vice versa. The value of the option is also affected by the time to expiration, the volatility of the underlying security, and the interest rate.
The risks described in paragraphs 1 through 9 of this section relate to debt obligations that are subject to credit default swaps on index-linked securities. The risks described in paragraphs 10 and 11 relate exclusively to options on index-linked securities.

10. In the event of a shortage of index-linked securities that are deliverable on exercise of a physical delivery option, OCC may alter special settlement procedures similar to those applicable to stock options, including the fixing of a cash settlement price payable by writers who would otherwise be unable to meet their delivery obligations into the discussion in Chapter VIII under "Settlement," and prohibit the exercise of puts by holders who would be unable to meet the resulting settlement obligations (see paragraph 5 under "Risks of Option Holders" above).

11. In the event that an issuer of an index-linked security calls the entire issue of the security, outstanding options on that issue will be adjusted to require delivery of a sufficient number of index-linked securities in the holding account of an option holder to meet the call. The exercise price will be adjusted to reflect the current market value of the index-linked securities. The holder of the option will be entitled to receive the exercise proceeds, in addition to any cash settlement amount, if applicable.

Credit default options are automatically exercised and pay a fixed cash settlement amount if a credit event occurs or if the underlying reference obligations cease to exist.

Credit default options are written on a variety of underlying reference obligations, including commercial paper, bonds, senior loans, and structured finance notes. Credit default options are the only derivatives that can be used to hedge both the credit risk of a reference obligation and the interest rate risk of a floating rate bond. The exercise price of a credit default option is determined by the issuer at the time of the transaction, and it is based on the difference between the current market value of the reference obligation and the exercise price.
ADJUSTMENT OF CREDIT DEFAULT OPTIONS

Adjustments may be made to the standardized terms of outstanding credit default options in order to ensure that the terms of the reference obligation are not materially altered in a manner that would be inconsistent with the terms of the reference obligations. Adjustments of credit default options may be made at the discretion of the clearinghouse or the clearinghouse's agent. The clearinghouse's agent may determine whether adjustments are necessary and, if so, the nature and extent of the adjustments. The clearinghouse's agent may adjust the strike price, maturity date, or other terms of the credit default option if the strike price, maturity date, or other terms of the credit default option are not materially altered in a manner that would be inconsistent with the terms of the reference obligation.

Repayment Event Adjustments. A repayment event is an event that materially alters the terms of the reference obligation. A repayment event may include, but is not limited to, the following:

1. The default of the reference entity.
2. The bankruptcy of the reference entity.
3. The liquidation of the reference entity.
4. The sale of a significant portion of the reference entity's assets.
5. The change in control of the reference entity.

If a repayment event occurs, the strike price of the credit default option may be adjusted. The strike price adjustment will be determined by the clearinghouse or the clearinghouse's agent. The strike price adjustment will be based on the change in the market value of the reference obligation and the change in the market value of the credit default option. The strike price adjustment will be made in a manner that is consistent with the terms of the reference obligation.

Expiration Event Adjustments. An expiration event is an event that occurs when the credit default option expires. If an expiration event occurs, the strike price of the credit default option may be adjusted. The strike price adjustment will be determined by the clearinghouse or the clearinghouse's agent. The strike price adjustment will be based on the change in the market value of the reference obligation and the change in the market value of the credit default option. The strike price adjustment will be made in a manner that is consistent with the terms of the reference obligation.

SPECIAL RISKS OF CREDIT DEFAULT OPTIONS

1. Pricing of credit default options can be complex. As such, investors should be aware of the potential risks associated with credit default options. Credit default options are designed to provide protection against losses in the event of a default event. However, credit default options are not a perfect substitute for protection against losses. Credit default options are subject to the same risks as other financial instruments, including credit risk, interest rate risk, and liquidity risk.

2. The source of price information used to price credit default options may be subject to a lack of transparency and other limitations. This is attributable to: (a) limited availability of price data for credit default options, (b) the lack of a widely accepted methodology for determining credit default option prices, and (c) the relatively new nature of credit default option markets.

3. In the event that a default event occurs, credit default options may not perform as expected. Credit default options may be worth less than expected, or they may not be liquidated at all. Credit default options may also be subject to counterparty risk, which could result in a loss of principal.

4. Credit default options may be complex financial instruments. Investors should be aware of the potential risks associated with credit default options, including credit risk, interest rate risk, and liquidity risk. Credit default options are not a perfect substitute for protection against losses.

5. Credit default options are subject to market risk. The value of credit default options can fluctuate over time, and investors should be aware of the potential for losses. Credit default options can be volatile, and investors should be prepared for the possibility of significant losses.

6. Credit default options are subject to regulatory risk. Regulatory changes can affect the value of credit default options. Investors should be aware of the potential impact of regulatory changes on the value of credit default options.

7. Credit default options may be subject to other risks, including counterparty risk, credit risk, and liquidity risk. Investors should be aware of the potential for losses and the potential for losses to be realized in a timely manner.

8. Credit default options are complex financial instruments. Investors should be aware of the potential risks associated with credit default options, including credit risk, interest rate risk, and liquidity risk. Credit default options are not a perfect substitute for protection against losses.
MARCH 2011 SUPPLEMENT

The Barclays 1994 version of the bond index was a composite of a credit default swap (CDS) index on the sovereign bond market and a market index (SMI). The SMI is an index of the sovereign bond market's performance and is calculated using the credit risk of the index's constituent bonds. The SMI is a market index and is not designed to measure the actual performance of the index's constituent bonds. It is a market index and is not designed to measure the actual performance of the index's constituent bonds.

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relative performance index. Indexed volatility index values will be affected by any factor that affects the component companies of the index, including, among other things, applicable laws, regulations and trading rules, the market-making and underwriting practices of the market on which the option is listed, and the liquidity and efficiency of those markets.

9. The first and second sentences of the tenth paragraph under the heading "RELATIVE PERFORMANCE INDICES, which is part of the discussion that was added on page 75 at the back of the Booklet by the December 2009 Supplemental is replaced by the following:

"Investors should be aware that there is a method of calculating the relative performance indices and the use of which different performance indices are suited for assessing, evaluating, comparing different investments or for making decisions to invest in different assets. Investors should only rely on the index for assessing the performance of an investment in a particular relative performance index.

In the event that one of the index components in an underlying relative performance index is eliminated as the result of a cash dividend or other event, the reporting authority may have the sole discretion to substitute the value of the index in that event.

10. The paragraphs that were added on page 76 of the Booklet as paragraphs 12 through 14 under the section captioned "RELATIVE PERFORMANCE INDICES, which is the first paragraph appearing under the caption "Features of Index Options" on page 24 of the Booklet, are deleted by the following:

"Adjustment of Index Options"

No adjustments will be made on the terms of index options if the event that index components are added or removed from the underlying index or if the relative weight of one or more such index components has changed. However, if an event that index options are added or removed from the underlying index, a second index option was issued to ensure that the exercise price of the index option is always equal to the exercise price of the index.

The exercise settlement value of the index option will become fixed based upon the last published value for the index, and the market price at which the options are traded. All options that are not in the money will be worthless and all that is in the money will have no time value. Options of an in-the-money option whose exercise value is accelerated must be forcibly exercised so that option prior to the accelerated exercise will expire in order to prevent the option from expiring unexercised. Writers of European-style option whose exercise date is accelerated must be forcibly exercised so that option prior to the expiration date of the option expires. As with other option for which the exercise price of the option is accelerated, the option will be forcibly exercised to prevent the option from being exercised at a disadvantageous price.

11. The paragraphs that were added on page 78 of the Booklet as paragraphs 12 through 14 under the section captioned "RELATIVE PERFORMANCE INDICES, which is the December 2009 Supplemental is replaced by the following:

"ADJUSTMENT OF INDEX OPTIONS"

12. The paragraphs that were added on page 78 of the Booklet as paragraphs 12 through 14 under the section captioned "RELATIVE PERFORMANCE INDICES, which is the December 2009 Supplemental are replaced by the following:

"Adjustment of Index Options"

No adjustments will be made on the terms of index options if the event that index components are added or removed from the underlying index or if the relative weight of one or more such index components has changed. However, if an event that index options are added or removed from the underlying index, a second index option was issued to ensure that the exercise price of the index option is always equal to the exercise price of the index.

The exercise settlement value of the index option will become fixed based upon the last published value for the index, and the market price at which the options are traded. All options that are not in the money will be worthless and all that is in the money will have no time value. Options of an in-the-money option whose exercise value is accelerated must be forcibly exercised so that option prior to the accelerated exercise will expire in order to prevent the option from expiring unexercised. Writers of European-style option whose exercise date is accelerated must be forcibly exercised so that option prior to the expiration date of the option expires. As with other option for which the exercise price of the option is accelerated, the option will be forcibly exercised to prevent the option from being exercised at a disadvantageous price.
14. As in the case of writers of other index options, owners of variable-rate options, inadequate-indexed options on pension or annuity plans, and option writers for their potential settlement obligations, by ensuring the underlying index. Following the risk of writing a variable-rate option, strategy-based index options or relative performance options may be seen more difficult than calculating the risk of writing other index options. Even if some offsetting of risk is possible, there are timing risks and other risk trade-offs to be considered in paragraphs 3 and 4 on pages 14 and 15 of the booklet whenever an investor attempts to apply strategies involving transactions in index options, strategy-based index options or relative performance options and transactions in abusive or illiquid options. Future contracts or other instruments related to stocks.

15. The following paragraph is inserted on page 16 of the booklet immediately following the paragraph that was added as paragraph 16 under the section captioned "Special Risks of index Options" by the December 2006 Supplement:

16. In the event that one of the index components of a relative performance index is eliminated as a result of a lump-sum merger of other assets, the remaining assets may cease to publish the value of the relative performance index on the market on which options on the relative performance index are traded while determining the calculation. The revised index components (if there is any) in the case of European-style options. For example, if in that case, the exercise settlement value of the option would be based upon the last published value of the underlying relative performance index. As a result, such options that are not in the money will be worthless and all that is left will be the option's value. Unlike an index-option option whose expiration date is subject to being accelerated, the underlying asset's price may be higher at the exercise price than is the market price of the underlying index. They may be designed to exercise at a predetermined time prior to the expiration of the option. However, if the option is struck to the exercise price, it may be assigned at no exercise price and then be required to perform the index's performance prior to the original expiration date. As with any other option for which the expiration date is accelerated, no adjustment would be made to compensate for the accelerated expiration date of a relative performance option.

JANUARY 2012 SUPPLEMENT

The January 2012 update of the booklet entitled "Characteristics and Uses of Standardized Options" (the "Booklet") is amended as provided below to accommodate options on relative performance indices of which the index components are equity securities (including funds shares).

1. The first paragraph following the caption "Relative Performance Indices," which was added to the December 2011 Supplement immediately following the section entitled "Strategy-Based Indexes" which was added to page 26 of the Booklet by the December 2009 Supplement, is replaced by the following paragraph:

A relative performance index measures the relative performance — generally the relative total return — of two index components. As all of the other index components, the only relative performance indices approved for trading are options on indices of which both index components are equity securities (one or both of which could be non-indexed funds shares). One of the components in each pair is referred to as the benchmark component and the second is referred to as the target component. The index is calculated by measuring the total return of the target component relative to the total return of the benchmark component. The index will rise as and if the asset that the relative performance index is used to track rises and falls as and if the benchmark component rises and falls.

The value of the relative performance index will be set to a base value, such as 100, initially. The following example illustrates the calculation of a relative performance index.

EXAMPLE: Assume that a relative performance index has an initial base value of 100. If the total return of the target component in one day is 10% and the total return of the benchmark component in one day is 5%, the index value of the relative performance index at the end of the one day period would equal 100 x (1 + 0.10) / (1 + 0.05) = 100 x 1.0524 = 105.24. If the total return of the target component in the one day period is 10% and the total return of the benchmark component in the one day period is 5%, the index value of the relative performance index at the end of the one day period would equal 100 x (1 + 0.05) / (1 + 0.10) = 100 x 0.9524 = 95.24.

The example above illustrates only a scenario where the total return assumed is for a one day period. Other periods would yield different results.

Investors and participants should consult the exchange on which these options are traded for a more complete description of the relative performance methodology.
November 2012 Supplement to Characteristics and Risks of Standardized Options

The February 1994 version of the booklet entitled Characteristics and Risks of Standardized Options (the "Booklet") is amended as provided below to accommodate the introduction of options originally listed to trade less than 100 shares:

The following changes Part II of the December 2009 Supplement:

1. The fourth paragraph on page 19 of the booklet is amended to read as follows:

As a general rule, no adjustment is made for ordinary cash dividends or cash distributions. A cash dividend or distribution announced prior to February 1, 2009, will generally be considered "ordinary" unless it exceeds 10% of the aggregate market value of the underlying security outstanding as of the close of trading on the declaration date. The same rule will continue to apply on and after that date with respect to options listed on the Exchange governed by OCC’s “grandfathered” rules for purpose of this rule (i.e., those opened prior to publication of the May 2007 Supplement that remain outstanding on February 1, 2009). In the case of all other option series, a cash dividend or distribution announced on or after February 1, 2009, will generally be considered "ordinary" regardless of size. If OCC believes that it was incorrect pursuant to a policy or practice of paying such dividends or distributions on a quarterly or other regular basis, no adjustment will normally be made for any cash dividend or distribution that amounts to less than $0.125 per underlying share. For contracts originally listed with a unit of trading less than 100 shares, no adjustment normally would be made for any cash dividends or distributions that amount to less than $12.50 per contract. As an exception to the general rule, options on fund shares will generally be adjusted for capital gains distributions even if made on a quarterly basis, and adjustments may be made for certain other distributions in respect of fund shares in special circumstances described in OCC’s rules, provided in each case that the amount of the adjustment would be $0.125 or more per fund share. Determinations whether to adjust for cash dividends or distributions not covered by the preceding rules, or when other special circumstances apply, are made on a case-by-case basis.

Dated: November 26, 2012
RISK DISCLOSURE STATEMENT FOR SECURITY FUTURES CONTRACTS

This disclosure statement discusses the characteristics and risks of standardized security futures contracts traded on regulated U.S. exchanges. At present, regulated exchanges are authorized to list futures contracts on individual equity securities registered under the Securities Exchange Act of 1934 (including common stock and certain exchange-traded funds and American Depositary Receipts), as well as narrow-based security indices. Futures on other types of securities and options on security futures contracts may be authorized in the future. The glossary of terms appears at the end of the document.

Customers should be aware that the examples in this document are exclusive of fees and commissions that may decrease their net gains or increase their net losses. The examples also do not include tax consequences, which may differ for each customer.

Section 1 – Risks of Security Futures

1.1. Risks of Security Futures Transactions

Trading security futures contracts may not be suitable for all investors. You may lose a substantial amount of money in a very short period of time. The amount you may lose is potentially unlimited and can exceed the amount you originally deposit with your broker. This is because futures trading is highly leveraged, with a relatively small amount of money used to establish a position in assets having a much greater value. If you are uncomfortable with this level of risk, you should not trade security futures contracts.

1.2. General Risks

Trading security futures contracts involves risk and may result in potentially unlimited losses that are greater than the amount you deposited with your broker. As with any high risk financial product, you should not risk any funds that you cannot afford to lose, such as your retirement savings, medical and other emergency funds, funds set aside for purposes such as education or home ownership, proceeds from student loans or mortgages, or funds required to meet your living expenses.

Be cautious of claims that you can make large profits from trading security futures contracts. Although the high degree of leverage in security futures contracts can result in large and immediate gains, it can also result in large and immediate losses. As with any financial product, there is no such thing as a “sure winner.”

Because of the leverage involved and the nature of security futures contract transactions, you may feel the effects of your losses immediately. Gains and losses in security futures contracts are credited or debited to your account, at a minimum, on a daily basis. If movements in the markets for security futures contracts or the underlying security decrease the value of your positions in security futures contracts, you may be required to have or make additional funds available to your carrying firm as margin. If your account is under the minimum margin requirements set by the exchange or the brokerage firm, your position may
be liquidated at a loss, and you will be liable for the deficit, if any, in your account. Margin requirements are addressed in Section 4.

*Under certain market conditions, it may be difficult or impossible to liquidate a position.* Generally, you must enter into an offsetting transaction in order to liquidate a position in a security futures contract. If you cannot liquidate your position in a security futures contracts, you may not be able to realize a gain in the value of your position or prevent losses from mounting. This inability to liquidate could occur, for example, if trading is halted due to unusual trading activity in either the security futures contract or the underlying security; if trading is halted due to recent news events involving the issuer of the underlying security; if systems failures occur on an exchange or at the firm carrying your position; or if the position is on an illiquid market. Even if you can liquidate your position, you may be forced to do so at a price that involves a large loss.

*Under certain market conditions, it may also be difficult or impossible to manage your risk from open security futures positions by entering into an equivalent but opposite position in another contract month, on another market, or in the underlying security.* This inability to take positions to limit your risk could occur, for example, if trading is halted across markets due to unusual trading activity in the security futures contract or the underlying security or due to recent news events involving the issuer of the underlying security.

*Under certain market conditions, the prices of security futures contracts may not maintain their customary or anticipated relationships to the prices of the underlying security or index.* These pricing disparities could occur, for example, when the market for the security futures contract is illiquid, when the primary market for the underlying security is closed, or when the reporting of transactions in the underlying security has been delayed. For index products, it could also occur when trading is delayed or halted in some or all of the securities that make up the index.

*You may be required to settle certain security futures contracts with physical delivery of the underlying security.* If you hold your position in a physically settled security futures contract until the end of the last trading day prior to expiration, you will be obligated to make or take delivery of the underlying securities, which could involve additional costs. The actual settlement terms may vary from contract to contract and exchange to exchange. You should carefully review the settlement and delivery conditions before entering into a security futures contract. Settlement and delivery are discussed in Section 5.

*You may experience losses due to systems failures.* As with any financial transaction, you may experience losses if your orders for security futures contracts cannot be executed normally due to systems failures on a regulated exchange or at the brokerage firm carrying your position. Your losses may be greater if the brokerage firm carrying your position does not have adequate back-up systems or procedures.

*All security futures contracts involve risk, and there is no trading strategy that can eliminate it.* Strategies using combinations of positions, such as spreads, may be as risky as outright long or short positions. Trading in security futures contracts requires knowledge of both the securities and the futures markets.
Day trading strategies involving security futures contracts and other products pose special risks. As with any financial product, persons who seek to purchase and sell the same security future in the course of a day to profit from intra-day price movements ("day traders") face a number of special risks, including substantial commissions, exposure to leverage, and competition with professional traders. You should thoroughly understand these risks and have appropriate experience before engaging in day trading. The special risks for day traders are discussed more fully in Section 7.

Placing contingent orders, if permitted, such as “stop-loss” or “stop-limit” orders, will not necessarily limit your losses to the intended amount. Some regulated exchanges may permit you to enter into stop-loss or stop-limit orders for security futures contracts, which are intended to limit your exposure to losses due to market fluctuations. However, market conditions may make it impossible to execute the order or to get the stop price.

You should thoroughly read and understand the customer account agreement with your brokerage firm before entering into any transactions in security futures contracts.

You should thoroughly understand the regulatory protections available to your funds and positions in the event of the failure of your brokerage firm. The regulatory protections available to your funds and positions in the event of the failure of your brokerage firm may vary depending on, among other factors, the contract you are trading and whether you are trading through a securities account or a futures account. Firms that allow customers to trade security futures in either securities accounts or futures accounts, or both, are required to disclose to customers the differences in regulatory protections between such accounts, and, where appropriate, how customers may elect to trade in either type of account.
Section 2 – Description of a Security Futures Contract

2.1. What is a Security Futures Contract?

A security futures contract is a legally binding agreement between two parties to purchase or sell in the future a specific quantity of shares of a security or of the component securities of a narrow-based security index, at a certain price. A person who buys a security futures contract enters into a contract to purchase an underlying security and is said to be “long” the contract. A person who sells a security futures contract enters into a contract to sell the underlying security and is said to be “short” the contract. The price at which the contract trades (the “contract price”) is determined by relative buying and selling interest on a regulated exchange.

In order to enter into a security futures contract, you must deposit funds with your brokerage firm equal to a specified percentage (usually at least 20 percent) of the current market value of the contract as a performance bond. Moreover, all security futures contracts are marked-to-market at least daily, usually after the close of trading, as described in Section 3 of this document. At that time, the account of each buyer and seller reflects the amount of any gain or loss on the security futures contract based on the contract price established at the end of the day for settlement purposes (the “daily settlement price”).

An open position, either a long or short position, is closed or liquidated by entering into an offsetting transaction (i.e., an equal and opposite transaction to the one that opened the position) prior to the contract expiration. Traditionally, most futures contracts are liquidated prior to expiration through an offsetting transaction and, thus, holders do not incur a settlement obligation.

Examples:

Investor A is long one September XYZ Corp. futures contract. To liquidate the long position in the September XYZ Corp. futures contract, Investor A would sell an identical September XYZ Corp. contract.

Investor B is short one December XYZ Corp. futures contract. To liquidate the short position in the December XYZ Corp. futures contract, Investor B would buy an identical December XYZ Corp. contract.

Security futures contracts that are not liquidated prior to expiration must be settled in accordance with the terms of the contract. Some security futures contracts are settled by physical delivery of the underlying security. At the expiration of a security futures contract that is settled through physical delivery, a person who is long the contract must pay the final settlement price set by the regulated exchange or the clearing organization and take delivery of the underlying shares. Conversely, a person who is short the contract must make delivery of the underlying shares in exchange for the final settlement price.

Other security futures contracts are settled through cash settlement. In this case, the underlying security is not delivered. Instead, any positions in such security futures contracts that are open at the end of the last trading day are settled through a final cash payment based on a
final settlement price determined by the exchange or clearing organization. Once this payment is made, neither party has any further obligations on the contract.

Physical delivery and cash settlement are discussed more fully in Section 5.

2.2. Purposes of Security Futures

Security futures contracts can be used for speculation, hedging, and risk management. Security futures contracts do not provide capital growth or income.

Speculation

Speculators are individuals or firms who seek to profit from anticipated increases or decreases in futures prices. A speculator who expects the price of the underlying instrument to increase will buy the security futures contract. A speculator who expects the price of the underlying instrument to decrease will sell the security futures contract. Speculation involves substantial risk and can lead to large losses as well as profits.

The most common trading strategies involving security futures contracts are buying with the hope of profiting from an anticipated price increase and selling with the hope of profiting from an anticipated price decrease. For example, a person who expects the price of XYZ stock to increase by March can buy a March XYZ security futures contract, and a person who expects the price of XYZ stock to decrease by March can sell a March XYZ security futures contract. The following illustrates potential profits and losses if Customer A purchases the security futures contract at $50 a share and Customer B sells the same contract at $50 a share (assuming 100 shares per contract).

<table>
<thead>
<tr>
<th>Price of XYZ at Liquidation</th>
<th>Customer A Profit/Loss</th>
<th>Customer B Profit/Loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>$55</td>
<td>$500</td>
<td>- $500</td>
</tr>
<tr>
<td>$50</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>$45</td>
<td>- $500</td>
<td>$500</td>
</tr>
</tbody>
</table>

Speculators may also enter into spreads with the hope of profiting from an expected change in price relationships. Spreaders may purchase a contract expiring in one contract month and sell another contract on the same underlying security expiring in a different month (e.g., buy June and sell September XYZ single stock futures). This is commonly referred to as a “calendar spread.”

