CHAPTER 1

Option Basics

To understand and implement option strategies effectively, you need to understand not only how stocks and the equity markets work, but what options are, how they function, and what affects their value. The strategy discussions in this book assume you are already familiar with stocks and options, so to refresh you on the basics, we have constructed Chapters 1 and 2 as a review of listed equity options. If you are already familiar with options, you can begin reading about call writing in Chapter 3.

What Are Options?

An *option* is a contract representing the right, for a specified term, to buy or sell a specified security at a specified price. Like stock, they are also standardized so they can trade on formal securities exchanges and are regulated by the Securities and Exchange Commission (SEC).

There are two types of options: *puts* and *calls.*

1. **Call option:** A contract representing the right for a specified term to *buy* a specified security at a specified price.
2. **Put option:** A contract representing the right for a specified time to *sell* a specified security at a specified price.

The specified price is known as the *strike,* or *exercise, price;* the specified term is determined by the option's *expiration date;* and the specified security is referred to as the *underlying security.* There are exchange-listed options on a number of securities and even non-securities (such as indexes), but this book

is devoted entirely to those on stocks and exchange-traded funds (ETFs).We may refer to both of these in aggregate as *equity options.* A standard equity option represents 100 shares of the underlying stock or ETF. Thus a call option on Disney with a strike price of $35 that expires in two months gives the buyer the right, anytime during the next two months, to buy 100 shares of Disney at $35 each.

- **Strike price:** The price at which the underlying security of an option can be purchased or sold by the contract buyer.
- **Expiration:** The date when the terms of an option contract terminate.
- **Underlying security:** The security that an option gives its buyer the right to buy or sell.

An option contract is not issued until a buyer and seller come together in the marketplace. When an exchange initiates trading on a particular option, no contract exists until the first transaction takes place. The option is issued when party A agrees to buy one or more contracts from party B, and additional contracts are issued as other buyers and sellers make deals.

Standardization

Although options contracts are legally binding, you need not call your attorney to draw one up when you want either to buy or to sell. Option contracts are originated and standardized by an independent entity called the Options Clearing Corporation (OCC). To comply with SEC regulations, the OCC files a prospectus for all options on behalf of all the buyers and sellers. It also sets, guarantees, and enforces all contract terms and keeps the master versions of all contracts. You see only a trade confirmation, as you most often do with stocks. (If you are curious, you can see the OCC prospectus on the Internet at www.optionsclearing.com under Publications.)

- **OCC:** The Options Clearing Corp., an independent entity that acts as the issuer and guarantor for all listed option contracts.

By standardizing contracts, the OCC enables options to be traded in the secondary market (on an exchange), just like a listed stock or bond. In other words, they are *interchangeable,* or *fungible.* When you buy 100 shares of Disney common stock for your account, you know that those shares are exactly the same as any other Disney common shares. Similarly, the OCC guarantees that when you buy a particular Disney call option, your contract

has the same terms—that is, it is for the same type of option, on the same underlying stock, with the same strike price and expiration—as all others referred to with the same designation. All options having identical terms are said to be part of the same series and are interchangeable.

- **Class:** All the options of the same type that have the same underlying security. For example, all the call options that exist for Microsoft stock are part of the same option class.
- **Series:** All the options in the same class that also have the same strike price and expiration date. For example, all IBM calls in January with a strike price of 150 are part of the same option series.

Listed options are those that are formally traded on a recognized exchange. *Non-listed,* or *over-the-counter* (OTC), options also exist, but they are not standardized and are used infrequently. For the most part OTC options are only used by institutions. All the options reported through quote services are listed, and options may be listed on more than one exchange. This does not affect the option's interchangeability. Option exchanges generally trade during the same hours as the underlying stocks plus a few extra minutes at the end of the day (4:02 P.M. Eastern time), except on the Friday before expiration, when they stop trading right at 4 P.M.

The OCC plays another important role: as intermediary between option buyers and sellers. When you buy or sell an option, you are actually dealing directly with the OCC (through your broker), rather than with a particular individual. That means you do not need to worry about the integrity of the transaction or about the other party's ability to pay. Their broker worries about that.

Option Listings

The option exchanges determine what options they will list—in other words, which underlying stocks they will allow options to trade on. Thus IBM, for instance, has no say as to whether options are listed on its shares. Currently, options are available on approximately 2,600 stocks and ETFs, with new listings added every month. The reason that figure is so small compared with the total universe of listed stocks is that only certain stocks meet the exchanges' requirements. Because of the close relationship between options and their underlying securities, primary among the exchanges' criteria are that the underlying stocks be listed and actively traded on a national market. Other requirements concern the number of shares outstanding, the stock's

TABLE 1.1 Option Examples

Underlying Security	Expiration Month	Strike Price	Type
Disney	October	35	Put
Home Depot	August	35	Call
IBM	January	150	Call
Intel	April	17.50	Call
Microsoft	July	26	Put

price history, its daily trading volume, the company's assets, and so on. As an example, new options listings are not approved for stocks trading below $7.50.