Spreaders may also purchase and sell the same contract month in two different but economically correlated security futures contracts. For example, if ABC and XYZ are both pharmaceutical companies and an individual believes that ABC will have stronger growth than XYZ between now and June, he could buy June ABC futures contracts and sell June XYZ futures contracts. Assuming that each contract is 100 shares, the following illustrates how this works.
<table>
<thead>
<tr>
<th>Opening Position</th>
<th>Price at Liquidation</th>
<th>Gain or Loss</th>
<th>Price at Liquidation</th>
<th>Gain or Loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>Buy ABC at 50</td>
<td>$53</td>
<td>$300</td>
<td>$53</td>
<td>$300</td>
</tr>
<tr>
<td>Sell XYZ at 45</td>
<td>$46</td>
<td>- $100</td>
<td>$50</td>
<td>- $500</td>
</tr>
</tbody>
</table>

Net Gain or Loss $200 - $200

Speculators can also engage in arbitrage, which is similar to a spread except that the long and short positions occur on two different markets. An arbitrage position can be established by taking an economically opposite position in a security futures contract on another exchange, in an options contract, or in the underlying security.

**Hedging**

Generally speaking, hedging involves the purchase or sale of a security future to reduce or offset the risk of a position in the underlying security or group of securities (or a close economic equivalent). A hedger gives up the potential to profit from a favorable price change in the position being hedged in order to minimize the risk of loss from an adverse price change.

An investor who wants to lock in a price now for an anticipated sale of the underlying security at a later date can do so by hedging with security futures. For example, assume an investor owns 1,000 shares of ABC that have appreciated since he bought them. The investor would like to sell them at the current price of $50 per share, but there are tax or other reasons for holding them until September. The investor could sell ten 100-share ABC futures contracts and then buy back those contracts in September when he sells the stock. Assuming the stock price and the futures price change by the same amount, the gain or loss in the stock will be offset by the loss or gain in the futures contracts.

<table>
<thead>
<tr>
<th>Price in September</th>
<th>Value of 1,000 Shares of ABC</th>
<th>Gain or Loss on Futures</th>
<th>Effective Selling Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>$40</td>
<td>$40,000</td>
<td>$10,000</td>
<td>$50,000</td>
</tr>
<tr>
<td>$50</td>
<td>$50,000</td>
<td>$0</td>
<td>$50,000</td>
</tr>
<tr>
<td>$60</td>
<td>$60,000</td>
<td>-$10,000</td>
<td>$50,000</td>
</tr>
</tbody>
</table>

Hedging can also be used to lock in a price now for an anticipated purchase of the stock at a later date. For example, assume that in May a mutual fund expects to buy stocks in a particular industry with the proceeds of bonds that will mature in August. The mutual fund can hedge its risk that the stocks will increase in value between May and August by purchasing security futures contracts on a narrow-based index of stocks from that industry. When the mutual fund buys the stocks in August, it also will liquidate the security futures position in the index. If the relationship between the security futures contract and the stocks in the index is constant, the profit or loss from the futures contract will offset the price change in the stocks, and the mutual fund will have locked in the price that the stocks were selling at in May.

Although hedging mitigates risk, it does not eliminate all risk. For example, the relationship between the price of the security futures contract and the price of the underlying
security traditionally tends to remain constant over time, but it can and does vary somewhat. Furthermore, the expiration or liquidation of the security futures contract may not coincide with the exact time the hedger buys or sells the underlying stock. Therefore, hedging may not be a perfect protection against price risk.

Risk Management

Some institutions also use futures contracts to manage portfolio risks without necessarily intending to change the composition of their portfolio by buying or selling the underlying securities. The institution does so by taking a security futures position that is opposite to some or all of its position in the underlying securities. This strategy involves more risk than a traditional hedge because it is not meant to be a substitute for an anticipated purchase or sale.

2.3. Where Security Futures Trade

By law, security futures contracts must trade on a regulated U.S. exchange. Each regulated U.S. exchange that trades security futures contracts is subject to joint regulation by the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC).

A person holding a position in a security futures contract who seeks to liquidate the position must do so either on the regulated exchange where the original trade took place or on another regulated exchange, if any, where a fungible security futures contract trades. (A person may also seek to manage the risk in that position by taking an opposite position in a comparable contract traded on another regulated exchange.)

Security futures contracts traded on one regulated exchange might not be fungible with security futures contracts traded on another regulated exchange for a variety of reasons. Security futures traded on different regulated exchanges may be non-fungible because they have different contract terms (e.g., size, settlement method), or because they are cleared through different clearing organizations. Moreover, a regulated exchange might not permit its security futures contracts to be offset or liquidated by an identical contract traded on another regulated exchange, even though they have the same contract terms and are cleared through the same clearing organization. You should consult your broker about the fungibility of the contract you are considering purchasing or selling, including which exchange(s), if any, on which it may be offset.

Regulated exchanges that trade security futures contracts are required by law to establish certain listing standards. Changes in the underlying security of a security futures contract may, in some cases, cause such contract to no longer meet the regulated exchange’s listing standards. Each regulated exchange will have rules governing the continued trading of security futures contracts that no longer meet the exchange’s listing standards. These rules may, for example, permit only liquidating trades in security futures contracts that no longer satisfy the listing standards.

2.4. How Security Futures Differ from the Underlying Security
Shares of common stock represent a fractional ownership interest in the issuer of that security. Ownership of securities confers various rights that are not present with positions in security futures contracts. For example, persons owning a share of common stock may be entitled to vote in matters affecting corporate governance. They also may be entitled to receive dividends and corporate disclosure, such as annual and quarterly reports.

The purchaser of a security futures contract, by contrast, has only a contract for future delivery of the underlying security. The purchaser of the security futures contract is not entitled to exercise any voting rights over the underlying security and is not entitled to any dividends that may be paid by the issuer. Moreover, the purchaser of a security futures contract does not receive the corporate disclosures that are received by shareholders of the underlying security, although such corporate disclosures must be made publicly available through the SEC’s EDGAR system, which can be accessed at www.sec.gov. You should review such disclosures before entering into a security futures contract. See Section 9 for further discussion of the impact of corporate events on a security futures contract.

All security futures contracts are marked-to-market at least daily, usually after the close of trading, as described in Section 3 of this document. At that time, the account of each buyer and seller is credited with the amount of any gain, or debited by the amount of any loss, on the security futures contract, based on the contract price established at the end of the day for settlement purposes (the “daily settlement price”). By contrast, the purchaser or seller of the underlying instrument does not have the profit and loss from his or her investment credited or debited until the position in that instrument is closed out.

Naturally, as with any financial product, the value of the security futures contract and of the underlying security may fluctuate. However, owning the underlying security does not require an investor to settle his or her profits and losses daily. By contrast, as a result of the mark-to-market requirements discussed above, a person who is long a security futures contract often will be required to deposit additional funds into his or her account as the price of the security futures contract decreases. Similarly, a person who is short a security futures contract often will be required to deposit additional funds into his or her account as the price of the security futures contract increases.

Another significant difference is that security futures contracts expire on a specific date. Unlike an owner of the underlying security, a person cannot hold a long position in a security futures contract for an extended period of time in the hope that the price will go up. If you do not liquidate your security futures contract, you will be required to settle the contract when it expires, either through physical delivery or cash settlement. For cash-settled contracts in particular, upon expiration, an individual will no longer have an economic interest in the securities underlying the security futures contract.

2.5. Comparison to Options

Although security futures contracts share some characteristics with options on securities (options contracts), these products are also different in a number of ways. Below are some of the important distinctions between equity options contracts and security futures contracts.
If you purchase an options contract, you have the right, but not the obligation, to buy or sell a security prior to the expiration date. If you sell an options contract, you have the obligation to buy or sell a security prior to the expiration date. By contrast, if you have a position in a security futures contract (either long or short), you have both the right and the obligation to buy or sell a security at a future date. The only way that you can avoid the obligation incurred by the security futures contract is to liquidate the position with an offsetting contract.

A person purchasing an options contract runs the risk of losing the purchase price (premium) for the option contract. Because it is a wasting asset, the purchaser of an options contract who neither liquidates the options contract in the secondary market nor exercises it at or prior to expiration will necessarily lose his or her entire investment in the options contract. Conversely, the seller of an options contract cannot lose more than the amount of the premium. The seller of an options contract is required to deposit margin to reflect the risk of its obligation, he or she may lose many times his or her initial margin deposit.

By contrast, the purchaser and seller of a security futures contract each enter into an agreement to buy or sell a specific quantity of shares in the underlying security. Based upon the movement in prices of the underlying security, a person who holds a position in a security futures contract can gain or lose many times his or her initial margin deposit. In this respect, the benefits of a security futures contract are similar to the benefits of purchasing an option, while the risks of entering into a security futures contract are similar to the risks of selling an option.

Both the purchaser and the seller of a security futures contract have daily margin obligations. At least once each day, security futures contracts are marked-to-market and the increase or decrease in the value of the contract is credited or debited to the buyer and the seller. As a result, any person who has an open position in a security futures contract may be called upon to meet additional margin requirements or may receive a credit of available funds.

Example:

Assume that Customers A and B each anticipate an increase in the market price of XYZ stock, which is currently $50 a share. Customer A purchases an XYZ 50 call (covering 100 shares of XYZ at a premium of $5 per share). The option premium is $500 ($5 per share X 100 shares). Customer B purchases an XYZ security futures contract (covering 100 shares of XYZ). The total value of the contract is $5000 ($50 share value X 100 shares). The required margin is $1000 (or 20% of the contract value).

<table>
<thead>
<tr>
<th>Price of XYZ at expiration</th>
<th>Customer A Profit/Loss</th>
<th>Customer B Profit/Loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>65</td>
<td>1000</td>
<td>1500</td>
</tr>
<tr>
<td>60</td>
<td>500</td>
<td>1000</td>
</tr>
<tr>
<td>55</td>
<td>0</td>
<td>500</td>
</tr>
<tr>
<td>50</td>
<td>-500</td>
<td>0</td>
</tr>
</tbody>
</table>
The most that Customer A can lose is $500, the option premium. Customer A breaks even at $55 per share, and makes money at higher prices. Customer B may lose more than his initial margin deposit. Unlike the options premium, the margin on a futures contract is not a cost but a performance bond. The losses for Customer B are not limited by this performance bond. Rather, the losses or gains are determined by the settlement price of the contract, as provided in the example above. Note that if the price of XYZ falls to $35 per share, Customer A loses only $500, whereas Customer B loses $1500.

2.6. Components of a Security Futures Contract

Each regulated exchange can choose the terms of the security futures contracts it lists, and those terms may differ from exchange to exchange or contract to contract. Some of those contract terms are discussed below. However, you should ask your broker for a copy of the contract specifications before trading a particular contract.

2.6.1. Each security futures contract has a set size. The size of a security futures contract is determined by the regulated exchange on which the contract trades. For example, a security futures contract for a single stock may be based on 100 shares of that stock. If prices are reported per share, the value of the contract would be the price times 100. For narrow-based security indices, the value of the contract is the price of the component securities times the multiplier set by the exchange as part of the contract terms.

2.6.2. Security futures contracts expire at set times determined by the listing exchange. For example, a particular contract may expire on a particular day, e.g., the third Friday of the expiration month. Up until expiration, you may liquidate an open position by offsetting your contract with a fungible opposite contract that expires in the same month. If you do not liquidate an open position before it expires, you will be required to make or take delivery of the underlying security or to settle the contract in cash after expiration.

2.6.3. Although security futures contracts on a particular security or a narrow-based security index may be listed and traded on more than one regulated exchange, the contract specifications may not be the same. Also, prices for contracts on the same security or index may vary on different regulated exchanges because of different contract specifications.

2.6.4. Prices of security futures contracts are usually quoted the same way prices are quoted in the underlying instrument. For example, a contract for an individual security would be quoted in dollars and cents per share. Contracts for indices would be quoted by an index number, usually stated to two decimal places.

2.6.5. Each security futures contract has a minimum price fluctuation (called a tick), which may differ from product to product or exchange to exchange. For example, if a particular security futures contract has a tick size of 1¢, you can buy the contract at $23.21 or $23.22 but not at $23.215.
2.7. Trading Halts

The value of your positions in security futures contracts could be affected if trading is halted in either the security futures contract or the underlying security. In certain circumstances, regulated exchanges are required by law to halt trading in security futures contracts. For example, trading on a particular security futures contract must be halted if trading is halted on the listed market for the underlying security as a result of pending news, regulatory concerns, or market volatility. Similarly, trading of a security futures contract on a narrow-based security index must be halted under such circumstances if trading is halted on securities accounting for at least 50 percent of the market capitalization of the index. In addition, regulated exchanges are required to halt trading in all security futures contracts for a specified period of time when the Dow Jones Industrial Average ("DJIA") experiences one-day declines of 10-, 20- and 30-percent. The regulated exchanges may also have discretion under their rules to halt trading in other circumstances – such as when the exchange determines that the halt would be advisable in maintaining a fair and orderly market.

A trading halt, either by a regulated exchange that trades security futures or an exchange trading the underlying security or instrument, could prevent you from liquidating a position in security futures contracts in a timely manner, which could prevent you from liquidating a position in security futures contracts at that time.

2.8. Trading Hours

Each regulated exchange trading a security futures contract may open and close for trading at different times than other regulated exchanges trading security futures contracts or markets trading the underlying security or securities. Trading in security futures contracts prior to the opening or after the close of the primary market for the underlying security may be less liquid than trading during regular market hours.
Section 3 – Clearing Organizations and Mark-to-Market Requirements

Every regulated U.S. exchange that trades security futures contracts is required to have a relationship with a clearing organization that serves as the guarantor of each security futures contract traded on that exchange. A clearing organization performs the following functions: matching trades; effecting settlement and payments; guaranteeing performance; and facilitating deliveries.

Throughout each trading day, the clearing organization matches trade data submitted by clearing members on behalf of their customers or for the clearing member’s proprietary accounts. If an account is with a brokerage firm that is not a member of the clearing organization, then the brokerage firm will carry the security futures position with another brokerage firm that is a member of the clearing organization. Trade records that do not match, either because of a discrepancy in the details or because one side of the transaction is missing, are returned to the submitting clearing members for resolution. The members are required to resolve such “out trades” before or on the open of trading the next morning.

When the required details of a reported transaction have been verified, the clearing organization assumes the legal and financial obligations of the parties to the transaction. One way to think of the role of the clearing organization is that it is the “buyer to every seller and the seller to every buyer.” The insertion or substitution of the clearing organization as the counterparty to every transaction enables a customer to liquidate a security futures position without regard to what the other party to the original security futures contract decides to do.

The clearing organization also effects the settlement of gains and losses from security futures contracts between clearing members. At least once each day, clearing member brokerage firms must either pay to, or receive from, the clearing organization the difference between the current price and the trade price earlier in the day, or for a position carried over from the previous day, the difference between the current price and the previous day’s settlement price. Whether a clearing organization effects settlement of gains and losses on a daily basis or more frequently will depend on the conventions of the clearing organization and market conditions. Because the clearing organization assumes the legal and financial obligations for each security futures contract, you should expect it to ensure that payments are made promptly to protect its obligations.

Gains and losses in security futures contracts are also reflected in each customer’s account on at least a daily basis. Each day’s gains and losses are determined based on a daily settlement price disseminated by the regulated exchange trading the security futures contract or its clearing organization. If the daily settlement price of a particular security futures contract rises, the buyer has a gain and the seller a loss. If the daily settlement price declines, the buyer has a loss and the seller a gain. This process is known as “marking-to-market” or daily settlement. As a result, individual customers normally will be called on to settle daily.

The one-day gain or loss on a security futures contract is determined by calculating the difference between the current day’s settlement price and the previous day’s settlement price.
For example, assume a security futures contract is purchased at a price of $120. If the daily settlement price is either $125 (higher) or $117 (lower), the effects would be as follows:

(1 contract representing 100 shares)

<table>
<thead>
<tr>
<th>Daily Settlement Value</th>
<th>Buyer’s Account</th>
<th>Seller’s Account</th>
</tr>
</thead>
<tbody>
<tr>
<td>$125</td>
<td>$500 gain (credit)</td>
<td>$500 loss (debit)</td>
</tr>
<tr>
<td>$117</td>
<td>$300 loss (debit)</td>
<td>$300 gain (credit)</td>
</tr>
</tbody>
</table>

The cumulative gain or loss on a customer’s open security futures positions is generally referred to as “open trade equity” and is listed as a separate component of account equity on your customer account statement.

A discussion of the role of the clearing organization in effecting delivery is discussed in Section 5.
Section 4 – Margin and Leverage

When a broker-dealer lends a customer part of the funds needed to purchase a security such as common stock, the term “margin” refers to the amount of cash, or down payment, the customer is required to deposit. By contrast, a security futures contract is an obligation and not an asset. A security futures contract has no value as collateral for a loan. Because of the potential for a loss as a result of the daily marked-to-market process, however, a margin deposit is required of each party to a security futures contract. This required margin deposit also is referred to as a “performance bond.”

In the first instance, margin requirements for security futures contracts are set by the exchange on which the contract is traded, subject to certain minimums set by law. The basic margin requirement is 20% of the current value of the security futures contract, although some strategies may have lower margin requirements. Requests for additional margin are known as “margin calls.” Both buyer and seller must individually deposit the required margin to their respective accounts.

It is important to understand that individual brokerage firms can, and in many cases do, require margin that is higher than the exchange requirements. Additionally, margin requirements may vary from brokerage firm to brokerage firm. Furthermore, a brokerage firm can increase its “house” margin requirements at any time without providing advance notice, and such increases could result in a margin call.

For example, some firms may require margin to be deposited the business day following the day of a deficiency, or some firms may even require deposit on the same day. Some firms may require margin to be on deposit in the account before they will accept an order for a security futures contract. Additionally, brokerage firms may have special requirements as to how margin calls are to be met, such as requiring a wire transfer from a bank, or deposit of a certified or cashier’s check. You should thoroughly read and understand the customer agreement with your brokerage firm before entering into any transactions in security futures contracts.

If through the daily cash settlement process, losses in the account of a security futures contract participant reduce the funds on deposit (or equity) below the maintenance margin level (or the firm’s higher “house” requirement), the brokerage firm will require that additional funds be deposited.

If additional margin is not deposited in accordance with the firm’s policies, the firm can liquidate your position in security futures contracts or sell assets in any of your accounts at the firm to cover the margin deficiency. You remain responsible for any shortfall in the account after such liquidations or sales. Unless provided otherwise in your customer agreement or by applicable law, you are not entitled to choose which futures contracts, other securities or other assets are liquidated or sold to meet a margin call or to obtain an extension of time to meet a margin call.

Brokerage firms generally reserve the right to liquidate a customer’s security futures contract positions or sell customer assets to meet a margin call at any time without contacting the customer. Brokerage firms may also enter into equivalent but opposite positions for your account in order to manage the risk created by a margin call. Some customers mistakenly
believe that a firm is required to contact them for a margin call to be valid, and that the firm is not allowed to liquidate securities or other assets in their accounts to meet a margin call unless the firm has contacted them first. This is not the case. While most firms notify their customers of margin calls and allow some time for deposit of additional margin, they are not required to do so. Even if a firm has notified a customer of a margin call and set a specific due date for a margin deposit, the firm can still take action as necessary to protect its financial interests, including the immediate liquidation of positions without advance notification to the customer.

Here is an example of the margin requirements for a long security futures position.

A customer buys 3 July EJG security futures at 71.50. Assuming each contract represents 100 shares, the nominal value of the position is $21,450 (71.50 x 3 contracts x 100 shares). If the initial margin rate is 20% of the nominal value, then the customer’s initial margin requirement would be $4,290. The customer deposits the initial margin, bringing the equity in the account to $4,290.

First, assume that the next day the settlement price of EJG security futures falls to 69.25. The marked-to-market loss in the customer’s equity is $675 (71.50 – 69.25 x 3 contacts x 100 shares). The customer’s equity decreases to $3,615 ($4,290 – $675). The new nominal value of the contract is $20,775 (69.25 x 3 contracts x 100 shares). If the maintenance margin rate is 20% of the nominal value, then the customer’s maintenance margin requirement would be $4,155. Because the customer’s equity had decreased to $3,615 (see above), the customer would be required to have an additional $540 in margin ($4,155 – $3,615).

Alternatively, assume that the next day the settlement price of EJG security futures rises to 75.00. The mark-to-market gain in the customer’s equity is $1,050 (75.00 – 71.50 x 3 contacts x 100 shares). The customer’s equity increases to $5,340 ($4,290 + $1,050). The new nominal value of the contract is $22,500 (75.00 x 3 contracts x 100 shares). If the maintenance margin rate is 20% of the nominal value, then the customer’s maintenance margin requirement would be $4,500. Because the customer’s equity had increased to $5,340 (see above), the customer’s excess equity would be $840.

The process is exactly the same for a short position, except that margin calls are generated as the settlement price rises rather than as it falls. This is because the customer’s equity decreases as the settlement price rises and increases as the settlement price falls.

Because the margin deposit required to open a security futures position is a fraction of the nominal value of the contracts being purchased or sold, security futures contracts are said to be highly leveraged. The smaller the margin requirement in relation to the underlying value of the security futures contract, the greater the leverage. Leverage allows exposure to a given quantity of an underlying asset for a fraction of the investment needed to purchase that quantity outright. In sum, buying (or selling) a security futures contract provides the same dollar and cents profit and loss outcomes as owning (or shorting) the underlying security. However, as a percentage of the margin deposit, the potential immediate exposure to profit or loss is much higher with a security futures contract than with the underlying security.

For example, if a security futures contract is established at a price of $50, the contract has a nominal value of $5,000 (assuming the contract is for 100 shares of stock). The margin
requirement may be as low as 20%. In the example just used, assume the contract price rises from $50 to $52 (a $200 increase in the nominal value). This represents a $200 profit to the buyer of the security futures contract, and a 20% return on the $1,000 deposited as margin. The reverse would be true if the contract price decreased from $50 to $48. This represents a $200 loss to the buyer, or 20% of the $1,000 deposited as margin. Thus, leverage can either benefit or harm an investor.

Note that a 4% decrease in the value of the contract resulted in a loss of 20% of the margin deposited. A 20% decrease would wipe out 100% of the margin deposited on the security futures contract.
Section 5 – Settlement

If you do not liquidate your position prior to the end of trading on the last day before the expiration of the security futures contract, you are obligated to either 1) make or accept a cash payment ("cash settlement") or 2) deliver or accept delivery of the underlying securities in exchange for final payment of the final settlement price ("physical delivery"). The terms of the contract dictate whether it is settled through cash settlement or by physical delivery.

The expiration of a security futures contract is established by the exchange on which the contract is listed. On the expiration day, security futures contracts cease to exist. Typically, the last trading day of a security futures contract will be the third Friday of the expiring contract month, and the expiration day will be the following Saturday. This follows the expiration conventions for stock options and broad-based stock indexes. Please keep in mind that the expiration day is set by the listing exchange and may deviate from these norms.

5.1. Cash settlement

In the case of cash settlement, no actual securities are delivered at the expiration of the security futures contract. Instead, you must settle any open positions in security futures by making or receiving a cash payment based on the difference between the final settlement price and the previous day’s settlement price. Under normal circumstances, the final settlement price for a cash-settled contract will reflect the opening price for the underlying security. Once this payment is made, neither the buyer nor the seller of the security futures contract has any further obligations on the contract.

5.2. Settlement by physical delivery

Settlement by physical delivery is carried out by clearing brokers or their agents with National Securities Clearing Corporation ("NSCC"), an SEC-regulated securities clearing agency. Such settlements are made in much the same way as they are for purchases and sales of the underlying security. Promptly after the last day of trading, the regulated exchange’s clearing organization will report a purchase and sale of the underlying stock at the previous day’s settlement price (also referred to as the “invoice price”) to NSCC. If NSCC does not reject the transaction by a time specified in its rules, settlement is effected pursuant to the rules of NSCC within the normal clearance and settlement cycle for securities transactions, which currently is three business days.

If you hold a short position in a physically settled security futures contract to expiration, you will be required to make delivery of the underlying securities. If you already own the securities, you may tender them to your brokerage firm. If you do not own the securities, you will be obligated to purchase them. Some brokerage firms may not be able to purchase the securities for you. If your brokerage firm cannot purchase the underlying securities on your behalf to fulfill a settlement obligation, you will have to purchase the securities through a different firm.
Section 6 – Customer Account Protections

Positions in security futures contracts may be held either in a securities account or in a futures account. Your brokerage firm may or may not permit you to choose the types of account in which your positions in security futures contracts will be held. The protections for funds deposited or earned by customers in connection with trading in security futures contracts differ depending on whether the positions are carried in a securities account or a futures account. If your positions are carried in a securities account, you will not receive the protections available for futures accounts. Similarly, if your positions are carried in a futures account, you will not receive the protections available for securities accounts. You should ask your broker which of these protections will apply to your funds.

You should be aware that the regulatory protections applicable to your account are not intended to insure you against losses you may incur as a result of a decline or increase in the price of a security futures contract. As with all financial products, you are solely responsible for any market losses in your account.

Your brokerage firm must tell you whether your security futures positions will be held in a securities account or a futures account. If your brokerage firm gives you a choice, it must tell you what you have to do to make the choice and which type of account will be used if you fail to do so. You should understand that certain regulatory protections for your account will depend on whether it is a securities account or a futures account.

6.1. Protections for Securities Accounts

If your positions in security futures contracts are carried in a securities account, they are covered by SEC rules governing the safeguarding of customer funds and securities. These rules prohibit a broker/dealer from using customer funds and securities to finance its business. As a result, the broker/dealer is required to set aside funds equal to the net of all its excess payables to customers over receivables from customers. The rules also require a broker/dealer to segregate all customer fully paid and excess margin securities carried by the broker/dealer for customers.

The Securities Investor Protection Corporation (SIPC) also covers positions held in securities accounts. SIPC was created in 1970 as a non-profit, non-government, membership corporation, funded by member broker/dealers. Its primary role is to return funds and securities to customers if the broker/dealer holding these assets becomes insolvent. SIPC coverage applies to customers of current (and in some cases former) SIPC members. Most broker/dealers registered with the SEC are SIPC members; those few that are not must disclose this fact to their customers. SIPC members must display an official sign showing their membership. To check whether a firm is a SIPC member, go to www.sipc.org, call the SIPC Membership Department at (202) 371-8300, or write to SIPC Membership Department, Securities Investor Protection Corporation, 805 Fifteenth Street, NW, Suite 800, Washington, DC 20005-2215.

SIPC coverage is limited to $500,000 per customer, including up to $100,000 for cash. For example, if a customer has 1,000 shares of XYZ stock valued at $200,000 and $10,000 cash in the account, both the security and the cash balance would be protected. However, if the
customer has shares of stock valued at $500,000 and $100,000 in cash, only a total of $500,000 of those assets will be protected.

For purposes of SIPC coverage, customers are persons who have securities or cash on deposit with a SIPC member for the purpose of, or as a result of, securities transactions. SIPC does not protect customer funds placed with a broker/dealer just to earn interest. Insiders of the broker/dealer, such as its owners, officers, and partners, are not customers for purposes of SIPC coverage.

6.2. Protections for Futures Accounts

If your security futures positions are carried in a futures account, they must be segregated from the brokerage firm's own funds and cannot be borrowed or otherwise used for the firm’s own purposes. If the funds are deposited with another entity (e.g., a bank, clearing broker, or clearing organization), that entity must acknowledge that the funds belong to customers and cannot be used to satisfy the firm’s debts. Moreover, although a brokerage firm may carry funds belonging to different customers in the same bank or clearing account, it may not use the funds of one customer to margin or guarantee the transactions of another customer. As a result, the brokerage firm must add its own funds to its customers' segregated funds to cover customer debits and deficits. Brokerage firms must calculate their segregation requirements daily.

You may not be able to recover the full amount of any funds in your account if the brokerage firm becomes insolvent and has insufficient funds to cover its obligations to all of its customers. However, customers with funds in segregation receive priority in bankruptcy proceedings. Furthermore, all customers whose funds are required to be segregated have the same priority in bankruptcy, and there is no ceiling on the amount of funds that must be segregated for or can be recovered by a particular customer.

Your brokerage firm is also required to separately maintain funds invested in security futures contracts traded on a foreign exchange. However, these funds may not receive the same protections once they are transferred to a foreign entity (e.g., a foreign broker, exchange or clearing organization) to satisfy margin requirements for those products. You should ask your broker about the bankruptcy protections available in the country where the foreign exchange (or other entity holding the funds) is located.
Section 7 – Special Risks for Day Traders

Certain traders who pursue a day trading strategy may seek to use security futures contracts as part of their trading activity. Whether day trading in security futures contracts or other securities, investors engaging in a day trading strategy face a number of risks.

*Day trading in security futures contracts requires in-depth knowledge of the securities and futures markets and of trading techniques and strategies.* In attempting to profit through day trading, you will compete with professional traders who are knowledgeable and sophisticated in these markets. You should have appropriate experience before engaging in day trading.

*Day trading in security futures contracts can result in substantial commission charges, even if the per trade cost is low.* The more trades you make, the higher your total commissions will be. The total commissions you pay will add to your losses and reduce your profits. For instance, assuming that a round-turn trade costs $16 and you execute an average of 29 round-turn transactions per day each trading day, you would need to generate an annual profit of $111,360 just to cover your commission expenses.

*Day trading can be extremely risky.* Day trading generally is not appropriate for someone of limited resources and limited investment or trading experience and low risk tolerance. You should be prepared to lose all of the funds that you use for day trading. In particular, you should not fund day trading activities with funds that you cannot afford to lose.
Section 8 – Other

8.1. Corporate Events

As noted in Section 2.4, an equity security represents a fractional ownership interest in the issuer of that security. By contrast, the purchaser of a security futures contract has only a contract for future delivery of the underlying security. Treatment of dividends and other corporate events affecting the underlying security may be reflected in the security futures contract depending on the applicable clearing organization rules. Consequently, individuals should consider how dividends and other developments affecting security futures in which they transact will be handled by the relevant exchange and clearing organization. The specific adjustments to the terms of a security futures contract are governed by the rules of the applicable clearing organization. Below is a discussion of some of the more common types of adjustments that you may need to consider.

Corporate issuers occasionally announce stock splits. As a result of these splits, owners of the issuer’s common stock may own more shares of the stock, or fewer shares in the case of a reverse stock split. The treatment of stock splits for persons owning a security futures contract may vary according to the terms of the security futures contract and the rules of the clearing organization. For example, the terms of the contract may provide for an adjustment in the number of contracts held by each party with a long or short position in a security future, or for an adjustment in the number of shares or units of the instrument underlying each contract, or both.

Corporate issuers also occasionally issue special dividends. A special dividend is an announced cash dividend payment outside the normal and customary practice of a corporation. The terms of a security futures contract may be adjusted for special dividends. The adjustments, if any, will be based upon the rules of the exchange and clearing organization. In general, there will be no adjustments for ordinary dividends as they are recognized as a normal and customary practice of an issuer and are already accounted for in the pricing of security futures. However, adjustments for ordinary dividends may be made for a specified class of security futures contracts based on the rules of the exchange and the clearing organization.

Corporate issuers occasionally may be involved in mergers and acquisitions. Such events may cause the underlying security of a security futures contract to change over the contract duration. The terms of security futures contracts may also be adjusted to reflect other corporate events affecting the underlying security.

8.2. Position Limits and Large Trader Reporting

All security futures contracts trading on regulated exchanges in the United States are subject to position limits or position accountability limits. Position limits restrict the number of security futures contracts that any one person or group of related persons may hold or control in a particular security futures contract. In contrast, position accountability limits permit the accumulation of positions in excess of the limit without a prior exemption. In general, position limits and position accountability limits are beyond the thresholds of most retail investors. Whether a security futures contract is subject to position limits, and the level for such limits, depends upon the trading activity and market capitalization of the underlying security of the security futures contract.
Position limits apply are required for security futures contracts that overlie a security that has an average daily trading volume of 20 million shares or fewer. In the case of a security futures contract overlying a security index, position limits are required if any one of the securities in the index has an average daily trading volume of 20 million shares or fewer. Position limits also apply only to an expiring security futures contract during its last five trading days. A regulated exchange must establish position limits on security futures that are no greater than 13,500 (100 share) contracts, unless the underlying security meets certain volume and shares outstanding thresholds, in which case the limit may be increased to 22,500 (100 share) contracts.

For security futures contracts overlying a security or securities with an average trading volume of more than 20 million shares, regulated exchanges may adopt position accountability rules. Under position accountability rules, a trader holding a position in a security futures contract that exceeds 22,500 contracts (or such lower limit established by an exchange) must agree to provide information regarding the position and consent to halt increasing that position if requested by the exchange.

Brokerage firms must also report large open positions held by one person (or by several persons acting together) to the CFTC as well as to the exchange on which the positions are held. The CFTC’s reporting requirements are 1,000 contracts for security futures positions on individual equity securities and 200 contracts for positions on a narrow-based index. However, individual exchanges may require the reporting of large open positions at levels less than the levels required by the CFTC. In addition, brokerage firms must submit identifying information on the account holding the reportable position (on a form referred to as either an “Identification of Special Accounts Form” or a “Form 102”) to the CFTC and to the exchange on which the reportable position exists within three business days of when a reportable position is first established.

### 8.3. Transactions on Foreign Exchanges

U.S. customers may not trade security futures on foreign exchanges until authorized by U.S. regulatory authorities. U.S. regulatory authorities do not regulate the activities of foreign exchanges and may not, on their own, compel enforcement of the rules of a foreign exchange or the laws of a foreign country. While U.S. law governs transactions in security futures contracts that are effected in the U.S., regardless of the exchange on which the contracts are listed, the laws and rules governing transactions on foreign exchanges vary depending on the country in which the exchange is located.

### 8.4. Tax Consequences

For most taxpayers, security futures contracts are not treated like other futures contracts. Instead, the tax consequences of a security futures transaction depend on the status of the taxpayer and the type of position (e.g., long or short, covered or uncovered). Because of the importance of tax considerations to transactions in security futures, readers should consult their tax advisors as to the tax consequences of these transactions.
Section 9 – Glossary of Terms

This glossary is intended to assist customers in understanding specialized terms used in the futures and securities industries. It is not inclusive and is not intended to state or suggest the legal significance or meaning of any word or term.

**Arbitrage** – taking an economically opposite position in a security futures contract on another exchange, in an options contract, or in the underlying security.

**Broad-based security index** – a security index that does not fall within the statutory definition of a narrow-based security index (see Narrow-based security index). A future on a broad-based security index is not a security future. This risk disclosure statement applies solely to security futures and generally does not pertain to futures on a broad-based security index. Futures on a broad-based security index are under exclusive jurisdiction of the CFTC.

**Cash settlement** – a method of settling certain futures contracts by having the buyer (or long) pay the seller (or short) the cash value of the contract according to a procedure set by the exchange.

**Clearing broker** – a member of the clearing organization for the contract being traded. All trades, and the daily profits or losses from those trades, must go through a clearing broker.

**Clearing organization** – a regulated entity that is responsible for settling trades, collecting losses and distributing profits, and handling deliveries.

**Contract** – 1) the unit of trading for a particular futures contract (e.g., one contract may be 100 shares of the underlying security), 2) the type of future being traded (e.g., futures on ABC stock).

**Contract month** – the last month in which delivery is made against the futures contract or the contract is cash-settled. Sometimes referred to as the delivery month.

**Day trading strategy** – an overall trading strategy characterized by the regular transmission by a customer of intra-day orders to effect both purchase and sale transactions in the same security or securities.

**EDGAR** – the SEC’s Electronic Data Gathering, Analysis, and Retrieval system maintains electronic copies of corporate information filed with the agency. EDGAR submissions may be accessed through the SEC’s Web site, [www.sec.gov](http://www.sec.gov).

**Futures contract** – a futures contract is (1) an agreement to purchase or sell a commodity for delivery in the future; (2) at a price determined at initiation of the contract; (3) that obligates each party to the contract to fulfill it at the specified price; (4) that is used to assume or shift risk; and (5) that may be satisfied by delivery or offset.

**Hedging** – the purchase or sale of a security future to reduce or offset the risk of a position in the underlying security or group of securities (or a close economic equivalent).
**Illiquid market** – a market (or contract) with few buyers and/or sellers. Illiquid markets have little trading activity and those trades that do occur may be done at large price increments.

**Liquidation** – entering into an offsetting transaction. Selling a contract that was previously purchased liquidates a futures position in exactly the same way that selling 100 shares of a particular stock liquidates an earlier purchase of the same stock. Similarly, a futures contract that was initially sold can be liquidated by an offsetting purchase.

**Liquid market** – a market (or contract) with numerous buyers and sellers trading at small price increments.

**Long** – 1) the buying side of an open futures contract, 2) a person who has bought futures contracts that are still open.

**Margin** – the amount of money that must be deposited by both buyers and sellers to ensure performance of the person’s obligations under a futures contract. Margin on security futures contracts is a performance bond rather than a down payment for the underlying securities.

**Mark-to-market** – to debit or credit accounts daily to reflect that day’s profits and losses.

**Narrow-based security index** – in general, and subject to certain exclusions, an index that has any one of the following four characteristics: (1) it has nine or fewer component securities; (2) any one of its component securities comprises more than 30% of its weighting; (3) the five highest weighted component securities together comprise more than 60% of its weighting; or (4) the lowest weighted component securities comprising, in the aggregate, 25% of the index’s weighting have an aggregate dollar value of average daily trading volume of less than $50 million (or in the case of an index with 15 or more component securities, $30 million). A security index that is not narrow-based is a “broad based security index.” (See Broad-based security index).

**Nominal value** – the face value of the futures contract, obtained by multiplying the contract price by the number of shares or units per contract. If XYZ stock index futures are trading at $50.25 and the contract is for 100 shares of XYZ stock, the nominal value of the futures contract would be $5025.00.

**Offsetting** – liquidating open positions by either selling fungible contracts in the same contract month as an open long position or buying fungible contracts in the same contract month as an open short position.

**Open interest** – the total number of open long (or short) contracts in a particular contract month.

**Open position** – a futures contract position that has neither been offset nor closed by cash settlement or physical delivery.

**Performance bond** – another way to describe margin payments for futures contracts, which are good faith deposits to ensure performance of a person’s obligations under a futures contract rather than down payments for the underlying securities.
Physical delivery – the tender and receipt of the actual security underlying the security futures contract in exchange for payment of the final settlement price.

Position – a person’s net long or short open contracts.

Regulated exchange – a registered national securities exchange, a national securities association registered under Section 15A(a) of the Securities Exchange Act of 1934, a designated contract market, a registered derivatives transaction execution facility, or an alternative trading system registered as a broker or dealer.

Security futures contract – a legally binding agreement between two parties to purchase or sell in the future a specific quantify of shares of a security (such as common stock, an exchange-traded fund, or ADR) or a narrow-based security index, at a specified price.

Settlement price – 1) the daily price that the clearing organization uses to mark open positions to market for determining profit and loss and margin calls, 2) the price at which open cash settlement contracts are settled on the last trading day and open physical delivery contracts are invoiced for delivery.

Short – 1) the selling side of an open futures contract, 2) a person who has sold futures contracts that are still open.

Speculating – buying and selling futures contracts with the hope of profiting from anticipated price movements.

Spread – 1) holding a long position in one futures contract and a short position in a related futures contract or contract month in order to profit from an anticipated change in the price relationship between the two, 2) the price difference between two contracts or contract months.

Stop limit order – an order that becomes a limit order when the market trades at a specified price. The order can only be filled at the stop limit price or better.

Stop loss order – an order that becomes a market order when the market trades at a specified price. The order will be filled at whatever price the market is trading at. Also called a stop order.

Tick – the smallest price change allowed in a particular contract.

Trader – a professional speculator who trades for his or her own account.

Underlying security – the instrument on which the security futures contract is based. This instrument can be an individual equity security (including common stock and certain exchange-traded funds and American Depositary Receipts) or a narrow-based index.

Volume – the number of contracts bought or sold during a specified period of time. This figure includes liquidating transactions.

October 2010
RISK DISCLOSURE STATEMENT

This statement is given to you as required by section 1210 of the Act.

The risk of loss in trading in futures contracts can be substantial. You should therefore carefully consider whether that kind of trading is appropriate for you in the light of your financial circumstances. In deciding whether or not you will become involved in that kind of trading, you should be aware of the following matters-

(a) You could sustain a total loss of the initial margin funds that you deposit with your futures broker to establish or maintain a position in a futures market.

(b) If the futures market moves against your position, you may be required, at short notice, to deposit with your futures broker additional margin funds in order to maintain your position. Those additional funds may be substantial. If you fail to provide those additional funds within the required time, your position may be liquidated at a loss and in that event you will be liable for any shortfall in your account resulting from that failure.

(c) Under certain conditions, it could become difficult or impossible for you to liquidate a position (this can, for example, happen when there is a significant change in prices over a short period).

(d) The placing of contingent orders (such as a 'stop-loss' order) may not always limit your losses to the amounts that you may want. Market conditions may make it impossible to execute such orders.

(e) A 'spread' position is not necessarily less risky than a simple 'long' or 'short' position.

(f) The high degree of leverage that is obtainable in futures trading because of small margin requirements can work against you as well as for you. The use of leverage can lead to large losses as well as large gains.

(g) If you propose to trade in futures options, the maximum loss in buying an option is the amount of the premium, but the risks in selling an option are the same as in other futures trading.

This statement does not disclose all of the risks and other significant aspects involved in trading on a futures market. You should therefore study futures trading carefully before becoming involved in it.

*I/We confirm that *I/*we have read and understand this risk disclosure statement and that the futures contracts trading terms used in it have been explained to *me/*us by the giver of this statement.
Foreword

The purpose of this explanatory memorandum is to provide investors and other interested parties with information about the options and futures that are listed on Euronext Amsterdam Derivative Markets N.V.

If this explanatory memorandum is distributed in connection with the conclusion of an options agreement or client agreement, it should be an original copy. This document cannot be reproduced for this purpose.

In this explanatory memorandum, Euronext Amsterdam Derivative Markets N.V. is referred to as the derivatives market.

No section or clause of this explanatory memorandum may be regarded as creating any right or obligation. Rights and obligations in respect of the trade in derivatives at Euronext shall depend solely on the rules and regulations of Euronext and the organisations which are responsible for clearing derivatives traded on this market.
What are options and futures?

What is an option?

An option gives the buyer the right, during a fixed period, to buy (call option) or sell (put option) a specified amount of the underlying value at a fixed price.

At Euronext’s derivatives market, options are traded on various underlying values such as shares, share indices, bonds, currencies and precious metals. The contract specifications of all option classes are contained in the appendix to this explanatory memorandum.

What is a futures contract?

A futures contract is an agreement to buy or sell a commodity or a financial instrument to be delivered by the seller to the buyer on a specified date in the future. The price is fixed when the contract is concluded. On Euronext’s derivatives market, futures are traded on various financial instruments such as share indices and currencies. The instruments on which the futures are based are known as the underlying values.

This explanatory memorandum only covers options and futures and does not include information about products such as warrants, other special products or flex options. Information about these products is available in other brochures.
Description of options

2.1 How does an option work?

An investor who buys an option concludes what is known as a opening buy transaction and is called the buyer. An opening buy transaction creates a long position in call or put options. Each option gives the holder the right to buy (call option) or sell (put option) a specified amount of the underlying value at a fixed price. The investor can liquidate this position by means of a closing sell transaction.

An investor who sells an option is called a writer. The writer concludes an opening sell transaction which creates a short position in call or put options. The writer of an option has the obligation, if assigned, to sell (call option) or buy (put option) a specified amount of the underlying value at a fixed price. However, exercising some types of options does not result in physical delivery of the underlying value but in cash settlement.

An investor who has previously sold (written) an option but wants to be released from the resulting obligation to buy or sell the underlying value can do so by means of a closing buy transaction. Writers can do this until they have been assigned, i.e. called upon to meet their obligations.

When investors write call options on an underlying value that they own (and have therefore agreed to sell at a fixed price if assigned to do so), the options are regarded as covered options. Investors can also write call options without actually owning the underlying value. If the option is exercised, the writer has to buy the underlying value before delivering it to the buyer. In this case, the option is called a naked option. Written put options are always naked options.
Euronext only allows investors to write naked options if they deposit sufficient collateral (margin).

There is no direct relationship between the buyer and the writer of an option. Euronext’s options clearing division ensures that the rights and obligations of investors remain in balance.

Because the options clearing division acts as the counterparty to both the buyer and the seller of the option, it takes over the rights and obligations resulting from the options from its clearing members. Clearing members are members of Euronext which are responsible for, among other things, the financial and administrative settlement of transactions in options.

Clearing members must, in turn, meet their obligations towards the introducing broker that executes the order on behalf of the investor. Introducing brokers are members of Euronext that pass orders to executing brokers. The options clearing division does not guarantee the solvency of the introducing broker that acts on the investor’s behalf.

There are risks involved in buying and selling options. Investors should not buy options unless they can afford to lose the premium they have to pay. Nor should they write naked options if they are not in a position to sustain a substantial financial loss.

Euronext monitors compliance with its rules and regulations and has the authority to examine all information relating to orders and transactions. This information may include the identity of the introducing brokers, clearing members, traders and investors involved in orders and transactions. In extraordinary circumstances, this type of information may be made available to the police and the authorities, for instance in the case of suspected insider trading.
Euronext has concluded agreements with a number of other exchanges. This means that it can pass information on to other foreign or domestic exchanges or regulators if this is necessary or desirable in connection with the detection and prevention of violations of its rules and regulations or improper activities.
3. Contract specifications

3.1 Standardisation

The options that are traded on the derivatives market meet certain standard conditions. The contract size, lifetime, expiration date and exercise price are standardised. The option premium is the only variable element. Option premiums are quoted as the amount payable for each unit of the underlying value (please see Euronext’s reference book).

The contract size is the quantity of the underlying value that corresponds to one option contract. The contract size is based on the trading unit and the pricing unit. The reference book states this information for each type of option.

The lifetime of an option is the maximum period during which the option represents a right. At the end of this period the option has no value. The lifetime of options traded on Euronext’s derivatives market varies from one month to five years. The lifetime of each option class is stated in the reference book.

The last day of trading in an option is the last day on which it is possible to trade in an expiring option series. For most classes this is the third Friday of the expiration month. If the markets are closed on the third Friday of the month, the last day of trading in the option series is the last day of trading before the third Friday of the expiration month (see also the reference book).

After trading has stopped in an expiring series, the right to buy or sell the underlying value can still be exercised, in most cases up to the day after the last day of trading. Your introducing broker may, however, observe different cut-off times. The cut-off time for selling an option is stipulated in the options agreement that you have concluded with your introducing broker. Other exceptions are detailed in the reference book.
The introducing broker is required to pass on to the options clearing division the exercise instructions received from its clients. If an option is exercised on the day after the last day of trading, the exercise instruction must be received by the options clearing division before 1 p.m. Each introducing broker is free to set a different, earlier cut-off time for submitting exercise instructions or orders for transactions in expiring series. Introducing brokers must inform their clients of these cut-off times.

The exercise price is the price at which the holder (i.e. buyer) of the option can buy or sell the underlying value when the option is exercised. The exercise price is stated as an amount payable for each unit of the underlying value.