Since 100 shares is the standard contract size for a single option, you only need to identify any option by the four items that make it unique: underlying stock; expiration month; strike price; and type. Table 1.1, for example, shows that IBM Jan 150 call designates a call option on IBM shares, expiring in January, with a strike price of 150.

Strike Price

Options on a particular stock are always available for at least several different strike prices above and below the current price of the stock. The number of strikes, which can sometimes rise to 50 or more on a single underlying, depend on the stock's price and volatility (how much the share price has moved historically). A volatile stock such as Research in Motion (RIMM), for example, currently has more than 50 strike prices for the January 2011 expiration month. The option exchanges offer strikes in increments of $2.50, $5, or $10, depending on the price of the underlying stock. Thus, if XYZ is selling for around $50 a share when options trading on the stock begins, the exchange would typically allow trading (for both puts and calls) on a range of strike prices including, say, $40, $45, $50, $55, and $60. On the other hand, if the share price is $16, you would probably see strike prices of $15, $17.50, and $20. As stocks move, new strike prices are added, although the exchanges generally do not add new strikes during the last few weeks before an expiration.

Depending on the price of the underlying stock at the time, options at various strike prices are said to be *in the money* or *out of the money.* These

terms are important to the covered writer (option seller) and will be referred to frequently in the text.

- **In the money (ITM):** Describes a *call* option whose strike price is *below* the current price of the underlying stock or a *put* with a strike *above* the current price. *Example:* When ABC stock is trading at $43, call options with strike prices of $40, $35, and $30 are all in the money.
- **Out of the money (OTM):** Describes a *call* option whose strike price is *above* the current price of the underlying stock or a *put* with a strike *below* the current price. *Example:* When ABC stock is trading at $43, call options with strike prices of $45, $50, and $55 are all out of the money.
- **At the money (ATM):** Describes an option that has a strike price equal to (or close to) the current price of the underlying stock. *Example:* A GHI call option with a strike of $30 is at the money when the stock is trading at or very close to $30.

Expiration

The most distinctive characteristic of options is their limited life, determined by the expiration date. On that date, they cease to exist, and any value they may have contained up to that point becomes moot. In contrast, when bonds mature, they can no longer be traded but they do make their last interest payment and repay their principal. When options expire, if they are in the money (ITM) by any amount (even $.01), they are automatically exercised by the Option Clearing Corp. It is important to remember whether you are a buyer or a seller of options.

To keep things standardized, all the options expiring in a particular month do so on the same day: the Saturday following that month's third Friday. Saturday was chosen to give brokers one last morning following the last trading day to reconcile their clients' positions and make sure there are no errors going into expiration. The third Friday of each month is therefore the last day expiring options can be traded. Expiring options can be bought or sold as usual on this Friday, but trading is frequently heavier than average, as people close out positions before they expire.

There are now options on some stocks and ETFs that expire at the end of each quarter or even each week.

One glance at an option table in the *Wall Street Journal* or on a computer shows that options on different stocks have expirations in different months. It

may appear strange to have options on one stock expire in January, February, April, and July while options on the next one expire in January, February, May, and August. Actually, there is logic to this, although it may seem a bit obscure. When options first began trading on formal exchanges in the 1970s, expirations were quarterly. Thus, for every stock, only three-month, six-month, and nine-month options were initially made available. Then, when three months passed and the first option expired, a new nine-month option would be added on to the end. It was done that way because there was not enough volume (liquidity) in the beginning to justify having options expiring every month for individual stocks, and because the quarterly cycle enabled the exchanges to offer option expirations that corresponded to the quarterly earnings calendar of the underlying companies.

So, in the beginning, options were designated to expire in one of the following three quarterly cycles (just to spread them out evenly throughout the year):

1. January-April-July-October.
2. February-May-August-November.
3. March-June-September-December.

Only three of the cycle months would be available at any one time, and when the nearest expiration passed, the next one in the calendar cycle would be added. If ABC options were introduced in cycle #1, they might begin trading with expirations in January, April, and July. On the Monday after the January options expired, the exchange would allow trading in October options, so that there would once again be three expiration months available.

For stocks on the January cycle, the process worked as follows:

When	**Expirations Available**
As of January 1:	January-April-July
When January options expired:	April-July-October
When April options expired:	July-October-January

. . . and so on.

It became evident, however, that both option buyers and sellers were more interested in the *near-month* expirations (the current calendar month and the next one out) than in the expirations three to nine months away. Reacting to this, the exchanges permitted the addition of two near-month expirations while keeping intact the quarterly cycle structure for the months

farther out. So, today, instead of only three available expiration months at any one time, there are four—the two nearest months and the next two months in the quarterly cycle.