When Euronext announces the introduction of options with a new expiration month, it sets a number of different exercise prices which are close to the market price of the underlying value at that time. Euronext sets the interval between the exercise prices for each option class individually.

In normal circumstances, once an option series has been listed by Euronext it will continue to be traded until the expiration date. Euronext can, however, prohibit or restrict opening transactions in certain series.

3.2 Types of options

There are two types of options: American style and European style. An American-style option can be exercised at any time during the option’s lifetime. A European-style option can only be exercised on the expiration date, although open positions in these options can be closed before expiration. The reference book provides details of whether a particular option is American or European style.
3.3 Exercising options

After being exercised options can be settled in two ways: by means of either physical delivery or cash settlement. In most cases, exercising an option results in the physical delivery of the underlying value. However, a number of options are settled in cash on the basis of the difference between the exercise price and the settlement price. The form of settlement used for each option class and, where applicable, the method used to calculate the settlement price is detailed in the reference book.

3.4 Underlying values

The financial instruments on which options are traded – the underlying values – are selected by Euronext. When selecting new option classes, Euronext gives preference to underlying values that are widely held and actively traded, particularly on official exchanges. Other criteria are also taken into account, such as the distribution of the ownership of the relevant instrument, trading volumes and price volatility. Euronext notifies issuers of shares on which options will be introduced of the fact that they have been selected for this. In exceptional circumstances, Euronext may decide to remove an option class from listing.

3.5 Currency

When Euronext selects a new option class, its first task is to establish which market is the main market for trading in the relevant underlying value. This is generally, though not necessarily, the home market, i.e. the market in the underlying value’s country of origin. The currency of the country of origin is usually the currency that is used at Euronext for quoting premiums for options on a particular underlying value.
3.6 Option premium

The option premium (price) is based on supply and demand between parties on the floor of the derivatives market. These parties generally base premiums on the price of the underlying value and the option’s remaining lifetime.

3.7 Adjustment

In the event of a capital restructuring, share split, rights issue or bonus issue involving the issuer of shares on which options are listed, the underlying value, trading unit, contract size and exercise prices of the affected option series may be adjusted. Other events, such as a public bid for a listed company, a merger or a liquidation, may also result in the adjustment of the underlying value. As a rule, no adjustment is made when cash dividends and dividends with a stock option are distributed.

Depending on the circumstances, the options clearing division may sometimes decide that with effect from a particular date the shares of a company that has been acquired by another and on which options are listed are to be replaced by other shares (for example shares in the company that made the acquisition). It may, however, decide that exercising the option will result in cash settlement instead of the physical delivery of the underlying shares, or that some other adjustment of the underlying value and/or contract specifications is warranted. Euronext makes every effort to ensure that information about such measures is provided as soon as possible.
4.1 Making a profit

Buyers of options expect a change in the price of the underlying value. The buyer of a call option hopes for a rise in the price, while the buyer of a put option hopes for a fall. In both cases, the investor can make a relatively larger profit with options than by investing a similar amount in the underlying value, because only a small sum (the option premium) needs to be invested to benefit in full from price movements in the underlying value. This is known as leverage. If the price of the underlying value rises, the price of call options will usually rise as well. Similarly, if the price of the underlying value falls, the price of put options will usually increase. This makes it possible for investors to make a profit on their options.

4.2 Earning extra income

An investor can also decide to write options in order to receive the option premium. Investors who actually own the underlying value can obtain an additional return on their portfolios in this way. However, if they are assigned to deliver the underlying value, they must sell the underlying value to the holder of the call option for less than its market value. When holders of put options exercise their rights, the writers have to buy the underlying value for more than its market value. The underlying value is bought and sold through the options clearing division. With both call and put options, the writer’s loss, though reduced by the option premium received, can be very substantial if there is a major change in the market price of the underlying value.
4.3 Protection against falls in value

Options also allow investors to protect themselves against falls in the price of the underlying value. Maximum protection is obtained by buying put options. Writing call options gives investors partial protection against decreases in the price of the underlying value, but in this case protection is limited to the amount of premium received.

4.4 Fixing the purchase or selling price of the underlying value

Options also make it possible to fix in advance the price at which the underlying value may be traded at some future date. For example, an investor who wants to set a maximum purchase price will be interested in buying call options. An investor who wants to set a minimum selling price will be interested in buying put options.
5 Buying options

5.1 Buying call options

5.1.1 Principle
Buyers of call options can benefit from increases in the price of the underlying value during the lifetime of their options because they have the right to buy the underlying value at a fixed price.

5.1.2 Possibilities
If the price of the underlying value rises, the option holder must take steps to realise the profit on the option. There are two possibilities:

- Investors can sell their options on the derivatives market. In this case, the holder is more interested in the increase in the option premium than in acquiring the underlying value. In general, the price of a call option increases in line with the price of the underlying value. The profit in this case consists of the proceeds from the sale less the original option premium and transaction costs. Because of leverage, a small rise in the price of the underlying value can generate a high profit (in percentage terms) on the original investment.

- Investors can exercise an American-style option at any time during the lifetime of the option. A European-style option can only be exercised on the expiration date. Depending on the specifications of the option, the underlying value is delivered when the option is exercised, or settlement takes place in the form of cash.
5.1.3 Risk
If there is no increase in the price of the underlying value, call option holders can lose their entire investment, i.e. the option premium plus the transaction costs. This is the maximum possible loss that buyers of call options can incur.

5.2 Buying put options

5.2.1 Principle
Buyers of put options can benefit from falls in the price of the underlying value which may occur during the lifetime of their options.

5.2.2 Possibilities
If the price of the underlying value falls, put option holders who wish to profit from this can choose between the following alternatives:

- They can sell their options on the derivatives market. In this case, the profit consists of the increase in the option premium. In general, the price of a put option increases as the price of the underlying value falls. The profit consists of the proceeds from the sale less the original option premium and transaction costs. Because of leverage, a small fall in the price of the underlying value can generate a high profit (in percentage terms) on the original investment.

- An American-style option can be exercised at any time during the lifetime of the option. A European-style option can only be exercised on the expiration date. Depending on the option specifications, the underlying value is delivered when the option is exercised, or settlement takes place in the form of cash.
5.2.3 Risk
If there is no fall in the price of the underlying value, put option holders can lose their entire investment, i.e. the option premium plus the transaction costs. This is the maximum possible loss that buyers of put options can incur.
Writing options

6.1 Writing call options

6.1.1 Principle
Writers of call options take on the obligation to sell the underlying value at the exercise price, if assigned to do so. In return, they receive the option premium.

6.1.2 Possibilities
6.1.2.1 Writing covered call options
The main objective for investors who write call options on an underlying value which they own (covered call options) is to obtain an extra return on their investment portfolio by receiving the option premium. A consequence of this is that the investor must accept the risk of having to sell the underlying value at a price agreed to in advance.

If the price of the underlying value falls below the exercise price, the option will probably expire without being exercised and the writer will retain the premium. The writer can also liquidate a position by concluding a closing transaction on the derivatives market.

However, if the price of the underlying value rises above the exercise price, there is a good chance that the call option will be exercised. The writer will then be required to deliver the underlying value.

In addition to earning premium income, investors may decide to write call options as a means of fixing a selling price for the underlying value. The selling price is then equal to the exercise price plus the premium received, less costs. If the option is not exercised, the investor will not have to sell the underlying value.
6.1.2.2 Writing naked call options
Investors who write call options on underlying values which they do not own (naked call options) should be aware that they run a potentially unlimited risk.

If the price of the underlying value rises above the exercise price, there is a good chance that the call option will be exercised. Writers will then be required to sell the underlying value at the exercise price. Because writers of naked call options do not own the underlying value, they will have to buy it first at the market price, which will be higher than the exercise price. The increase in the price of the underlying value can, in theory, be unlimited, which means that the writer of a naked call option runs an unlimited risk.

Writers of naked call options must therefore have the financial means to purchase and deliver the underlying value if the option is exercised. To guarantee this, they have to provide an amount of margin specified by Euronext. The margin system is explained in Euronext’s brochure on minimum margin requirements.

6.1.3 Risk
Because of the large losses which may be incurred, writing call options is only suitable for experienced investors that have the financial means to sustain such losses. The extent of the writer’s risk depends largely on whether the options are covered or naked.

Writers must therefore provide collateral. If the options are covered, the underlying value is held in a blocked account. If the options are naked, margin must be deposited. Writers of call options (covered or naked) who expect to be required to deliver the underlying value because of a rise in its price may be able to avoid delivery by concluding a closing buy transaction on the derivatives market before being assigned to make the delivery.
6.2 Writing put options

6.2.1 Principle
Writers of put options take on the obligation to buy the underlying value at the exercise price, if assigned to do so. In return, they receive the option premium.

6.2.2 Possibilities
The main objective of investors who write put options is to receive the option premium. A consequence of this is that the investor has to accept the risk of having to buy the underlying value at a price agreed to in advance.

If the price of underlying value rises above the exercise price, the option will probably expire without being exercised and the writer will retain the premium. As long as the option has not been exercised, the writer can liquidate the option position by concluding a closing transaction on the derivatives market.

However, if the market price of the underlying value drops below the exercise price, the put option may be exercised. The writer will then be required to buy the underlying value at a price that is higher than the current market price.

In addition to making a profit on option premiums, the investor may also consider writing put options as a means of fixing a purchase price for the underlying value. The purchase price is then equal to the exercise price less the option premium, plus costs. If the option is not exercised, the underlying value will not be delivered and the investor will keep the profit earned on the option.
6.2.3 Risk
The writer of a put option accepts the risk of having to buy the underlying value at a price that is substantially higher than the current market price.

A written put option is always naked. The investor must therefore have the financial means to pay for the underlying value in the event that the option is exercised, and hence has to provide the margin specified by Euronext.

Writers of put options who expect to have to take delivery of the underlying value because of a fall in its price can avoid doing so by concluding a closing buy transaction on the derivatives market before being assigned to take delivery.
Investors who wish to buy or sell an option can place an order with an introducing broker. Every investor must sign an option agreement before conducting any transactions. If the introducing broker also manages the investor’s portfolio, the investor must also sign a portfolio management agreement.

7.1 Orders

An order must specify the option class, the type of option (put or call), the expiration month, the exercise price and the number of contracts to be bought or sold. The order must also indicate whether it is an opening or closing transaction. Investors can also set a limit on the price at which they are prepared to buy or sell options.

An introducing broker can require collateral from the investor, in cash or another form, before accepting any orders. In the case of written options, the introducing broker has to obtain collateral from the investor.

Euronext cannot guarantee that there will always be a market of sufficient size in every option series to enable an investor to liquidate an open position at the price they want. It also cannot guarantee that a favourable movement in the price of the underlying value will enable the holder of an option to sell it at a profit. The option premium depends not only on the expected movement in the price of the underlying value, but also on factors such as the remaining lifetime of the option and supply and demand in that particular option series.
7.2 Commission

Introducing brokers charge their clients commission for buy and sell transactions concluded on the derivatives market. Investors are advised to ask their introducing broker what amount of commission will be charged in a particular case and whether or not there are other fees or taxes that should be taken into account.

7.3 Transaction confirmation

Investors should be aware that the primary evidence of their rights and obligations consists of an entry in the records kept by their introducing broker. Members of Euronext are therefore required to provide written confirmation of each option transaction conducted by them on behalf of their clients. Investors are advised to check these confirmation reports carefully and to report any errors or objections immediately.

7.4 Position statements

Members of Euronext must also provide each client on request with a statement showing the client's open positions in each option series. Exemption from this obligation may be granted if the confirmation report for each new transaction also shows the client's overall position in that particular series. Investors can only exercise options or conduct closing transactions via the introducing broker through which they opened the relevant option position. They may, however, submit a written request for their position in the books of their current introducing broker to be transferred to another Euronext member that is prepared to take over their position.
7.5 Position limits

Euronext is authorised to set limits on the maximum number of options that can be held or written by investors acting on their own or jointly with others. Introducing brokers are required to inform their clients of the limits in force at the time an order is given. Euronext can decide that positions which exceed these limits must be liquidated. Purchased call options belong to the same side of the market as written put options (buy side) and together may not exceed the relevant limit. Similarly, purchased put options belong to the same side of the market as written call options (sell side) and together may not exceed the relevant limit. The reference book states the position limits applying to members of the public at the time of publication.

7.6 Collateral

Writers of covered call options must deposit an amount of the underlying value that is sufficient to cover the potential obligations arising from their option transactions.

Euronext allows investors to write naked call options. Writers of these options hope to collect the option premium without having to deliver the underlying value. They will, of course, have to provide sufficient collateral (known as margin) if they follow this high-risk strategy, because they have to be able to deliver the underlying value at the exercise price if the option is exercised.

Euronext permits the writing of naked call options so long as margin is provided. The minimum margin requirements are calculated by Euronext and published each day in the Dutch Daily Official List (Officiële Prijscourant).
Written put options are always naked. Writers of put options must therefore always comply with the margin requirements set by Euronext. Before conducting any option transactions, investors should be fully aware of the precise conditions which will be applied by their introducing broker when calculating the margin to be provided. This margin may be higher than the minimum margin required by Euronext.

7.7 Segregation of assets

Introducing brokers that are established in the Netherlands but are not registered as credit institutions with the Dutch central bank are not permitted to hold positions and funds on behalf of clients, with the exception of certain professional investors. In such cases, the position resulting from an option transaction is transferred as quickly as possible to an introducing broker or clearing member which is authorised to trade on the derivatives market and which is also registered with the Dutch central bank. Investors must conclude a special agreement (referred to as a tripartite agreement) when entering into a relationship with their introducing broker.
8.1 Exercising options

Investors who wish to exercise an option must inform their introducing broker. The deadline for doing so is specified in the option agreement that every investor concludes with their introducing broker. In the case of cash settlement, no underlying value is delivered. Instead the contract is settled in cash on the basis of the difference between the exercise price and the settlement price.

The investor’s exercise instruction is then passed on to the options clearing division. Exercise instructions are irrevocable. Once the options clearing division has received these instructions, holders of exercised call options must pay their introducing broker the exercise price (multiplied by the contract size) for the underlying value. Investors who exercise put options have to deliver the underlying value, in return for which they receive the exercise price.

8.2 Exercise limits

Under its rules, Euronext is authorised to set limits on the number of options that may be exercised by an individual option holder within a specified timeframe. Before conducting any option transactions, investors should ask their introducing broker for details of the limits that will apply to them. Put and call options are considered separate classes and are not added together when checking these limits. The reference book lists the exercise limits applying to members of the public at the time of publication.
8.3 Assignment procedure

When options are exercised, a writer is selected at random to deliver the underlying value (call option with physical delivery), buy the underlying value (put option with physical delivery), or arrange cash settlement (cash-settlement contract).

Introducing brokers inform writers of options as quickly as possible of the fact that they have been assigned to sell the underlying value (call option with physical delivery), buy the underlying value (put option with physical delivery) or arrange cash settlement (cash-settlement contract).

8.4 Delivery of and payment for the underlying value

The underlying value must be delivered to a financial institution/custodian nominated by the options clearing division. Payment must be made to a bank specified by the options clearing division.

Shares that are delivered as a result of an equity option being exercised and which were listed cum-dividend on the day the option was exercised must be delivered cum-dividend. Shares that were listed ex-dividend on the day the option was exercised must be delivered ex-dividend.

The options clearing division reserves the right to decide in specific situations that exercised options are to be settled in cash and not by means of physical delivery. Settlement then takes place on the basis of a settlement price calculated by the options clearing division. While the situation lasts, investors who have exercised options or have been assigned lose the right to insist on the delivery of the underlying value.
8.5 Commission on delivery

When the underlying value is delivered as a result of exercising and assignment, introducing brokers charge the standard market commission for the underlying value.

Investors are advised to ask their introducing broker how much commission will be charged in a particular case and whether there are any other fees or taxes that have to be taken into account.
Description of futures

9.1 How do futures work?

Investors can buy and sell futures that are traded on the derivatives market by placing an order with an introducing broker. Buying a future is known as an opening buy transaction. This creates a long position, which is also called a buy position. An investor with a long position has agreed to purchase the underlying value at a fixed date in the future. In this context, investors should note that all the financial futures that are currently listed are cash-settlement contracts.

In this memorandum, holders of long positions are referred to as buyers. In principle, buyers make a profit when their futures rise in price and lose money when their futures fall in price. Buyers can liquidate long positions by selling their futures. Such transactions are referred to as a closing sell.

Investors that sell a futures contract conduct an opening sell transaction. Investors can sell futures without first buying them. An opening sell creates a short position, which means that the investor has agreed to sell the underlying value at a fixed date in the future.

In this memorandum, holders of short positions are referred to as sellers. Sellers make a profit when their futures fall in price, and lose money when their futures rise in price. Sellers can liquidate short positions by buying futures. Such transactions are referred to as a closing buy.

The price of a futures contract is not always the same as the market price of the underlying value. In addition to the market price, other factors, including market sentiment, interest rates and dividends or coupons distributed on the underlying value, affect the price of a futures contract. As a result, the price of a futures contract does not always move in proportion to rises and falls in the market price of the underlying value.
When trading futures, the investment needed to open a position is only the initial margin required by Euronext. This margin serves as collateral to ensure that the obligations attached to the futures contract will be met. The margin, which is the same for buyers and sellers, is paid back if the position is closed. Euronext sets minimum margin requirements, but introducing brokers are free to set higher margin requirements. Euronext is at all times authorised to increase the minimum margin requirements.

Profits and losses are calculated every day and settled immediately in cash on the basis of the closing price of the relevant futures contract. The investor must immediately make up any losses by depositing additional margin, known as variation margin. Profits and losses are settled daily, as the profit or loss of just one day may exceed the amount of initial margin deposited. It is also important for investors to ensure that they have sufficient funds to pay for variation margin. Investors should not trade in futures unless they are capable of withstanding a substantial financial loss.

### 9.2 Example

On the third Wednesday in November the level of the AEX index is 465. An investor expects the level of the index to rise and buys two FTI November contracts. These are futures on the AEX index that expire on the third Friday of November. Each FTI contract represents the level of the index multiplied by 200. Every one-point change in the level of the index leads to a profit or loss of € 200 per contract.

If the initial margin required for an FTI contract is € 9,720, an investor who holds two contracts must provide the following initial margin:

\[ 2 \times € 9,720 = € 19,440 \]
In this case, the value of the investment, in which the index represents a share portfolio, is as follows:

\[
2 \text{ contracts} \times 200 \times 1 \times 465 = € 186,000
\]

To invest in the share portfolio represented by the index and thus obtain the same profit potential, the investor would have had to pay € 186,000 instead of € 19,440. The prospect of a high return on a relatively small investment is known as leverage.

The investor’s initial investment and its development are explained below.

**Wednesday**
The AEX index stands at 465 points. The investor buys two FTI November contracts priced at 466. The price of the future is not the same as the level of the AEX index.

During the day, prices rise. At the end of the day, the AEX index has risen to 467 points, and the closing price of the November FTI contract is 467.50. Profits and losses are immediately settled in cash. At the end of the first day, the price at which the position was opened is compared with the closing price of the futures contract to determine the investor’s profit.

\[
1.5 \text{ points price gain} \times 2 \text{ contracts} \times € 200 \text{ per point} = € 600
\]

**Thursday**
On Thursday the AEX index rises by 4 points and closes at 471 points. However, the price of the November FTI contract does not always follow the index precisely. Today, the FTI contract rises 3 points, not 4, and closes at 470.50. When this closing price is compared with the previous day’s, the price gain is as follows:

\[
470.50 - 467.50 = 3 \text{ points}
\]
The investor’s profit is as follows:

3 points price gain × 2 contracts × €200 per point = €1,200

Friday
This is the third Friday in November and the last day of trading in the November FTI contract. Instead of selling his futures, the investor decides to have his open futures position settled via Euronext. This is only possible after the close of the last day of trading and is done at the settlement price. The settlement price is fixed by Euronext’s derivatives market, and in the case of the FTI contract is based on the level of the AEX index calculated at fixed intervals on the last day of trading. The settlement price on this particular Friday is 469. Given the closing price on Thursday, the investor has lost 1.5 points (470.50 – 469). On other days, he would have to make the following additional margin deposit (variation margin):

1.5 points price loss × 2 contracts × €200 per point = €600

However, because the position has been settled, the margin can be released.

The final profit is the aggregate of the results from Wednesday, Thursday and Friday:

Profit = €600 + €1,200 – €600 = €1,200

In other words, because the price at the time of the opening buy transaction was 466 but the settlement price is 469, on balance the investor has made the following profit:

3 points × 2 contracts × €200 = €1,200
9.3 Options clearing

There is no direct relationship between the buyer and the seller of a futures contract. The only legal relationship the investor enters into by means of an opening buy or sell transaction in futures is with the introducing broker that holds their open position in futures. In turn, the introducing broker has a legal relationship with its clearing member. Clearing members are members of Euronext which are responsible for, among other things, the settlement and administration of futures contracts.

There are a number of clearing members, all of which have a legal relationship with the options clearing division. This structure means that open futures positions only result in obligations on the part of the options clearing division towards clearing members. Clearing members hold futures positions in their own name but for the account and risk of introducing brokers. Neither the options clearing division nor the clearing members can guarantee the solvency of the introducing broker that acts on the investor’s behalf.

9.4 Segregation of assets

Introducing brokers that are established in the Netherlands but which are not registered as credit institutions with the Dutch central bank are not permitted to hold positions and funds on behalf of clients, with the exception of certain professional investors. In such cases, the position resulting from a futures transaction must be transferred as quickly as possible to an introducing broker or clearing member which is authorised to trade on the derivatives market and which is also registered with the Dutch central bank. Investors must conclude a special agreement (referred to as a tripartite agreement) when entering into a relationship with their introducing broker.
10.1 Standardisation

The futures that are traded on the derivatives market meet certain standard conditions. The underlying value, contract size, trading currency, last day of trading and delivery or settlement conditions are standardised. The price of the futures contract is the only variable element, and can be negotiated on the floor of the exchange.

10.2 Underlying value and contract size

The financial instruments on which futures are based, such as share indices and currencies, are known as underlying values and are selected by Euronext. When selecting new futures contracts, Euronext gives preference to underlying values that are widely held and actively traded. The contract size is the quantity of the underlying value that corresponds to one futures contract.

In exceptional circumstances, Euronext may decide to remove a futures contract from listing. In the event of a capital restructuring, share split, rights issue or bonus issue, or in other exceptional circumstances affecting the underlying value of the futures contract, the underlying value may be adjusted. The contract size of a futures contract and the number of futures that an investor holds may also be changed. Other events, such as a public bid for a listed company, a merger or a liquidation, may also result in the adjustment of the underlying value. As a rule, no adjustment is made when cash dividends and dividends with a stock option are distributed.
10.3 Last day of trading

The last day of trading in a futures contract is the last day on which it is possible to trade in an expiring contract. Both opening and closing transactions can be concluded up to the time that a futures contract expires. In very exceptional cases, however, Euronext can prohibit opening transactions in certain futures.

10.4 Settlement

In the case of cash-settlement contracts, all futures positions that are still open at the end of the last day of trading are settled in cash on the basis of the settlement price calculated by Euronext. Buyers and sellers of futures who wish to avoid cash settlement have to close their positions by the last day of trading.
11 What can financial futures be used for?

11.1 Making a profit

 Buyers and sellers of futures expect a change in the price of the underlying value. Buyers of futures hope for a rise in the price, while sellers hope for a fall. Investors who accurately predict price movements can therefore make a profit.

 The margin that has to be provided is much less than the amount to which the futures contract relates. As a result, it is possible to earn – or lose – a relatively large amount of money with a limited amount of starting capital. This is known as leverage. Leverage works in both directions, which means that an investor can not only earn a proportionately much larger profit with futures, but can also suffer a proportionately much greater loss than if the same amount of capital had been invested directly in the underlying value. In theory, the price of a future can rise or fall by an unlimited amount, and so the risk run by investors in futures is, in theory, unlimited.

11.2 Protection against changes in value

 Futures also allow investors to protect themselves against unwanted changes in the price of financial instruments. This is known as hedging. A hedge transaction ensures that the investor is immune to unwanted changes in the price of the underlying value. There are two types of hedge transactions: long hedge and short hedge.
If an investor plans to buy certain financial instruments at some time in the future, he or she can buy futures now as protection against future increases in the price of the underlying value. The investor’s aim is to ensure that all or part of any increase in the price of the financial instrument can be offset by a profit on the futures that have been purchased. This transaction is a long hedge.

Conversely, investors who already own certain financial instruments can protect themselves against a fall in prices by selling futures. Here the aim is to ensure that all or part of any decline in the value of the financial instruments can be offset by a profit on the futures that have been sold. This transaction is a short hedge.

In a long hedge transaction, the investor hopes that any losses on the futures will be offset by a change in the price of the underlying value that is held or will be purchased. In a short hedge transaction, the investor expects that a change in the price of the futures will offset any loss on the underlying value. However, a hedge position is not free of risk. With a long hedge, for example, any loss on the futures is immediately settled in cash, while any profit resulting from a change in the price of the underlying value cannot be collected until the underlying value is sold. This means that even with hedge transactions investors must be in a position to withstand losses on their futures positions. Furthermore, the price of futures contracts does not change in line with the price of the underlying value.
12 Trading financial futures

12.1 Placing an order

Investors can buy or sell futures that are traded on the derivatives market by placing an order with an introducing broker. In some circumstances, other parties are also authorised to act as intermediaries. The right to execute orders is, however, restricted to introducing brokers. Investors should contact Euronext if they are not certain whether or not they are dealing with an official introducing broker that is a member of Euronext.

12.2 Orders

An order must specify the name of the relevant futures contract, the contract month and the number of futures to be bought or sold. The order must also indicate whether it is an opening or closing transaction. Investors can also set a limit on the price at which they are prepared to buy or sell futures. When a limit has been set on the price, the order is called a limit order. Whether or not a limit order can be filled is dependent on market conditions.
12.3 Collateral

Euronext can not guarantee that there will always be a market of sufficient size to enable investors to liquidate their open positions in futures.

Introducing brokers always require that their clients provide collateral, in cash or another form, before accepting buy and sell orders for futures from them. The margins required by Euronext must be deposited and maintained with the introducing broker for as long as the open position exists, regardless of any interim profits or losses made by the investor. If an investor fails to provide initial margin or variable margin on time, the introducing broker has the right to close one or more open contracts for the investor’s account and risk.

Investors who wish to conclude futures transactions should be fully aware of the precise conditions which will be applied by their introducing broker when calculating the minimum margin to be provided. This margin may be higher than the minimum margin required by Euronext.

12.4 Commission

Introducing brokers charge their clients commission for the futures that they buy and sell on the derivatives market. Euronext does not stipulate the fees that are charged by introducing brokers. Investors are advised to ask their introducing brokers what amount of commission will be charged in a particular case and whether or not there are other fees or taxes that should be taken into account.
12.5 Transaction confirmation

Investors should be aware that the primary evidence of their rights and obligations consists of an entry in the records of their introducing broker. Members of Euronext are therefore required to provide written confirmation of each futures transaction conducted by them on behalf of their clients. Investors are advised to check these confirmation reports carefully and to report any errors or objections immediately.

12.6 Position statements

Members of Euronext must also provide each client on request with a statement showing all of the investor's open positions.

Investors can only request cash settlement or conduct closing transactions via the introducing broker through which they opened the relevant futures position. They may, however, submit a written request for their position in the books of their current introducing broker to be transferred to another introducing broker.

12.7 Position and reporting limits

Euronext is authorised to set limits on the maximum number of futures that can be held by investors acting on their own or jointly with others. Euronext can adjust these limits at any time. Introducing brokers are required to inform their clients of the limits that are in force. Euronext can decide that positions which exceed these limits must be liquidated.
Introducing brokers are also required to report open positions that exceed a certain level to Euronext. In exceptional circumstances, Euronext can also require that the introducing broker concerned closes the open position or reduces it to the level demanded by Euronext.

12.8 Insight into transaction data

Euronext monitors compliance with its rules and regulations and has the authority to examine all information relating to orders and transactions. This information may include the identity of the investors involved in orders and transactions. In extraordinary circumstances, this type of information may be made available to the police and the authorities, for instance in the case of suspected fraud or insider trading.

Euronext has concluded agreements with a number of other exchanges. This means that it can pass on information to other foreign or domestic exchanges or institutions if this is necessary or desirable in connection with the detection and prevention of violations of its rules or improper activities.
Under its rules and regulations, Euronext can restrict trading in one or more products, impose special conditions, or suspend or cease trading in those products. Euronext can also decide to delete transactions. This only happens in exceptional circumstances when Euronext decides that these measures are necessary to maintain a fair and orderly market.

European-style options cannot be exercised before the expiration date. If any special measures, as described above, have been introduced, holders of in-the-money options may not be able to realise their profit when they wish. The reference book states which options are European-style options.

In theory, trading in all types of options and futures may cease or be suspended if trading on the market where the underlying value is listed is disrupted. Trading in index products will usually cease if trading in the underlying securities which make up the index is stopped or disrupted to any extent, or if Euronext no longer has complete and uninterrupted access to calculations of the level of the index.

Although highly unlikely, the derivatives market could be affected by a telephone or communications failure or by a malfunction in its computer systems. This could disrupt the market, causing investors and members to sustain losses.
Euronext and its associated companies accept no responsibility for any losses suffered by investors as a result of the circumstances described above or for any other reason.

Euronext’s supervision of trading on the exchange floor does not guarantee that irregularities cannot occur. Euronext accepts no responsibility for any losses suffered as a result of such irregularities.

In accordance with European guidelines, the supervision of Euronext members that are active abroad or are not based in the Netherlands is partly the responsibility of the relevant foreign regulators.
Euronext can enter into alliances with foreign exchanges to expand the opportunities for trading in options and futures. Transactions concluded on a foreign exchange are governed by the provisions and regulations of that exchange.
Dutch Securities Institute Complaints Committee

Investors who believe that their interests have been adversely affected by the actions or negligence of their introducing broker can submit a written complaint to the Dutch Securities Institute Complaints Committee.

Before a complaint can be handled by the DSI Complaints Committee, investors must first submit the complaint to their introducing broker. If they fail to reach an agreement at this stage, this must be confirmed in a written notice from one of the parties to the other. The complaint must not have been brought before another authority or have been the subject of a verdict by another authority.

In certain circumstances, the DSI Complaints Committee may refuse to consider a complaint. This may occur when:

- the interests involved are not of sufficient significance;
- more than one year has passed since the complaint was submitted to the member;
- the events relating to the complaint occurred an unreasonably long time ago.

The DSI Complaints Committee is independent and its members are in no way connected with Euronext or any of its members.

The recommendations of the DSI Complaints Committee are binding.

The secretariat of the DSI Complaints Committee can be contacted at P.O. Box 3861, 1001 AR Amsterdam, The Netherlands.
If an introducing broker has acted in a way that has damaged the interests of investors and has failed to compensate them for their losses, the investors concerned can submit a request for financial compensation to the Compensation Fund for Investors (Stichting Schadefonds Beleggers).

The fund’s board decides whether or not compensation will be granted, and how much compensation should be paid out. The Compensation Fund for Investors does not provide any right to compensation or guarantee that compensation will be provided.
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April 2003
Euronext LIFFE Disclosure

1. **Rules of LIFFE and our capacity:** All contracts in the terms of an Exchange Contract made on LIFFE shall be subject to the Rules of LIFFE as from time in force. As a member of LIFFE, our affiliate, which shall act as executing broker, contracts only as a principal in respect of contracts in the terms of an Exchange Contract. In the event of a conflict between the Rules of LIFFE and the terms of this Agreement, the Rules of LIFFE as from time to time in force, shall prevail.

LIFFE Risk Disclosure for Financial Futures: Pursuant to General Notice Number 1376, issued 18 March 1999 with an effective date of 12 April 1999, LIFFE requires that we provide you with certain information in connection with your trading of equity futures and options through LIFFE CONNECT, as follows:

**Client Issues**

1. Exclusion of liability as set forth in section 6 below, unless otherwise expressly provided for, the Exchange shall not be liable to any member or client for loss or damage caused as a result of such curtailment of trading opportunities.

2. **Client Orders** Prior to the commencement of trading, clients must undertake to understand the characteristics of order types recognised in LIFFE CONNECT and be aware that the Exchange has a number of powers which, if exercised, may impact upon the ability of a member to submit an order on behalf of a client or which may lead to the cancellation of an order after submission to the LIFFE CONNECT trading Host prior to execution. In particular, in addition to the powers already available to the Exchange (including those in relation to investor protection and proper markets), clients should be aware that, in respect of LIFFE CONNECT:

   - For Futures:
     1. the Exchange has the power to suspend a member’s access, or access via a particular ITM or ITMs, following a single warning, and to terminate a member’s access under certain conditions;
     2. the Exchange will cancel all outstanding orders on the default of a member;
     3. orders outside the price limits will be rejected automatically by the Trading Host;
     4. all orders (with the exception of GTC orders) will be cancelled automatically at Market close or when the ITM under which the order was submitted is logged out without being transferred to an alternative ITM;
     5. all orders (including GTC orders) will be cancelled at close of business on the Last Trading Day of the expiry month to which they relate; and
     6. all orders with the exception of GTC orders will be cancelled automatically if the Trading Host fails.

   - In respect of every contract made between us subject to the Rules of LIFFE, we shall have made an equivalent contract on the floor of the market for execution by open outcry or in the market conducted on the Automated Pit Trading system, or shall have accepted the allocation of any such contract.

3. Allocated: In respect of every contract made between us for allocation to another member specified by you:

   - in the event that such other member accepts the allocation, we shall (without prejudice to any claim we may have for commission or other payment) upon such acceptance cease to be a party to the contract and shall have no obligation to you for its performance;

4. **Allocation on Delivery or Exercise:** IN THE EVENT THAT CUSTOMER’S ACCOUNT BALANCE HAS ZERO EQUITY OR IS IN DEFICIT AT ANY TIME, OR THE ACCOUNT DOES NOT HAVE A SUFFICIENT ACCOUNT BALANCE TO MEET MARGIN REQUIREMENTS, IB SHALL HAVE THE RIGHT IN ITS SOLE DISCRETION, BUT NOT THE OBLIGATION, TO LIQUIDATE ALL OR ANY PART OF CUSTOMER’S POSITIONS (INCLUDING BY THE ENTRY OF OFFSETTING TRANSACTIONS) AT ANY TIME AND IN SUCH MANNER AND IN ANY MARKET AS IT DEEMS NECESSARY, WITHOUT PRIOR NOTICE OR MARGIN CALL TO THE CUSTOMER, AND CUSTOMER AGREES TO BE RESPONSIBLE FOR, AND PROMPTLY PAY TO IB, ANY DEFICIENCIES IN CUSTOMER’S ACCOUNT WHICH ARISE FROM SUCH LIQUIDATION. IB shall also have the right to liquidate all or any part of Customer positions without prior notice to the Customer in the same manner as provided above. If any dispute arises concerning any Customer Trade, or upon Customer’s failure to timely discharge its obligations to IB; or upon the Customer’s insolvency or filing of a petition in bankruptcy or for protection from creditors, or upon the appointment of a receiver, or whenever IB deems it necessary or advisable for IB’s protection. Any such liquidation shall establish the amount of Customer’s gain or loss. Customer shall reimburse and hold IB harmless for all actions, omissions, costs, expenses, fees (including attorney’s fees), losses, claims or liabilities associated with any such transactions undertaken by IB. Customer shall be responsible for all resulting losses on Customer’s positions notwithstanding IB’s delay in or failure to liquidate any such positions. For “Long Option Only Accounts”, Customer may not exercise options, and must close-out options by offset. If options which do not settle in cash are not closed-out by Customer prior to one hour prior to expiration, Interactive Brokers is authorized in its sole discretion to close-out Customer’s option position, or sell any position into which the option position is converted upon expiration, and credit or debit Customer’s account accordingly. Customer shall pay Interactive Brokers all fees, costs, and expenses related to such close-out, and shall hold Interactive Brokers harmless for any actions taken or not taken in connection with such close-outs. Customer acknowledges and agrees that options contracts may not be exercised. Options positions may only be closed out by offset. Except for cash-settled options, if Customer has not offset options contract positions at least one (1) hour prior to the time specified by an exchange for final settlement, Interactive Brokers is authorized to do so, or to otherwise close out the resulting positions, and credit or debit Customer’s account accordingly. Customer shall pay Interactive Brokers for all costs and expenses related to such close-outs and shall hold Interactive Brokers harmless for any actions taken, or not taken, in connection therewith.

5. **Margin:** Customer shall monitor Customer’s account so that at all times the account shall contain a sufficient Account Balance to meet the margin requirements set by IB, margin requirements which IB may modify for any Customer for open and new positions at any time in IB’s sole discretion. The required margin may exceed the margin required by any exchange or clearing house. IB
may reject any Customer Order while determining the correct margin status of Customer’s account. Customer shall maintain, without notice or demand, a sufficient Account Balance at all times so as to continuously meet the margin requirements established by IB. IB has no obligation to notify Customer of any failure to meet margin requirements in Customer’s account prior to exercising its rights and remedies under this Agreement. Customer understands that IB will not issue margin calls, and that IB will not credit Customer’s account to meet intraday margin deficiencies.

6. **The Market - Exclusion of liability (rule 1.4):** The Exchange is obliged under the Financial Services Markets Act 2000 to ensure that business conducted by means of its facilities is conducted in an orderly manner and so as to afford proper protection to investors. To this end, the Exchange will at all times endeavour to maintain a fair and orderly market as is consistent with the Exchange’s legal obligations and the object of the market.

The Exchange wishes to draw to your attention of members and clients that, inter alia, business on the market may from time to time be suspended or restricted or the market may from time to time be closed for a temporary period or for such longer period as may be determined in accordance with LIFFE’s including, without limitation, as a result of a decision taken under Rule 4.16 or 4.17 on the occurrence of one or more events which require such action to be taken in the interests of inter alia, maintaining a fair and orderly market. Any such action may result in the inability of one or more members and through such members one or more clients to enter into contracts in accordance with the Rules on the terms of Exchange Contracts either by means of contracts entered into on the market floor or through ATS.

Furthermore, a member and through the member one or more clients may from time to time be prevented from or hindered in entering into contracts in the terms of Exchange Contracts, or errors in orders or in contracts in the terms of Exchange Contracts may arise, as a result of a failure or malfunction of communications, or equipment, or market facilities, or the ATS central processing systems, or one or more ATS workstations supplied to the member by the Exchange or otherwise used by the member or software supplied to the member by the Exchange or any other person.

The Exchange wishes to draw the following exclusion of liability to the attention of members and clients. Unless otherwise expressly provided in LIFFE’s rules or in any other agreement to which the Exchange is party, the Exchange shall not be liable to any member or client for loss (including any indirect or consequential loss including, without limitation, loss of profit), damage, injury or delay, whether direct or indirect, arising from any of the circumstances or occurrences referred to in Rule 1.4.2. or from any act or omission of the Exchange, its officers, employees, agents or representatives under LIFFE’s Rules or pursuant to the Exchange’s obligations under statute or from any breach of contract by or any negligence howsoever arising of the Exchange, its officers, employees, agents or representatives.

7. **Arbitration.** Any dispute arising from or relating to this agreement, in so far as it relates to contracts made between us subject to the Rules of LIFFE, and any dispute arising from or relating to any such contract as aforesaid and made hereunder shall, unless resolved between us, be referred to arbitration under the arbitration rules of LIFFE, or to such other organisation as LIFFE may direct before either of us resort to the jurisdiction of the courts (other than to obtain an injunction or an order for security for a claim).

8. **Governing Law.** This agreement and all contracts made under this agreement shall be subject to and construed in accordance with English law.

9. **Jurisdiction:** Subject to the arbitration clause [above in this agreement], disputes arising from this agreement or from contracts made under this agreement shall (for our benefit) be subject to the exclusive jurisdiction of the English courts to which both parties hereby irrevocably submit, provided that this shall not prevent us bringing an action in the courts of any other jurisdiction.

10. **Changes to Agreement:** Notwithstanding any previous agreement between us to the contrary, we now agree that a variation of the terms agreed between us from time to time does not require the written agreement of both of us. This notification shall take effect 12 days after despatch by us, provided that you do not object within 10 days of receipt.
DERIVATIVE FINANCIAL INSTRUMENTS TRADED ON THE MONEP
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IMPORTANT

The MONEP, along with all of France's capital markets, will switch to the euro on 4 January 1999, when the member states of Economic and Monetary Union adopt a single currency.

Until that date, MONEP contracts will be quoted in French francs (equity options) or in index points with an index multiplier denominated either in French francs (options and futures on the CAC 40 index) or in ecu (options and futures on the Dow Jones STOXX®50 and Dow Jones Euro STOXX®50 indices). All financial transfers pursuant to transactions (premiums and margin to be paid or received following exercise and assignment not resulting in physical delivery, fees) will be made in French francs.

Beginning on 4 January 1999, the characteristics of MONEP contracts (strike prices on equity options, trading unit of contracts derived from the CAC 40 and the Dow Jones STOXX®50 and Dow Jones Euro STOXX®50 indices) will be converted and expressed in euro on the basis of the French franc/euro conversion rate as set by the European Council (for contracts denominated in French francs) and at 1 euro per ecu for contracts denominated in ecu.

Quotations will be made in euro (equity options) or in index points valued in euro (options and futures on the CAC 40, Dow Jones STOXX®50, and Dow Jones Euro STOXX®50 indices).

The same is true for payments between intermediaries.

However, payments between clients and intermediaries who maintain their accounts can be made, at the client's choice, in French francs or in euro.

This English translation has been prepared by Monep SA for the convenience of English-speaking readers. However, only the French text has any legal value. Consequently, the translation may not be relied upon to sustain any legal claim, nor should it be used as the basis of any legal opinion. Monep SA expressly disclaims all liability for any inaccuracy herein.
Prospectus

The MONEP is a regulated market in derivative financial instruments. It is managed by the market operator Monep SA, which sets the operating rules.

This Prospectus (Note d'Information) has been prepared by Monep SA and was approved by the stock market supervisor, the Commission des Opérations de Bourse (COB visa no. 98-430) on 2 June 1998.

Pursuant to COB regulation 97-02, a copy of the Prospectus, together with the technical specifications of the contracts traded on the MONEP and appended hereto, is given to prospective clients by their broker before they sign an account agreement or place an order for the first time.

When dealing with a potential client that is not a professional investor, a broker may not accept orders or funds until seven days after said the client has received this document and has confirmed in writing that he is familiar with its contents.

Because of the substantial risks involved in using derivative financial instruments, we recommend that you read this Prospectus carefully.

IMPORTANT

Trading on the MONEP requires a thorough knowledge of that market's mechanisms and products.

Accordingly, before trading the options and futures listed on the MONEP, prospective users must familiarise themselves with the basic trades and strategies used on the market.

In view of the potential risks, investors are advised to commit only a small portion of their assets on the futures and options markets.

Options and futures are used to manage securities portfolios by hedging risk. Index options and index futures protect investors against overall price movements in the market, while equity options cover them against specific risks related to a particular security.

Options and futures can also be used to carry out highly leveraged speculative operations.

Furthermore, options and futures provide significant opportunities for arbitrage, i.e. profiting from temporary price differences between options and futures and their underlying instruments.

While options have many advantages, they are also sophisticated instruments entailing a number of risks and constraints to which prospective users must pay close attention.

In particular, users must be aware that, in contrast with the more conventional direct purchase or sale of equities, the overall commitment on a option transaction is not necessarily limited to the initial outlay. This is the case for option writers (sellers), who must deposit collateral (margin) in response to margin calls, which are calculated each day on their options positions. Failure to respond to these daily margin calls entails immediate liquidation of positions (see below, pages 16 and 23). Options writers must therefore anticipate margin calls and make the necessary arrangements to meet them immediately.

An investor in options must be able to assess the risks that his position may entail. If he writes an option (calls or puts), he may be exposing himself to unlimited financial risk in the event on an unfavorable price movement in the underlying instrument. He is subject to the buyer's decision if the option is exercised, and must be able to assess his risk either in order to accept it in full or to limit the amount involved.
Index options carry their own risks, which stem from the nature of their underlying instrument. For example, hedging the risk of loss by taking offsetting positions in the underlying shares is complicated by the need to construct and maintain a portfolio with a weighted composition identical to that of the index. Moreover, if a buyer exercises his option, a period of time will elapse before the assigned seller can be notified by his broker. During this period, the value of the hedging portfolio may decline in relation to the amount to be paid as a result of the assignment, which is calculated on the basis of the settlement index on the date of exercise.

Futures contracts make it possible to commit substantial sums of money for a minimum initial outlay ("margin"). Investors should therefore be aware that their financial risk depends on the number of contracts they hold, not on the margin called by their broker.

Consequently, an investor's potential losses can exceed the initial outlay.

Funds are transferred from the investor to the broker, and vice versa, every day. The losses implied by adverse movements in futures contracts are measured on a daily basis.

An investor must be able to cover any losses without delay. If he fails to do so, his broker is required to liquidate his positions immediately.
The derivative financial instruments listed on the MONEP include options and futures on equity securities, equity baskets, and equity indices.

Two factors underpin the negotiability of the options and futures listed on the MONEP:

- Their listing and quotation on a regulated market permits the centralisation of orders.
- Contract characteristics are standardized as follows.

**Options**

- Exercise style (American or European)
- Contract size (quantity of the underlying asset)
- Strike price
- Expiration date

**Futures**

- Contract size (quantity of the underlying asset)
- Delivery month
- Delivery modes

Contracts with identical characteristics are fungible.

The presence of a clearing house is another prerequisite for negotiability. Intervening between buyers and writers, the clearing house breaks the initial contractual link between holder and writer, enabling each to close out his position without having to seek out his initial counterparty.

Since the contracts listed on the MONEP are negotiable, both the holder and the writer, independently of each other, can sell (for the holder) or buy (for the writer) on the market the contract that was initially concluded, thus unwinding their position before the contract's expiration date. For this reason, orders sent to a broker must indicate whether the investor is opening a new position or closing all or part of an existing position.

An open position can be closed out only by the broker with whom the opening purchase or sale has been registered.

**MONEP OPTIONS**

Option contracts eligible for listing on the MONEP include options on individual equity securities as well as options on equity indices or baskets.

Accordingly, the more active and well-capitalized equity securities on the Paris market are suited to serve as the underlying interest for options contracts.

The same is true for the major equity and sector-based indices, regardless of whether they are national in scope or represent price movements in major financial centers.
Options definitions

An option grants its buyer (holder) the right, but not the obligation, to buy (call) or sell (put) a given quantity of an underlying asset at a given price (strike price) on or until a pre-established date. An option that can be exercised at any time during its life is known as an American-style option. An option that can be exercised only at expiration date is known as a European-style option.

Option contracts on securities give the buyer the right to buy (call) or sell (put) a given number of stocks or bonds. Index option contracts give their holder the right to collect any profit that may result from the difference between the value of the day's settlement index (or expiration settlement index) and the option's strike price.

An option writer is bound by the holder's decision to exercise the contract or not. If the option is exercised, the writer is notified of the fact by the clearing house, a procedure called "assignment". If the holder so demands, the assigned writer must meet the obligations stemming from his contract. The assigned seller of a put must either buy the securities (equity options) or pay the cash amount equal to any loss that results if the index value is less than the option strike price (index options). Similarly, the assigned seller of a call must sell the securities or pay the difference between the index value and the option strike price. In return for this constraint, the option writer receives a consideration (premium) from the buyer as soon as the trade is completed.

The premium is the price quoted on the market for each open option series (i.e. calls or puts on the same underlying asset with the same expiration date and strike price).

The four basic trades

Buying calls. In return for payment of the premium, call options give the holder the right to buy a specified amount or value of a particular underlying interest at the strike price stipulated in the option contract. An American-style option can be exercised at any time; a European-style option can be exercised only at expiration. With equity options, the underlying interest is a quantity of shares. With index options, the holder makes a profit if the value of the index is higher than the option's strike price. In both cases, if the value of the underlying instrument falls, the buyer's profit is potentially unlimited. If the value of the underlying instrument rises, the buyer's profit is potentially unlimited.

(See example A)

Writing calls. The writer of a call is in the opposite situation to the holder. He receives the premium immediately, but is obligated for the duration of the contract either to sell the underlying asset at the strike price, in the case of equity options, or, in the case of index options, to pay the buyer, if the latter so wishes, the amount resulting from the difference between the index value and the strike price. Profits are limited to the premium received at the time of the sale, and losses are potentially unlimited in case of a rise in the price of the underlying instrument.

(See example B)

Buying puts. In return for payment of the premium, put options give the holder the right to sell the underlying interest in the quantity (value) and at the strike price stipulated in the option contract. An American-style option can be exercised at any time; a European-style option can be exercised only at expiration. With equity options, the underlying interest is a quantity of shares. With index options, the holder of a put makes a profit if the value of the index is lower than the option's strike price. In both cases, if the value of the underlying instrument falls, the put-holder's profit increases in the same proportions. If the value of the underlying instrument rises, his losses are confined to the premium paid at the time of purchase.

(See example C)

Writing puts. The writer of a put is in the opposite situation to the holder. He receives the premium immediately, but is obligated for the duration of the contract — if the holder so decides — to buy the underlying asset at the strike price, or, in the case of index options, to pay the difference between the strike price and the index value. If the price of the underlying instrument rises, the writer's profit is limited to the premium. If the price falls, his losses are potentially unlimited.

(See example D)
The simplest and least risky strategy is to buy options. Option holders run a limited and known risk, which cannot exceed the premium regardless of movements in the underlying instrument. Moreover, they can make a potentially unlimited profit (in case of a rise in the underlier for a call, in case of a decline for a put). But in both cases, their losses cannot exceed the premium paid at the time of purchase.

In contrast, writers of options (calls and puts) run a potentially unlimited financial risk in case of an adverse movement in the underlying interest, while their profits are limited to the premium received at the time of the sale.

More complex strategies can be constructed by combining these basic strategies, i.e. by simultaneously buying and/or selling options of the same class but different characteristics. Such strategies are complex and should be used only by investors possessing a sound understanding of the basic concepts.

The four basic trades

Example A

The buyer of an American-style call with June expiration on XYZ Company’s stock, with a strike price of FF500 and a premium of FF20, has, until the next-to-last trading day in June, the right to buy a certain number of XYZ shares (generally 10) at a unit price of FF500, whatever changes may have occurred in the share price since the acquisition of his contract.

He makes a profit if the share price rises above FF520 (i.e. the strike price plus the premium).

Example B

Using the data from the previous example, we see that the call writer’s profit amounts to FF20 per share (to be multiplied by the contract size, i.e. the number of shares per option contract) if the price of XYZ Company’s stock remains below FF520. Above that level, he may have to sell XYZ stock at a detrimental price, and his loss increases as the stock price rises.

Example C

The holder of an American-style put on the CAC 40 index, expiring in June, with a strike price of 3,900 and a premium of FF200, can, by exercising the right conferred by his contract before the last trading day in June, make a profit if the index value is less than FF3,700 (the strike price less the premium paid). If he exercises his right when the settlement index stands at 3,600, he will receive an amount equal to:

\[(3,900 - 3,600) - 200 = FF100\]

Taking into account the unit of trading (see Contract Specifications), his total profit expressed in francs will actually be:
Example D

In the previous example, the option writer's profit is limited to FF100 in case of a rise in the index. Taking into account the unit of trading (see Contract Specifications), his total profit expressed in francs will actually be FF200 x 50 = FF10,000. But his risks of a loss are unlimited once the index level falls below 3,700.

NOTE: For index options, the strike price and premium – like the level of the index – are expressed in index points. Each index point is assigned a value in currency units (see Contract Specifications).

Exercising options

Exercising an option cancels the contract registered in the opening position. On the MONEP, the exercise of an option position has the following effect on the day of exercise:

- Index options: The position is settled by cash payment of the difference, converted into currency units, between the value of the daily settlement index (or the expiration settlement index) and the strike price. The daily settlement index is computed daily and the expiration settlement index is computed on the contract expiration date.

- Equity options: The position is settled by a purchase or sale of the underlying security, at the pre-arranged price (strike price) on the market in which the security is traded (monthly settlement or cash).

Positions taken in an underlying asset following exercise or assignment are settled (by delivery of securities versus payment of the corresponding funds) according to the rules, and within the time periods, applicable to the market on which that asset trades.

As regards options on stocks traded for monthly settlement, only those exercise instructions reaching the broker and registered in clearing accounts two trading days before the account day at the latest are taken into consideration in the delivery-versus-payment procedures for that monthly account period.

In-the-money options (see Glossary) are automatically exercised upon expiration, unless the holder's instructions to the contrary are received by the broker and registered in clearing before the close of the trading session on the expiration day*.

Trades executed on a cash-settlement market give rise to an entry in the client's account, made at the latest on the day after the trade. This contrasts with monthly-settlement trades, for which delivery-versus-payment is postponed to the end of the account period and which can be unwound before account day by taking offsetting positions.

Consequently, before executing a sell order involving options on a cash-settled stock, brokers can demand that their clients deposit:

- **stocks** that might be deliverable by a call writer.
- **funds** to pay for stocks that might have to be bought by a put writer

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* Options are exercised automatically only if they are in the money, even by only hundredth of the reference currency unit (equity options) or for one-hundredth of a point (index options), without taking into account transaction costs (commissions, broker's fees, etc). Consequently, options that are at the money (i.e. the current value of the underlier is the same as the option's strike price) are not exercised automatically.
Corporate actions and contract adjustments

Payment of an ordinary dividend does not lead to a modification of the terms of the option contract. However, contract specifications may be adjusted in the case of exceptional cash distributions of dividends (exceptional dividends from reserves, distributions in addition to the ordinary dividend, distributions of paid-in capital in excess of par, etc.). Contract specifications may also be adjusted when a stock goes ex-rights or when an event occurs that can significantly influence the price of a contract’s underlying interest. Such adjustments are made to ensure that the initial situation of the buyers and sellers is not modified by changes to the underlying instrument. The adjustment may apply to either the option strike price alone or the option strike price and the number of securities covered by the contract.

MONEP FUTURES

The futures contracts listed on the MONEP relate to equity indexes or baskets of equities.

Accordingly, the major equity and sector-based indices, whether domestic or representative of prices on major markets abroad, are suited to serve as the underlying interest for futures contracts.

Futures definitions

A financial futures contract is a legally binding agreement to buy or sell a specified quantity of financial assets at a price fixed when the contract is arranged. Delivery of the assets and payment of the corresponding cash occurs at a pre-established future date.

Consequently, a futures transaction always involves an interval of time between initiation and execution of the contract.

Not all futures contracts require physical delivery of the underlying asset. Certain contracts are cash-settled, i.e. the commitment is satisfied by cash payment of the difference between the price at which the contracts were negotiated and that at which they are closed out.

The procedures for closing out positions in futures contracts listed on the MONEP are stated in the Contract Specifications appended to this Prospectus.

Basic futures strategies

Futures contracts offer a flexible and efficient means of taking positions ahead of an expected move in the price of the underlying asset. They can be used for hedging or speculation.

Furthermore, they provide significant opportunities for arbitrage, i.e. profiting from temporary price differences between markets. Since arbitrage is a complicated process, it is not recommended for unsophisticated investors.
1. Hedging

Hedging enables an investor to reduce the risk of loss from a sharp swing in value of an asset.

To place a hedge, the investor takes a futures position that is equal to and opposite the position in the underlying asset.

Losses on the underlier are offset in full or in part by gains on the future, and vice versa.

Example:

To hedge the risk of a decline in stock prices, on 10 February an investor with an equity portfolio worth FF200,000 sells an index future in the same amount for delivery at the end of March.

If the index has fallen 10% by the expiration date, the investor's portfolio is worth FF180,000, i.e. a loss of FF20,000.

By exercising the future, which has also lost 10%, he generates a profit of FF20,000.

Conversely, if the index has risen 10%, the portfolio is worth FF220,000, i.e. a gain of FF20,000.

The exercise of the futures contract, which has also risen 10%, results in a loss of FF20,000.

Index futures are tools for active risk management. They allow investors to protect a diversified stock portfolio from adverse market trends, known as market risk or systematic risk.

The effectiveness of this protection depends on:

- portfolio structure, i.e. the extent to which it mirrors the composition of the index, both in terms of component stocks and their weightings;

- basis risk, i.e. the difference between the price of the futures contract and the level of the index, and how that difference changes over time.

The above example therefore assumes:

- that the portfolio replicates exactly the composition of the index, with the same component stocks and weightings,

- that the price of the futures contract moves towards the level of the index as the contract's expiration date approaches (i.e. basis is assumed to be zero at expiration).

2. Speculating

Speculation allows an investor to make a profit on the prospective change in the market value of an asset. He will take a "bull" position if he expects the asset price to rise and "bear" position if he expects it to fall. In the case of a futures contract on a stock index, the investor is speculating on the movement of the market as a whole.

Naturally, the quest for gain entails the risk of loss.

Example:

An investor expects stock prices to fall. He sells a stock index future for March delivery with an initial value of FF200,000.
If the market declines by 10%, the investor buys back for FF180,000 the futures contract he sold for FF200,000, thus making a gain of FF20,000.

However, if the market advances 10%, the investor repurchases for FF180,000 the futures contract he sold for FF200,000, thus making a loss of FF20,000.

**APPENDIX: TAX TREATMENT**

For natural persons resident in France, the taxation of gains and losses realized during a tax year on transactions in futures and options depends mainly on the nature of such transactions and whether such investors are classified as "occasional", "regular" or "professional" participants. (cf Articles 35-I-8°, 92-2-5°, 120-I2° and 150 ter to nonies of France’s General Tax Code, or CGI).

The net gains made on the MONEP, including those resulting from the exercise of options, by persons with the status of occasional participants are subject, from the first French franc, to taxation at the regulation capital gains rate. The French tax authorities accept general offsetting of gains and losses from options and futures transactions against those from the disposal of securities.

In general, regular participants are liable for income tax, computed on the sliding scale applicable to professional income for the profits made during the calendar year, unless they elect to be taxed under the rules pertaining to industrial and commercial income (they are then considered professional investors).

Note that the distinction between "occasional" and "regular" participants is made by the tax authorities.

The taxable event occurs when the position is closed out in any of the following ways:

**Options:**
- Through a closing transaction (i.e. buying back a short position or selling out a long position). The realized gain or loss is equal to the difference between the premium paid and premium received.
- Through exercise or assignment. The gain (loss) is the difference between the price of the underlying asset on the exercise date and the strike price minus (plus) the option premium paid (received).
- Through abandonment at expiration. The realized gain (loss) is equal to the premium received (paid).

**Futures:**
- Through a closing transaction (i.e. buying back a short position or selling out a long position).
- Through settlement at maturity.
  The realized gain (loss) is equal to margin received less margin paid.

For legal persons, realized gains and losses on MONEP transactions enter into the determination of the year's taxable income subject to corporation tax. Should they arise, unrealized gains and losses on MONEP positions open from one financial year to the next are included for the determination of taxable income (Article 38-6-1 of France’s General Tax Code or "CGI"). Separate rules apply to hedges and offsetting trades (CGI Articles 38-6-2, 38-6-2 bis, and 38-6-3).

Realized gains by non-residents on the French options and futures markets are not taxed in France.
The Institutional Structure

Supervision and oversight

Public authorities

- The Ministry of the Economy and Finance, through the Treasury Department, supervises the general organisation of regulated markets and vouchsafes their official status by means of ministerial orders (arrêtés).

- The Commission des Opérations de Bourse (COB) is primarily responsible for promoting and checking information given to investors, overseeing the protection of savings, and ensuring the proper operation of French markets in financial instruments.
  Commission des Opérations de Bourse (COB)
  Tour M irabeau, 39-43 quai André Citroen
  75015 Paris, France
  Tel: (+33 1) 4058 6565

- The Comité des Établissements de Crédit et Entreprises d'Investissement (CECEI) certifies investment services providers (credit institutions and investment firms) whose program of operations has been approved by the Conseil des Marchés Financiers (CMF). In collaboration with the CMF, the CECEI issues European Passports, under which investment services providers are authorized to operate in all member states of the European Union.
  Comité des Établissements de Crédit et Entreprises d'Investissement (CECEI)
  39 rue Croix-des-Petits-Champs
  75001 Paris, France
  Tel: (+33 1) 4292 4292

- The Comité de la Réglementation Bancaire et Financière (CRBF) establishes rules governing the solvency of investment services providers, with reference to minimum capital requirements, prudential ratios, etc.
  Comité de la Réglementation Bancaire et Financière (CRBF)
  39 rue Croix-des-Petits-Champs
  75001 Paris, France
  Tel: (+33 1) 4292 4292

- The Commission Bancaire is responsible for scrutinizing the financial situation of investment services providers.
  Commission Bancaire
  73 rue de Richelieu
  75002 Paris, France
  Tel: (+33 1) 4292 4292

Professional authorities

As a regulated market, MONEP is supervised by the Conseil des Marchés Financiers. The CMF is a professional authority with regulatory and disciplinary powers whose members are appointed by the Ministry of the Economy and Finance. It approves the organization and operating rules of regulated markets on which financial instruments are traded.

Conseil des Marchés Financiers
31 rue Saint Augustin
75002 Paris, France
Tel. (+33 1) 5535 5535
**Market operator**

The market operator is Monep SA, a wholly owned subsidiary of SBF-Paris Bourse. It is responsible for organizing and managing the MONEP and also for overseeing market operations and participants. Monep SA draws up the organization and operating rules of the MONEP, approves applications for membership of the market and decides on the admission to listing of new contracts.

It is responsible for:
- managing and monitoring the market
- registering trades
- recording members' positions
- processing exercise instructions and assignment of positions
- calling and monitoring margin deposited with SBF-Paris Bourse
- monitoring positions and risk
- overseeing trading and clearing members

Monep SA
39 rue Cambon
75039 Paris cedex 01, France
Tel. (+33 1) 4927 1800

**Clearing house**

SBF-Paris Bourse, in its capacity as credit institution, is the MONEP's clearing house. It ensures final settlement for MONEP clearing members of trades admitted to clearing and registered by Monep SA.

SBF-Paris Bourse
39 rue Cambon
75039 Paris cedex 01, France
tel. (+33 1) 4927 1000

**MONEP PARTICIPANTS**

MONEP participants include trading members and clearing members.

**Trading members**

Participants are eligible for trading membership in several capacities:

1. **Investment firms and credit institutions** who have been authorized to provide investment services, as defined in the Financial Activities Modernization Act (Law 96-597 of 2 July 1996)\(^1\)

**Investment services providers** may operate in either or both of the following capacities:

- As executing brokers of orders from third parties or for their own account. All buy and sell orders issued by a client in respect of MONEP contracts are presented on the market by the client's broker. Executing brokers are responsible vis-à-vis their clients for final execution of orders.

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\(^1\) The "investment services" governed by the Act include the receipt and transmission of orders for third parties, the execution of orders for third parties, and own-account trading.
Market makers, who serve the function of ensuring a continuous liquid market in option contracts. Market makers undertake at all times to quote bid and ask prices on all classes of options for which they are authorized and to act as principal for a minimum number of contracts at those prices.

2. Natural or legal persons known as own-account traders (négociateurs pour compte propre, "NCP").

NCPs are authorized by the Conseil des Marchés Financiers to trade for their own account on the MONEP, and may not execute orders for a third party. The involvement of NCPs in the market helps to ensure a more liquid market in futures contracts.

3. Associate members - members of other exchanges, referred to as Globex associate members "MAG".

"Associate members" are authorized to trade on the MONEP with the approval of their home exchange and after authorization by the Conseil des Marchés Financiers, pursuant to a cross-trading agreement linking several exchanges.

Associate members are subject to the rules and regulations of their country and exchange of origin. When trading on the MONEP, they are required to respect the relevant provisions of the rules established by Monep SA. Associate members who contravene those rules are answerable to their home exchange.

4. Members of markets outside France, granted access under reciprocity agreements.

Monep SA may admit the following as MONEP members, within the framework of a reciprocity agreement:
- Investment services providers who are members of regulated markets recognized by EU Member States.
- Members of a market of a country that is not an EU Member State, on condition that such members have been authorized by the Conseil des Marchés Financiers.

Clearing members

By agreement with Monep SA and SBF-Paris Bourse, investment services providers and legal persons approved as such may be clearing members of MONEP. Clearing members record the trades made by trading members and guarantee final settlement vis-à-vis clients. Clearing members are del credere agents, i.e. as regards the clients whose accounts they hold, they remain liable for the proper execution of contracts recorded in their name until the expiration date.

The functions of trading and clearing are not mutually exclusive.

OPERATING PROCEDURES

Organization of trading

The financial instruments listed on the MONEP are traded solely on the NSC automated system. The instruments are divided in two groups, each governed by specific rules for quotation and trading.

Prior to placing orders on the MONEP, clients must ask the intermediary who maintains their account to provide them with the list of options and futures in each quotation group and with the relevant trading rules.
I. Continuous Group (continuous quotation)

Orders for continuously quoted options and futures are entered into the NSC system throughout the trading session and matched on a regular basis. They are executed automatically whenever a counterparty is found.

The trading session takes place according to the timetable mentioned in the Contract Specifications appended to this Prospectus.

The permanent presence of market makers ensures a liquid options market. Market makers’ contractual obligations are stated in specifications documents established by the market operator. Own-account traders (NCPs) handle the same function in futures contracts.

Under the operating rules for the Continuous Group, order execution depends on two priorities:

- price: the buy (sell) order showing the highest (lowest) price is executed first;
- time: if two orders carry the same limits, priority is given to the one entered into NSC first.

II. Multi-Fixing Group (quotation by call auction, “fixing”)

Options traded in the Multi-Fixing Group are quoted solely on NSC by means of a general matching procedure known as the fixing procedure.

The quoted price that results from this procedure is the price at which the greatest number of contracts can be traded.

Two matching periods are held daily at pre-determined times, set by Monep SA and published in a notice known as an Avis.

In addition, members may request additional matching sessions at any time. In such cases, the market is informed beforehand.

Unlike option contracts traded in the Continuous Group, the options in the Multi-Fixing Group are not covered by a market making procedure that guarantees liquidity.

Consequently, users must be aware that, in the absence of sufficient counterparty orders or satisfactory price conditions, the only way of closing out a position may be to exercise the option (on or before the expiration date) or to abandon the option upon expiration.

Price fluctuation limits

In principle, there are no limits on the fluctuation of option prices.

Monep SA has implemented a “circuit breaker” mechanism that makes it possible to simultaneously suspend quotation of options and futures on a given index when the price of the index futures prices fluctuates beyond a limit set by Monep SA and published in an Avis. Trading in CAC 40 index options and futures may also be suspended when a significant number of CAC 40 component stocks cannot be quoted.

In such circumstances, Monep SA can, if necessary, call for additional margin from clearing members in the course of the session. The call for additional margin may be passed along by intermediaries to the clients for whom they maintain accounts.

The rules for activation of the circuit-breaker appear in the contract specifications appended to this Prospectus.
Effects of trading halts

In the event of a trading halt involving an underlying security, Monep SA may decide to suspend trading in the corresponding class of options, depending on the reasons for the trading halt in question.

Unavailability of information concerning the price of the underlying stock automatically releases the market makers from their obligations.

If trading is suspended, the holders' right to exercise their options is not affected. Hence option writers remain subject to their commitments to the buyers.

MARKET SAFEGUARDS

Guarantee of final performance

Positions taken in the options and futures admitted to clearing on the MONEP are covered by a guarantee of final performance provided by all clearing members vis-à-vis the clients for whom they maintain accounts (Article 48 of the Financial Activities Modernization Act of 2 July 1996) and by SBF-Paris Bourse in its capacity as clearing house vis-à-vis clearing members (Article 2.1.5 of the MONEP organization and operating rules).

The guarantee of final performance covers:

- For options:
  * payment of premiums resulting from trades and payment of cash amounts resulting from exercise and assignment
  * payment of cash and delivery of securities resulting from the closing of positions in underlying securities, pursuant to exercise and assignment

- For futures:
  * payment of margin and, in the case of deliverable contracts, delivery of securities against payment.

If a clearing member is in default, Monep SA, at the request of SBF-Paris Bourse, is required immediately to liquidate the said member's proprietary positions.

Client positions recorded in the accounts of the defaulting member, together with the related margin held by that member, can be transferred to another clearing member, at the request of the client, on condition that the said client has fulfilled its own obligations.

Clients that fail to fulfil these obligations after they have been ordered to do so will have their positions liquidated.

By exception, SBF-Paris Bourse can also extend, individually and indirectly, the guarantee of final performance to one or more clients at the request of the clearing member who maintains their accounts.

In such a case the client's margin deposits are transferred to SBF-Paris Bourse, which can then transfer them to another clearing member in the event of the default of a clearing member who keeps client accounts.

The client should ask its clearing member to explain the conditions under which the clearing member may request SBF-Paris Bourse to extend the clearing house guarantee to the client.

When approached with the case, SBF-Paris Bourse informs the clearing member of approval or rejection of the request. The clearing member informs the client and, in the case of approval, sends the client a copy of the approval notice received from SBF-Paris Bourse.
By exception, the guarantee of final settlement also concerns clients that have a direct and valid agreement with a clearing member and that have been duly identified by the clearing member to the clearing house for certain CAC 40 futures maturities. For transactions in such maturities, SBF-Paris Bourse agrees to transfer the client positions and the related available margin amounts up to the minimum required margin amount, provided that the clients have performed their own obligations. SBF-Paris Bourse will, where necessary, reconstitute the margin to be paid to clients.

In all cases, the client must have been expressly notified by the intermediary with whom he opened his account (investment service provider or any other legal person authorized as a clearer) whether he is entitled to the SBF-Paris Bourse guarantee of final performance in the event of the intermediary's default.

**Margining**

**Depositing margin**

As clearing house for the MONEP, SBF-Paris Bourse calls for margin from clearing members to cover their commitments. Such deposits are calculated on positions recorded in each category of clearing account (house, client, non-clearer intermediary and, where applicable, market maker) opened in clearing members' names. The amount is subject to a daily adjustment, which is communicated to clearing members. The corresponding payments must be made before the opening of the day's trading session. To ensure a safe market, any client trading in MONEP contracts must deposit margin with the broker who maintains the account. The margin level must be at least equal to that calculated under the applicable rules by Monep SA.

**Margin on options**

Clearing and non-clearing intermediaries who maintain accounts must require their clients to hold, at all times, sufficient collateral to buy back their short positions on the assumption of the most adverse price movement in the underlying assets during the following trading session. The collateral required represents the theoretical cost of liquidating the client's options portfolio (or liquidating value). Options purchased are valued as assets (i.e. the position has a positive liquidating value) while options sold are counted as liabilities (i.e. a negative liquidating value).

Monep SA determines the values of positions in each series on the basis of a pre-set range of changes in the underlying asset price (price movements against which the clearing house has decided to cover itself). For each class, it adopts the most negative or the least positive liquidating value. When the algebraic sum of the liquidating value for each class of options in the client portfolio is negative, the liquidating value of the portfolio shows an overall debit balance. This debit balance represents the required margin. When the balance is positive, the liquidating value of the portfolio is in credit, and no margin is required.

The margin requirement is adjusted on a daily basis. If a daily requirement is lower than the previous day's, the previous margin is adjusted downwards; if it is higher, then the client must deposit additional margin with his broker. If the client fails to respond to a margin call before the close of the following trading session, his broker must immediately liquidate his position.

Since option buyers pay their premiums immediately, they are not exposed to risk with regard to the contracts they hold. Hence, holders of long positions in options (calls or puts) are not subject to margin calls.

**Margin on futures**

The initial margin required for trading in CAC 40 futures, which represents a fraction of the face value of the contract, is determined by Monep SA. Clients that are not regular participants (see above) must deposit initial margin before placing an order.
Regular and professional participants must make their deposits at the latest before the opening of the day's trading session on the day after the trade.

Initial margin is adjusted daily to reflect changes in the client's commitments. If the client increases his positions, the broker issues a demand for additional funds (known as a margin call); if he scales back his positions, the broker will refund all or part of the margin deposit.

The collateral deposited by clients with their brokers must be capable of being readily converted to cash and must therefore benefit from a highly liquid market. Margin collateral may include cash, debt securities and equity securities such as French Treasury Bonds, OATs, Bunds, US Treasury Bills, mutual funds, and securities underlying options or included in indices on which options and futures are based (see Contract Specifications).

The full list of eligible assets is established by SBF-Paris Bourse and published in an Avis. Assets accepted as margin (other than cash in French francs) are valued daily at market value or, in the case of debt securities, at nominal value, adjusted where appropriate by a discount percentage ("haircut") corresponding to the estimated price risk on those assets.

Pursuant to Article 49 of the Financial Activities Modernization Act, margin deposited by clients with members of a clearing house, regardless of the nature of such deposits, is made over immediately to the clearing member in order to enable him to settle any debit balance that may arise from the mandatory liquidation of positions and to pay off any monies owing to that member.

**Variation margin**

Positions remaining open in futures contracts are valued daily ("marked to market") on the basis of the daily settlement price, calculated by Monep SA at the end of each trading session on the basis of market prices.

In the event of a difference between two daily valuations, a margin call is issued. This is equal to the difference (a) between the price at which the contract was initially traded and the daily settlement price on the day the position was taken, or (b) between the previous day's daily settlement price and the current daily settlement price throughout the life of the contract.

If the difference is positive (credit margin), the client's account is credited with the gain. If the difference is negative (debit margin), the broker makes a margin call and the client must cover the shortfall before the opening of the next session.

Positions closed out during the trading session give rise to receipt or payment of the gain or loss resulting from the difference between the trade's closing price on the one hand and either the original traded price or the previous day's settlement price.

**Example**

- On 4 January, a client buys a CAC 40 future at FF200,000 (payment of margin deposit: FF10,000)

- On 5 January, when the contract is priced at FF190,000; the client receives a margin call for FF10,000 beyond the margin already deposited.

- On 6 January, when the contract is priced at FF205,000; the client's margin account is credited for FF15,000. The margin deposit is retained by the broker.
Part Three: Relations between client and intermediary

Before trading on the MONEP, investors are urged to obtain information about the mechanisms and rules pertaining to that market, and also about strategies for using options and futures. Furthermore, they are advised to engage the services of a specialized broker (an investment firm or credit institution) to advise them.

OPENING AN ACCOUNT

When a client opens an account with a broker, he enters into a written agreement.

There are two types of accounts that can be opened in a client’s name with a broker: an execution account and a discretionary account.

Execution account: The client initiates and takes full responsibility for market operations (placing orders, checking and monitoring operations, etc), while the broker is involved only as an account-holder.

In the case of an execution account, the agreement between the broker and his client must cover, as a minimum, the method of order transmission, conditions for calling and depositing margin, procedures for informing the client about transactions made on his behalf or concerning the account situation, the frequency at which such information is to be provided, the broker’s fees, and the procedures for terminating the agreement.

Clients that personally manage their own portfolios are permitted to engage the services of an investment services provider (investment firm or credit institution) or an agent appointed by a provider and operating on an exclusive basis on behalf of and under the responsibility of that provider.

This investment services provider or agent may not, under any circumstances, initiate orders on behalf of the client, who alone is responsible for his transactions.

Discretionary account: Persons who do not wish to manage their accounts themselves may use the services of an authorized agent. This agent may be either a COB-approved portfolio management company or an investment firm or credit institution duly authorized by the COB. When a client opens a discretionary account, he enters into a written agreement giving the authorized agent the right to initiate transactions on his behalf.

If the aforementioned agreement authorizes the use of derivative financial instruments, the principal’s express permission must be sought before positions can be taken in such instruments. In this respect, the principal must specify the type of transactions authorized (hedging and/ or speculation) together with the associated procedures, the markets and derivative financial instruments on which transactions can be made, and also the exposure limits, in particular the maximum permitted loss or the maximum portion of the portfolio than can be committed on these markets and/ or products.

The discretionary account agreement must include the notation "all other transactions not enumerated are prohibited".
The discretionary agreement must include at least the following information:

- The business name and address of the broker with whom the discretionary account has been opened.
- The investment objectives.
- The procedures for informing the client of his commitments and results, and the frequency at which such information is to be provided.

Informational requirements include the transmission, at least once per month, of the following:

- A statement showing the value of each position and the overall portfolio.
- A management report detailing the policy applied over the period in question, any changes in management strategy, open interest, the results of completed trades, and the balance on the margin account.
- An assessment of position risk.
- The remuneration for the discretionary service, which can be linked to results, but not the number of transactions.
- Transaction fees.
- The duration of the contract, as well as procedures regarding extension.
- The terms for canceling the contract (note that the agreement can be cancelled at any time by either party).

When requested, an agent must inform his principal immediately of the account balance.

Provision must also be made for the agent to inform his principal immediately in the event that the trades transacted by the agent result in a level of actual or potential cumulative loss specified in the agreement.

**Placing orders**

**Method of transmission**

Orders may be sent to brokers in various ways, unless otherwise specified in the account agreement:

- By letter, telegram, fax or telex.
- By the Minitel teletex service, the internet, or electronic routing (for those establishments offering this service).
- By telephone, the broker having the option of demanding written confirmation.

To avoid disputes over order execution, we recommend using instantaneous transmission media that can date-stamp messages (telex, fax, etc.) or sending written confirmation of telephone orders, noting all of the details of the orders placed.
Instructions and details on orders

Even though order instructions are transmitted in an informal manner, a number of details must nevertheless be clearly specified.

General specifications

These include:
- the nature of the operation (buy/ sell and, for options, opening/ closing transaction),
- identification of the contract.

For options, identification of the class and the series covered by the order as well as the number of contracts to be traded.

Note that the series must be identified by type (call or put), strike price and expiration date.

For futures, identification of the contract and its maturity as well as the number of contracts to be traded.

Example A:
"Buy 10 Lafarge December 1998 calls, strike price 600 as an opening transaction".
“Buy 10 CAC 40 futures for December 1998 delivery”

Order duration

Orders may show one of the following specifications:

- Day orders (validité jour) may be executed during the trading session of the day on which they are transmitted. Failing execution, they are automatically cancelled at the close of the session.

- Fixed term orders (à date déterminée) may be executed at any time until the trading session on the date set by the client (e.g. good for two days, good for the week). Failing execution, they are automatically cancelled.

- Good Till Cancelled orders (”à révocation”), for options, trades are settled, or at the close on the last trading session of the month. In this case, they may be renewed. Clients can change or cancel a GTC order at any time before the above dates.

GTC orders on expiring option series are automatically cancelled at the end of the session on the expiration date.

If duration is not specified, orders are considered to be day orders.

Execution price

Orders may be placed on the MONEP:

- "at market price" (au prix du marché), i.e., without price specifications.

- "with a limit price" (à cours limité), i.e., at a maximum price in case of a buy order, or a minimum price in case of a sell order. (Example B)

Clients must set the limit on their orders in conformity with the minimum price fluctuation (tick size) defined by Monep SA and stated in the Contract Specifications appended to this Prospectus.

Example B:
"Buy 10 Lafarge December 1998 calls, strike price 600 as an opening transaction for FF30, day order".

“Buy 10 CAC 40 futures, December 1998 delivery at FF3,800; order good till 15 December“.
Option prices are highly volatile. It is therefore inadvisable to place orders at market price because they may be executed at a price that differs considerably from that prevailing when the order was entered. We recommend investors to set a limit price on their orders.

Furthermore, limit orders for futures contracts may be designated as "stop-limit" orders. For purchases, a stop-limit order can be executed when the traded price equals or exceeds its limit. For sales, a stop-limit order is executed when the traded price is equal to or lower than its limit.

Once the limit is triggered, there is no ceiling on a buy stop-limit order nor floor on a sell stop-limit order. Accordingly, clients have little control over the actual execution price when using stop-limit orders.

Order execution is always subject to the existence of an adequate counterparty, even if the limit is quoted after the order has been received.

Note, however, that professional ethics require dealers to make every effort to execute their clients' orders at the best available price.

**Transaction fees**

Monep SA receives a fee on all trades executed on the MONEP, in the amounts stated in the Contract Specifications appended to this Prospectus. Transaction fees also apply upon liquidation at maturity of futures contracts and may apply upon the exercise of index options (see applicable Contract Specifications).

Brokers also charge fees, the levels of which are not regulated.

Value-added tax is levied at the prevailing rate on commissions and brokers' fees.

**MONITORING POSITIONS ON A CONSTANT BASIS**

An investor's situation on the options market changes constantly each trading day, depending on variations of the underlying asset(s). Consequently, investors must remain constantly vigilant in case they need to act immediately in order to defend their interests. They must also make the appropriate arrangements if an option is exercised. For an assigned writer, exercise results in one of the following:

- an immediate cash payment (for index options),
- an accounting entry (delivery versus payment) in the name of the client on the day following the assignment at the latest (options whose underlier is traded on a cash market),
- a position on the monthly settlement market (for equity options whose underlying securities are traded on the monthly settlement market), which has different margin rules and risks from those on the options market.

The attention of clients is therefore drawn to the following:

- The margin that a client maintains with his broker must at all times be equal to or greater than the minimum margin requirement, as calculated and adjusted daily by Monep SA pursuant to market regulations. The conditions under which initial and subsequent margin is deposited must be agreed between the client and the broker.

- The broker is required to liquidate, by the following trading day, any position for which the client has not deposited sufficient margin at the end of a session. In this event, the client is required to pay any debit balance that may result from such liquidation within one trading day. To avoid the risk of being unable to meet a margin call in due time, non-professional investors are advised to maintain a margin balance higher than the regulatory requirement.
Reporting of operations

The broker-client agreement must stipulate the procedures and timeframes for providing the client with the information he needs to monitor his positions and assess the accompanying risks.

For the client’s safety, positions should be monitored daily.

To ensure timely monitoring of options trades on the MONEP, clearing members are advised to send the following documents to clients for whom they maintain accounts:

Transaction report: consisting of a list of the trades carried out on the client’s behalf.

The transaction report contains the following information:

<table>
<thead>
<tr>
<th>For options trades</th>
<th>For futures trades</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contract specifications</td>
<td>Contract specifications</td>
</tr>
<tr>
<td>Option type (calls or puts)</td>
<td>Side (buy or sell)</td>
</tr>
<tr>
<td>Number of contracts traded</td>
<td>Number of contracts traded</td>
</tr>
<tr>
<td>Transaction date</td>
<td>Execution date</td>
</tr>
<tr>
<td>Transaction registration number</td>
<td>Transaction registration number</td>
</tr>
<tr>
<td>Nature of transaction (opening or closing)</td>
<td>Debit or credit margin</td>
</tr>
<tr>
<td>Gross transaction amount (premium x contract size x number of contracts)</td>
<td>Brokerage fees</td>
</tr>
<tr>
<td>Brokerage fees</td>
<td>Commissions payable to Monep SA</td>
</tr>
<tr>
<td>Commissions payable to Monep SA</td>
<td>Net transaction amount</td>
</tr>
</tbody>
</table>

In the event of a disagreement concerning the conditions under which their orders were executed, clients must inform their brokers thereof as soon as they receive their transaction reports, which must be dispatched no later than the trading day following the day of the transaction.

Exercise and assignment notice: consisting of a list of the long positions in options exercised by the client or short positions assigned to the client. The exercise and assignment notice contains the following information:

- Specifications of the contracts exercised or assigned.

For equity options:
- Number of securities bought or sold
- Gross transaction amount.

For index options:
- Gross cash amount receivable or payable
- Exercise fees if any (see contract specifications) for which the buyer alone is liable
- Net amount receivable

Open interest statement: a list the client’s of open positions by class and by series.

<table>
<thead>
<tr>
<th>For options positions</th>
<th>For futures positions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contract specifications</td>
<td>Contract specifications</td>
</tr>
<tr>
<td>Indication of the previous day’s position brought forward</td>
<td>Transaction side (buy or sell)</td>
</tr>
<tr>
<td>The day's transactions (opening or closing)</td>
<td>Number of contracts open in the position</td>
</tr>
<tr>
<td>Transfers of contracts pending settlement</td>
<td>Transaction registration number</td>
</tr>
<tr>
<td>Contracts exercised or assigned</td>
<td>Debit or credit margin</td>
</tr>
<tr>
<td>Expired contracts</td>
<td>Initial margin</td>
</tr>
<tr>
<td>Net position</td>
<td></td>
</tr>
</tbody>
</table>
- **Margin calculation statement:** the value of net positions in options at market close, computed on the assumption of the most unfavorable movement in the underlying stock.

The margin calculation statement contains the following information:

- Class.

For each class:

- Day's closing price (or closing index) of the underlying asset.
- Price (or index) used as the most unfavorable assumption.

For each series:

- Settlement price of the series, determined daily by Monep SA.
- Value of open interest in the series at the settlement price - known as the current liquidating value. (Options purchased have a positive liquidating value, options sold have a negative liquidating value).
- Theoretical price of the series on the basis of the price (or index) used as the most unfavorable assumption.
- Value of open interest in the series at the theoretical price - known as the adopted liquidating value.
- Sum of adopted liquidating values, by class.
- Balance of adopted liquidating values for all classes constituting the portfolio. (When the balance is negative, the liquidating value shows an overall debit, which corresponds to the margin requirement. When the balance is positive, the liquidating value is in overall credit and no margin is required).

- **Financial statement:** showing the client's net position.

For options, the financial statement takes into account the margin requirement and the margin already on deposit. The financial statement contains the following information:

- Margin requirement, as shown on the margin calculation statement.
- Margin deposited by the client with his broker, analyzed according to the type of instrument deposited.
- Total margin on deposit.
- Net position (A debit balance represents the additional margin required; a credit balance indicates a reduction in the previous margin requirement).

For futures, the financial statement shows the client's net position, taking into account the margin requirement and the margin already on deposit.
Glossary

Terminology common to options and futures

Clearing house: the body responsible for the registration of transactions and for guaranteeing the full performance of operations and commitments to clearing members.

Client/broker account agreement: The written agreement that defines the contractual relationships between the client and the broker who maintains its account.

Combined strategies: Positions opened or trades made simultaneously by an investor in options of the same class but different characteristics, or in different maturities of the same futures contract (e.g. spread, straddle).

Del credere agent: As del credere agents, MONEP clearing members, guarantee final execution of the transactions they record, vis-à-vis the clearing house as well as the clients for whom they maintain accounts.

Derivative financial instruments: Options and futures on transferable securities, stock market indices, interest rates, currencies, or commodities.

Discretionary trading authorization/Discretionary account agreement: Agreement fulfilling the requirements of the Commission des Opérations de Bourse by which a person delegates an investment services provider to manage his transactions in the financial markets.

Expiration settlement index/Delivery settlement price: computed and disseminated on contract expiration day, it is used as a basis for automatic exercise of option contracts that are in the money on expiration and to determine the last margin call and cash settlement basis for futures contracts.

Fungibility: Property by which contracts with identical characteristics can be substituted. Since MONEP contracts are fungible a position can be offset by taking an opposing position in a contract with the same characteristics as the contract originally traded.

Investment services providers: Investment firms (including the former categories of brokerage firms "sociétés de bourse" and portfolio management companies "sociétés de gestion de portefeuille") and credit institutions.

Margin deposits: A good-faith deposit that must be deposited by members with Monep SA and by clients with the brokers that hold their accounts in order to ensure that contractual obligations on options and futures positions can be met. The purpose of margin deposits is to cover any debit balance that may arise when a position is liquidated (q.v.) following an incident of default.

Maturity: The date on which an option contract expires (expiration date) or a futures contract is settled.

Underlying interest/Underlying asset: the instrument or asset (stock, bond or index) to which options or futures relate.

Unit of trading (contract size): the number of units of the underlying instrument represented by the contract, i.e. the contract size.
Expressed as number of shares for equity options and in monetary units per index point for index options and index futures.
For option contracts on equities, this may vary according to the underlying securities on which the contract bears. Traders are therefore advised to check with their broker before placing orders.
Glossary of options terminology

**American-style option:** an option that can be exercised, at the holder's choice, at any time until the option expires.

**Assignment:** the obligation incumbent on an option seller to carry out the obligations relating to his contract (purchase or sale of the underlying instrument), in response to a buyer's decision to exercise an option.

**At the money:** an option is at the money when the value of the underlying instrument is the same or almost the same as the strike price of the option contract.

**Call:** an option contract granting the holder the right to buy the underlying instrument at the agreed strike price. A call obliges the writer to sell the underlying instrument at the agreed strike price if he is assigned against.

**Class (of options):** the set of options of the same exercise style (American or European) within the same maturity range (short-term or long-term) and pertaining to the same instrument.

**Closing index:** the last index calculated and published when the markets close, used as the basis of margin calculations.

**Contract value:** this is obtained by multiplying the premium's quoted price by the unit of trading (contract size).

**Daily settlement index:** computed and disseminated each trading day, it is used as a daily reference for exercising American-style options.

**European-style option:** an option that can be exercised by the buyer only on the contract expiration date.

**Exercise:** a decision, reserved for the option holder, to request execution of the contract.

**In the money:** a call is said to be in the money when the value of the underlying instrument is greater than the option strike price. A put is in the money when its strike price is greater than the value of the underlying instrument.

**Intrinsic value:** The price of the underlying asset minus the option strike price (calls); or the strike price minus the price of the underlying asset (puts).

Intrinsic value represents the gain that would result from exercise by the option holder.

**Market maker:** a trading member, who has the duty of maintaining a continuous, liquid market in options by trading solely for his own account.

**Out of the money:** a call is out of the money when the value of the underlying instrument is less than the option strike price. A put is out of the money when its strike price is less than the value of the underlying instrument.

**Premium:** the option price resulting from matching of buy and sell orders submitted to the market.

**Put:** an option contract granting the purchaser the right to sell the underlying instrument at the agreed strike price. A put obliges the seller to purchase the underlying instrument at the agreed strike price if he is assigned against.
Series (of options): all options of the same class, the same type (call or put) bearing on the same quantity of the underlying instrument, and having the same strike price and the same expiration date.

Strike price: the price at which the option holder may purchase (in case of a call) or sell (in case of a put) the underlying instrument.

Time value (speculative value): Difference between an option's premium and its intrinsic value. Time value is determined by several factors: volatility of prices of the underlying asset, strike price, remaining life of the option, short-term interest rates, and dividends on the underlying securities.

Volatility: Measures the price fluctuation of a financial asset over a given time (historic volatility) or the expectation of future price fluctuations (future volatility or implied volatility, determined on the basis of the option price).

Glossary of terms relative to the CAC 40 futures contract

Daily settlement price: Calculated by Monep SA for futures contracts at the closing of each trading session, the daily settlement price is used to determine variation margin and to mark open positions to market.

Financial futures contract: A legally binding agreement to buy or sell a specified quantity of financial assets at a price and date fixed at the time of initiating the contract. The position can be closed out at a pre-established date either by:

- delivering the underlying financial asset against payment of the corresponding funds:
- cash settlement of the difference between the price fixed when the position was opened and the price at which the position is closed.

Liquidation: Forcing closing by the clearing house of a defaulting clearing member's positions or by a clearing member of a defaulting client's positions for whom he maintains accounts.

Local (Négociateur pour compte propre "NCP"): Legal or natural person who trades solely for his own account in futures contracts, thus enhancing their liquidity.

Settlement: Closing an open position on expiration by means of a cash payment.

Variation margin: At the end of each trading day, clients' positions are marked to market on the basis of the daily settlement price, thereby producing a potential loss or gain which is charged or credited to the account.
APPENDIX: Contract Specifications for various products

Product notes: Contracts specifications

Short-term equity options
Long-term equity options
Long-term options on the CAC 40 Index (PXL)
CAC 40 index futures contract - EUR 10-
Options on the Dow Jones STOXX® 50 Index
Futures on the Dow Jones STOXX® 50 Index
Options on the Dow Jones Euro STOXX® 50 Index
Futures on the Dow Jones Euro STOXX® 50 Index
Dow Jones Stoxx® Bank futures contract
Dow Jones Stoxx® Bank options
Dow Jones Stoxx® Energy futures contract
Dow Jones Stoxx® Energy options
Dow Jones Stoxx® Telecommunications futures contract
Dow Jones Stoxx® Telecommunications options
Dow Jones Stoxx® L&M Technology futures contract
Dow Jones Stoxx® L&M Technology options
Dow Jones Stoxx® L&M Insurance futures contract
Dow Jones Stoxx® L&M Insurance options
Dow Jones Stoxx® L&M Pharmaceutical futures contract
Dow Jones Stoxx® L&M Pharmaceutical options
Dow Jones Stoxx® L&M Media futures contract
Dow Jones Stoxx® L&M Media options
Important Information on Loss Exposures in Respect of Forward Exchange Transactions

Dear Customer,

In forward exchange transactions, the profit potential is confronted with a high loss exposure. Any investor who wishes to conclude a forward exchange transaction must have been informed of the risks beforehand.

A. General Information on Loss Exposures in Respect of Forward Exchange Transactions

The German Stock Exchange Act (Borsengesetz) provides in Section 53, sub-section 2 that we inform you of the following risks:

Forfeiture or depreciation
The rights you acquire under forward exchange transactions may forfeit or depreciate as the rights conferred under such transactions are in any case limited in time. The shorter the time limit, the greater your risk may be.

Incalculable losses
Your loss exposure in commitments under forward exchange transactions may be indeterminable and may also include your entire property, beyond the collateral furnished by you.

Missing hedging opportunities
It is possible that transactions by which risks under forward exchange transactions entered into shall be excluded or limited (closing transactions) will not be concluded at all or only be concluded at a price meaning a loss for you.

Additional loss potential in respect of borrowings or as a result of currency fluctuations.
Your loss exposure will increase if you make use of a credit facility for your forward exchange transactions. The same applies to forward transactions where your liabilities or claims are denominated in a foreign currency or a unit of account (e.g. ECU).

B. Risks in the individual types of transactions

I. Purchase of options

1. Purchase of an option on securities, currencies or precious metals

The transaction:
If you purchase an option on securities, currencies or precious metals, you acquire the claim for delivery or acceptance of the underlying instrument at the price already fixed when purchasing the option.

Your risk:
Changes in the price of the underlying instrument, such as e.g. the stock on which your option is based, may reduce the value of your option. In the case of a call option, such depreciation will be triggered by price losses, whereas in the case of a put option, price gains of the underlying instrument will trigger a depreciation. If such depreciation occurs, it will in each case be disproportionate in relation to the changes in the price of the underlying instrument, so that your option may even be worthless. Your option may, however, also depreciate if the price of the underlying instrument does not change, as the value of your option is co-determined by other price determinants (such as the maturity or the frequency and intensity of price fluctuations of the underlying instrument. Due to the limited maturity of an option, in such case you cannot rely on the price of the option recovering in good time. If your expectations as to the market development are not come up to and you therefore waive the exercise of the option or fail to exercise it, your option will expire worthless at the end of its maturity. In such case, your loss will be composed of the price paid for the option plus the costs incurred by you.

2. Purchase of an option on financial futures

The transaction:
When purchasing an option on financial futures, you acquire the right to enter into a contract on terms fixed beforehand, by which contract you undertake to purchase and sell, for example, securities, currencies or precious metals for forward delivery.

Your risk:
First, such option is also subject to the risk mentioned under no. 1 above. However, after exercising the option, you run new risks; these new risks are dependent on the financial futures contract then entered into and may be considerably higher than your original risk - i.e. the price paid for the option. Then, you will incur the additional risks under the forward exchange transactions with forward...
II. Sale of options and forward exchange transactions with forward settlement

1. Sale with forward delivery and sale of a call option on securities, currencies or precious metals

The transaction:
As a seller for forward delivery, you assume the obligation to deliver securities, currencies or precious metals at an agreed purchase price. As seller of a call option, you will assume that obligation only if the option is exercised.

Your risk:
In case of a price increase, you must nevertheless effect delivery at the price agreed before, and that price may be considerably lower than the current market price. If the underlying instrument which you have to deliver is already in your possession, you will no longer enjoy the advantage of increasing market prices. If you wish to acquire the underlying instrument only at a later point in time, the current market price may be considerably higher than the price agreed in advance. That price difference represents your risk. The loss exposure cannot be determined in advance, which means that it is theoretically unlimited. The loss exposure may exceed the collateral furnished by you to a considerable extent in the event that you do not possess the instrument to be delivered but only wish to acquire it at maturity. In such case, you may incur considerable losses, as - depending on the market situation - you may be forced to purchase at a very high price or to effect cash settlement payments in case an acquisition of the instrument is rendered impossible for you.

Please note:
if the underlying instrument which you have to deliver is in your possession, you are protected from losses incurred by an acquisition; however, if these assets are blocked in whole or in part for the duration of your forward exchange transaction (as collateral), you may not dispose of the same during that period of time or prior to the closing of your futures contract, nor can you sell such assets in order to avoid losses in case of decreasing prices.

2. Purchase with forward delivery and sale of a put option on securities, currencies or precious metals

The transaction:
As a purchaser for forward delivery or as seller of a put option, you assume the obligation to purchase securities, currencies or precious metals at an agreed price.

Your risk:
In case of decreasing prices, you must nevertheless take delivery of the purchased instrument at the price agreed before, and that price may be considerably higher than the current market price. That price difference represents your risk. The loss exposure cannot be determined in advance and may exceed collateral furnished by you (if any) to a considerable extent. If you intend to resell the product immediately after taking delivery thereof, you should note that it may be impossible, or very difficult, for you to find a purchaser; depending on the market situation, it is possible that you will only succeed in selling the instrument with a considerable price reduction.

3. Sale of an option on financial futures contracts

The transaction:
When selling an option on a financial futures contract, you assume the obligation to enter into a contract on terms fixed in advance, by which contract you undertake to purchase and sell, for example, securities, currencies or precious metals for forward delivery.

Your risk:
Should the option sold by you be exercised, you run the risk of a seller or purchaser for forward delivery, as set out in Sections 1 and 2 of this Chapter II.

III. Options and financial futures contracts containing a cash settlement

The transaction:
Several forward exchange transactions only contain a cash settlement. These include in particular:

- options and financial futures contracts on an index, i.e. a variable number which is calculated on the basis of a portfolio of securities determined according to certain criteria, and the variations of which mirror the price movements of these securities;
- options and financial futures contracts on the interest rate for a time deposit with a standardised maturity.

Your risk:
If your expectations are not met, you have to pay the difference between the price fixed at the conclusion of the transaction and the current market price at maturity. That difference represents your risk. The amount of the loss suffered by you cannot be determined
in advance. It may exceed collateral furnished by you (if any) to a considerable extent.

C. Additional risk under forward exchange transactions

I. Forward exchange transactions containing a currency risk

The transaction:
When entering into a forward exchange transaction in respect of which your commitment or the consideration to be claimed by you is denominated in a foreign currency or a unit of account (e.g. the ECU), or where the value of the underlying instrument is determined thereby (such as in the case of gold), you are exposed to an additional risk.

Your risk:
In this case, your loss exposure is not only linked with the performance of the underlying instrument. Developments on the foreign exchange market can rather cause additional incalculable losses. Currency fluctuations may:

- reduce the value of the purchased option;
- increase the price of the underlying instrument to be delivered by you for the settlement of forward exchange transactions if the same is payable in a foreign currency or a unit of account. The same applies to a payment obligation under the forward exchange transaction to be settled by you in a foreign currency or a unit of account;
- reduce the value or the sales proceeds of the underlying instrument to be taken delivery of or the value of the payment received.

II. Transactions intended to exclude or limit risks

Do not rely upon being able to enter into transactions at any time during the term so as to compensate for, or limit, your risks under forward exchange transactions. Whether or not you have that possibility depends on the market conditions and also on the structuring of your forward exchange transaction. It may be that you will not be in a position to enter into said transactions at all, or only at an unfavorable market price, so that you will incur a loss.

III. Drawing on a credit facility

Your risk will increase if you use a credit facility for the financing of, in particular, the acquisition of options or the performance of your delivery and payment obligations under forward exchange transactions. In such case, if the market development is contrary to your expectations, you must - in addition to the loss suffered - also pay interest on the credit facility and redeem the same. You should therefore never start from the assumption that you will be in a position to pay interest and capital in respect of such credit facility from gains achieved under forward exchange transactions. Rather make sure prior to entering into a transaction that your financial situation allows you to pay interest on, or - should the situation arise - redeem, such credit facility at short notice even if you suffer losses instead of gains.

D. Certification in securities

The risks in respect of the transactions described above will not change if rights and obligations are certificated (e.g. in a warrant).

According to Section 53, sub-section 2 of the German Stock Exchange Act (Borsengesetz), this Information Memorandum must be signed by you if you wish to enter into forward exchange transactions.
Swiss Risk Disclosure for Futures

Swiss Risk Disclosure - Characteristics and Risks of Futures

1. Principles

Futures contracts may be associated with special financial risks and are therefore only suitable for investors familiar with this type of business, with adequate liquid assets and capable of bearing any eventual losses.

This notice provides some fundamental information about the general characteristics of and the risks normally associated with futures contracts.

2. Characteristics

2.1 Definition

A futures contract subsumes the commitment to buy or deliver on a specified date (settlement date) a specified quantity of a particular underlying instrument at a price as agreed on the contract date.

The following products may be underlying instruments of a futures contract:

- assets such as stocks, bonds, commodities, precious metals;
- benchmarks such as currencies, interest rates, indices.

2.2 Types of futures

Futures are listed contracts and standardized in terms of quantity of underlying instruments and expiration date.

Over the counter (OTC) futures (also referred to as forwards) are traded off the floor. They may be standardized or subject to individual contract specifications as agreed between the buyer and the seller.

2.3 Margin requirement and margin cover

An initial margin is agreed at the outset of the contract for both, the forward purchase and the forward short sale of an underlying instrument. The initial margin is usually expressed in terms of a percentage of the purchase price of eligible instruments.

An additional variation margin is determined periodically throughout the life of the contract. The variation margin represents the accounting profit or loss resulting from the fluctuation of the futures contract or the underlying instrument. The variation margin may amount to a multiple of the initial margin. The calculation method of the variation margin during the life of the contract or in the event of its closing out is subject to the relevant stock exchange regulations and the details of the contract.

Throughout the life of the contract the investor must maintain a sufficient margin cover with the securities dealer, as required for the initial and variation margins.

2.4 Closing out and execution

On principle, the investor may close out contracts at any time up to expiration date.

Subject to the type of contract and the relevant stock exchange regulations, the contract may be closed out either by selling the contract or by entering into an identical contract with a converse buying or selling commitment. In the latter case, the buying or selling obligation arising from the first contract is neutralized by the converse contract.

Unless closed out prior to the expiration date, the contracts must be exercised on expiration date according to the following principles:

Futures contracts on assets may be exercised by physical delivery of the underlying assets or by cash settlement. These contracts are usually exercised by physical delivery, unless the possibility of cash settlement is exceptionally provided by the contract or the relevant stock exchange regulations. Other particulars of the exercise, in particular the place of exercise, are subject to individual contract details.

Futures contracts on benchmarks (except currencies) cannot be exercised by physical delivery of the underlying instrument. The
method of exercise is invariably cash settlement.

In the case of physical delivery of the underlying instrument, the full value of the contract is due, whereas cash settlement is limited to the difference between the price agreed at the outset of the contract and the current market value at the time of exercise. Consequently, the investor must hold more liquidity for physical delivery contracts than for cash settlement contracts.

3. Risks

3.1 Fluctuations of the contract or the underlying instrument

Investors in futures contracts always have certain expectations with regard to the performance of the contract or the underlying instrument within the relevant period of time. If the performance fails to match the investor’s expectations, the following risks may arise for the investor.

Regardless of an increase of value of the contract or the underlying instrument, the futures seller must deliver the underlying instrument on settlement date at the initially agreed price which may be far below the current market value. Hence, the seller’s risk lies in the difference between the price agreed at the outset of the contract and the current market value at expiration date. Since there is, in theory, no upper limit for market rates, the seller’s potential loss is unlimited and may exceed the margin requirement considerably (see point 2.3).

Regardless of a decline in value of the contract or the underlying instrument, the futures buyer must buy the underlying instrument on settlement date at the initially agreed price which may be far beyond the current market value. Hence, the buyer’s risk lies in the difference between the price agreed at the outset of the contract and the current market value on expiration date. The buyer thus risks to incur a loss equal at a maximum to the initially agree price. The loss may exceed the margin requirement considerably (see point 2.3).

3.2 Restricted or suspended closing out

Stock exchanges may determine price limits for certain futures contracts in order to prevent excessive price volatility. The investor must be aware that closing out such futures contracts may be restricted or suspended once the price limit has been reached. Investors should therefore establish whether any price limits exist before entering into futures contracts.

3.3 Purchasing underlying instruments in the case of short sales

Investors who sell forward an underlying instrument which they do not hold at the outset of the contract (short sale) carry the risk that they may have to purchase the underlying instrument later at an unfavorable current market rate, in order to be able to deliver the underlying instrument on expiration date.

3.4 Special risks inherent in over-the-counter (OTC) futures

The market for standardized OTC futures is generally transparent and liquid. Therefore contracts can be usually closed out. There is no organized market for OTC futures with special individual contract terms. Closing out these contacts is therefore subject to the counterparty’s consent.

3.5 Combinations

This notice cannot provide a conclusive description of all risks that may arise in individual cases, due to the large variety of feasible combinations.

Since combinations consist of various elements, the risk pattern may change significantly when individual elements of the total position are closed out. Consequently, investors should obtain detailed information on the specific risks inherent in combinations before entering into combination contracts.
Swiss Risk Disclosure - Characteristics and Risks of Options

1. Characteristics

1.1 Definitions

1.1.1 Rights and Duties

By paying the option fee (premium), the option buyer acquires the right, without the obligation, to buy from (call option) or sell to (put option) the writer of an option a specified quantity (size of contract) of a product (underlying instrument) at a fixed price (strike price) up to or on a specified date (expiration date).

Receiving the premium, the option writer has the obligation to deliver the underlying instrument to (call option) or buy the underlying instrument from (put option) the buyer of the option at the strike price. In the case of warrants (see point 1.2.1 below), the issuer of the warrant is directly committed to the holder of the warrant.

The details of an option may be either standardized or subject to individual agreements between the buyer and the writer.

1.1.2 Underlying instruments

The following products may be underlying instruments of an option:

- assets such as stocks, bonds, commodities, precious metals,
- benchmarks such as currencies, interest rates, indices or
- any combination and derivatives (e.g. futures)

1.1.3 "In-the-money", "out-of-the-money", "at-the-money" options

A call option has an intrinsic value, i.e. it is "in-the-money", if the current market value of the underlying instrument is higher than the strike price. A put option is "in-the-money" if the current market value of the underlying instrument is below the strike price.

A call option is "out-of-the-money" if the current market value of the underlying instrument is lower than the strike price. A put option is "out-of-the-money" if the current market value of the underlying instrument is higher than the strike price.

The option is "at-the-money" if the current market value of the underlying instrument is equal to the strike price.

1.1.4 "American", "European" options

"American" options may be exercised up to their expiration date.

"European" options may be exercised only on their expiration date.

1.1.5 Physical delivery or cash settlement options

When exercising a "physical delivery" option, the buyer of a call option is entitled to receive the underlying instrument against payment of the strike price. Accordingly, the writer must purchase the underlying instrument from the buyer of a put option at the strike price.

In the case of cash settlement options, the amount to be settled is the difference between the strike price and the market value of the underlying instrument, provided that the option is "in-the-money".

1.2 Types of options

1.2.1 Warrants, listed options

The issuer certifies the rights and duties arising from the options in a certificate which is customarily traded on a stock exchange (listed).
1.2.2 Traded options

Traded options are standardized non-certificated options which are traded on special exchanges in accordance with the rules and regulations of such exchanges (e.g. on the SOFFEX Swiss Options and Financial Futures Exchange).

1.2.3 Over-the-counter (OTC) options

Particularly OTC options on precious metals and currencies can be standardized according to market practice and publicly offered. In contrast, tailor-made OTC options are specifically designed for individual investors.

OTC options are entered into directly between the buyer and the writer off-exchange. They are not listed and usually non-certificated. Consequently, a position in OTC options can only be closed by entering into a corresponding offsetting transaction with the same counterparty.

1.3 Margin requirement

The writer of an option has to deposit an adequate quantity of the underlying instrument or provide another collateral (margin cover) during the life of the option. The margin is determined by the securities dealer. The stock exchange determines the minimum margin for traded options. If the margin cover proves insufficient, the securities dealer may require the writer to provide an additional collateral (further margin).

2. Risks

2.1 Risks associated with the purchase of options

2.1.1 Call options and put options

The value of a call option declines if the market value of the underlying instrument falls; the value of a put option declines if the market value of the underlying instrument rises. The decrease in value expands the less the option is in-of-the-money, generally accelerates as the life of the option diminishes and is proportionally larger than the decrease in value of the underlying instrument.

The value of the option may also decline while the market value of the underlying instrument remains unchanged or develops favorably for the buyer, for instance due to a drop in the current value of the option or an adverse supply and demand situation. Consequently, the buyer must take into account that the value of the option may decline and that the option may even be worthless on expiration date, thus resulting in a loss up to the amount of the premium which the buyer initially paid.

2.1.2 Call and put options on futures

Call options which entitle the holder to entering into futures contacts as a buyer, and put options which entitle to entering into futures contracts as a writer, are analogously subject to the risks stipulated in point 2.1.1. Upon exercise, the remarks stipulated in point 3 of the notice “characteristics and risks associated with futures contracts” apply.

2.2 Risks associated with writing options

The writer of an option must take into consideration that the buyer may exercise hi/her rights even if the option is only at-of-the-money or out-of-the money, in the case of “American” options this may be at any time up to the expiration date.

2.2.1 Covered call options

The writer of a covered call option owns the quantity of underlying instruments corresponding to the size of the contract. If their market value exceeds the strike price, the writer misses the according profit. However, the writer assumes the full risk of any losses caused by a drop in market value. If the underlying instruments are blocked fully or in part to cover the liability during the life of the option, they may not be sold to forestall any future losses.

2.2.2 Naked call options

The writer of naked call options does not own the relevant underlying instruments. In the case of physical delivery options, the risk lies in the spread between the strike price at which the underlying instruments must be delivered when the option is exercised, and the price at which the writer must procure them. In the case of cash settlement options, the risk lies in the difference between the strike price and the market value of the underlying instrument. As the market value may be considerably higher than the strike price when the option is exercised, the risk is undefinable and in theory unlimited.

In particular, the writer of “American” options must take into consideration that the option may be exercised under very difficult
market conditions and that it may then be very expensive or indeed impossible to obtain the underlying instruments required for physical delivery.

The writer must be aware that an eventual loss could substantially exceed the value of the collateral deposited (margin cover).

2.2.3 Put options

For the writer of put options the risk lies in the possibility that the market value of the underlying instrument may fall below the strike price. The loss the writer then faces corresponds to the difference between the market value and the strike price. In particular, the writer of physical-delivery "American" put options runs the risk of having to purchase underlying instruments under market conditions where such underlying instruments can be resold only with great difficulty or at a significant loss or where resale is impossible.

The writer risks to incur losses which could substantially exceed the value of the collateral deposited (margin cover).

2.2.4 Call and put options on futures

Writers of call or put options undertake to enter into futures contracts as a buyer or seller respectively, and are accordingly subject to the risks described in points 2.2.1 to 2.2.3. Upon exercise, the remarks stipulated in point 3 of the notice "characteristics and risks associated with futures contracts" apply.

3. Combinations

3.1 Definition

The term combination applies when two or more options are written for the same underlying instrument, whereas these options must differ at least in the type of option (put, call), quantity, strike price, expiration date or type of position (long, short).

3.2 Special Risks

This notice cannot provide a conclusive description of all risks that may arise in individual cases, due to the large variety of feasible combinations. Consequently, investors should obtain detailed information on the specific risks associated with a combination before entering into such transactions.

As combinations consist of various options, the risks may change substantially by closing some of these options.

4. "Exotic" options

4.1 Definition

Exotic options differ from "ordinary" call and put options as described in point 1.1 ("plain vanilla" options) in that they are subject to additional arrangements or conditions. Their payoff structure can therefore not be achieved by any combination of "plain vanilla" options alone or with underlying instruments. Exotic options can be issued either as "tailor made" OTC options or as certificated options.

4.2 Special risks

Due to the practically unlimited variety of feasible exotic options, this notice cannot provide a conclusive description of all risks inherent in them. Consequently, investors should obtain detailed information on the specific risks associated with exotic options before entering into such transactions.

The overview hereafter provides the description of a number of typical exotic options which entail special risks in addition to the risks outlined in point 2. The risks outlined in point 2 apply analogously.

4.3.1 Path-dependent options

In the case of path-dependent options the market value of the underlying instruments is relevant during the life of the options and not only on the expiration or exercise date. Consequently, the investor must take into consideration any fluctuations in market value of the underlying instrument throughout the life of the option.

- Barrier options
- The rights arise ("knock-in" barrier option) or expire ("knock-out" barrier option) when the market value of the underlying instrument reaches or exceeds a specified threshold ("barrier", also "instrike" or "outstrike") within a given period. The term "kick-in" or "kick-out" barrier option applies if the "barrier" is set between the value of the underlying instrument when the option is entered into and when it expires.

"Double-barrier options" are barrier options with two "barriers" (marking the upper and lower threshold). They also occur as "knock-in" and "knock-out" barrier options.

**Risk note:** The buyer of a barrier option must be particularly aware that his/her option rights only arise ("knock-in" or "kick-in" options) respectively lapse absolutely ("knock-out" or "kick-out" options) when the market value of the underlying instrument reaches the "barrier".

- **Payout options**

Payout options pay a fixed amount agreed in advance.

"Digital" or "binary" options pay out if the market value of the underlying instruments reaches or exceeds the "barrier" once during a specified period ("one-touch digital option") or on expiration date ("all-or-nothing digital option").

The "one-touch digital option" pays the fixed amount either as soon as the barrier is reached or only on expiration date, the latter being also referred to as a "lock-in option".

On the other hand, the "lock-out option" pays the fixed amount on expiration date only if the market value of the underlying instrument does not reach the "barrier" during a specified period.

**Risk note:** The writer of a payout option is liable to pay the fixed amount in full when the "barrier" is reached, irrespective of whether and to what extent the option is "in-of-the-money" when it is exercised or on expiration date. Therefore the amount due may be considerably higher for the writer, respectively much lower for the buyer, than the intrinsic value of the option.

- **Asian options**

In the case of an Asian option, the market value of the underlying instrument is recorded at regular intervals during a specified period. The average value thus assessed is used to determine the value of the underlying instrument of an "average-rate option" or the strike price of an "average-strike option".

**Risk note:** As a consequence of applying the average value of an "average-rate option", the value of the option on expiration date may be considerably lower for the buyer, respectively higher for the writer, than the difference between the strike price and the market value on expiration date.

In relation to the strike price observed at the outset, the strike price determined in the case of an "average-strike option" may be significantly higher for the buyer of a call option, respectively lower for the buyer of a put option, however it may be considerably lower for the writer of a call option, respectively higher for the writer of a put option.

- **Lookback options**

In the case of a lookback option, the market value of the underlying instrument is recorded at regular intervals during a specified period.

In the case of a "strike-lookback option", the lowest market value is used as the strike price for a call option and the highest market value is used as the strike price of a put option.

In the case of a "prize-lookback option", the strike price remains unchanged, however the top rate is used for the valuation of the underlying instrument of a call option and the bottom rate is used for the valuation of the underlying instrument of a put option.

**Risk note:** The assessed strike price as well as the assessed value of the underlying instrument of a lookback option may deviate substantially from the actual values on expiration date. The writer of the above options must be aware that the applicable strike price or market value is invariably the least advantageous for him/her.

- **Contingent options**
In the case of contingent options, the premium becomes due only if the market value of the underlying instrument reaches the strike price during the life of the option (American options) or on expiration date (European options).

**Risk note:** The buyer of a European contingent option must consider that the premium will become due in full on expiration date, although the option may be only just "at-of-the-money" or minimally "in-of-the-money".

- **Cliquet and ladder options**

  In the case of a cliquet option (also "ralchet option"), at certain, usually regular, intervals, the strike price for the following period is adjusted to the current market value of the underlying instrument, any intrinsic value of the option is recorded and accumulated during the life of the option.

  The ladder option differs from the cliquet option in that the adjustment is not affected periodically but whenever the underlying instrument reaches specific market values. As a rule, only the highest intrinsic value is recorded (the "lock-in"), in rare cases all recorded intrinsic values are accumulated.

  **Risk note:** The writer of a cliquet option owes the total accumulated "lock-in" amount in addition to any intrinsic value of the option on expiration date. The writer of a ladder option owes the respective highest "lock-in" amount in addition to any intrinsic value of the option on expiration date. The writer may therefore owe an amount considerably higher than just the intrinsic value of the option on expiration date.

4.3.2 Options on several underlying instruments

- **Spread and outperformance options**

  Both options are based on two underlying instruments. The valuation of the spread option is based on the absolute difference in performance between the underlying instruments, whereas the valuation of the outperformance option is based on the relative difference between the underlying instruments in percentage terms.

  **Risk note:** Despite a positive performance of both underlying instruments, the performance difference between the underlying instruments may be equal or lower in absolute as well relative terms, thus having a negative impact on the value of both types of this option.

4.3.3 Options on several underlying instruments

- **Compound options**

  The underlying instrument of a compound option is another option; i.e. compound options are call options on call or put options, as well as put options on call or put options.

  **Risk note:** Compound options may have a strong leverage effect. The writer of a compound option must be aware that his/her liability may soar high very quickly.