The January cycle now works as follows:

When	**Expirations Available**
As of January 1:	January-February-April-July
(February is now added so that there will be two near-month expirations.)	
When January options expire:	February-March-April-July
(March is added as the second near month.)	
When February options expire:	March-April-July-October
(There are already two near months, so October is added as the next quarterly month.)	

. . . and so on.

Don't feel that you need to memorize these rules. Just be aware that there will always be two near-month options available for each stock and two expiration months farther out that will vary from stock to stock.

Since their inception in 1990, options with greater than nine-month terms have also been available. They are called *long-term equity anticipation securities* (LEAPS) and are available on close to 800 stocks at the present time. LEAPS usually expire in either December or January and may be available as far out as three years. Otherwise, they work the same way as regular listed options. As time brings them into the normal option expiration cycle, LEAPS become the regular option for that month, whether December or January.

Adjustments

When certain events affecting an underlying security occur—such as a stock split, merger, or spin-off—the terms of the option contract need to be adjusted so that both holders and writers have essentially the same position after the event as they did before it. These adjustments may affect strike price and number of underlying shares, but never expiration date.

Say XYZ Corp. decides to split its stock two-for-one. The company is issuing an additional share for each one currently outstanding, and the share price is consequently cut in half. Stockholders thus retain the same percentage ownership in XYZ Corp. after the split as before. But the holder

TABLE 1.2 Effect of Stock Splits on Options

	Before Stock Split	After Stock Split
Price of XYZ stock	$85/share	$42.50/share
Stockholder	Owns 200 shares	Owns 400 shares
Option Writer	Short 2 Jan 85 calls	Short 4 Jan 42.5 calls

of an unadjusted call option on XYZ would have the right to buy 100 shares that represent only half as much ownership in the company as before. The terms of option need to change to reflect the change in the underlying stock.

Adjustments are decided upon, and effected by, a joint panel of the option exchanges and the OCC. In the XYZ example, on the effective date of the split, both holders and writers of existing options on the stock would have the number of their contracts doubled and the strike prices of these contracts halved. The before-and-after scenario is illustrated in Table 1.2.

Odd splits, such as 3-for-2 or 5-for-4, can yield even stranger fractional strike prices, such as 16.7. There cannot, however be a fractional option, so in these odd splits, the number of shares represented by one contract may change—to 133 or 150, for example—to match the new strike price.

Regular cash dividends (those equal to less than 10 percent of the value of the stock) are not considered sufficient to adjust the terms of an option. The rationale is that these dividends are built into the price of the stock over time and do not materially change the value enough to warrant specific option adjustments. Besides, it would be impractical to do so every time a company issued a regular dividend.

When a company spins off a new entity, shares in the spin-off become part of the deliverable in outstanding option contracts. If company XYZ, for example, issues 10 shares of QRS for each 100 shares of XYZ common, a contract formerly calling for the delivery of 100 shares of XYZ will now call for 100 shares of XYZ and 10 shares of QRS.

Exercise and Assignment

While it is certainly possible, and in fact commonplace, to buy and sell options without ever exercising them, it is very important for all option investors to be aware of the process and implications of exercise and assignment.

The Basic Mechanics

When holders wish to invoke the right given them by their option to buy or sell the underlying stock, they are said to exercise their option. This is accomplished by informing their broker. Notice can be verbal, just like placing an order to buy or sell stock (which is essentially what an exercise is anyway). Thus, if you hold a call option for DEF stock and you decide to exercise, you are essentially entering a buy order for DEF at the strike price, except that your order would be routed to the OCC rather than directly to the exchange where the stock trades. Exercises take effect at night after the close of trading. Since the price is determined by the option strike, it does not matter what time of day an option is exercised.

Options that can be exercised at any time before expiration are said to be *American style;* those that can be exercised only at expiration are called *European style* or *capped.* This has nothing to do with where they trade. Equity options on individual stocks all trade American style. Index options trade European style.

As noted above, the standard *contract size* (or *unit of trading)* is 100 shares. That is the number of shares that the writer must deliver if a holder exercises the contract. These shares are sometimes referred to as the *deliverable.* There are listed options on common stocks as well as on some preferred stocks and American depositary receipts (ADRs) on foreign securities and on various other financial instruments, including futures and stock indexes. Index options may stipulate *cash delivery* instead of *physical delivery*, because of the practical considerations of buying every stock in an index. All equity options require physical delivery of the underlying shares. The process of actually delivering an underlying security as part of an option exercise is called *settlement* and is handled by your broker just like the settlement of a regular stock transaction.

When an option is exercised by one or more holders, the OCC must determine to whom in the writers' pool to *assign* that exercise for fulfillment—in other words, which writer has to sell his or her stock. The notification process is referred to as an *assignment.* The OCC keeps the master record of which member brokerage firms are either short or long every option. It distributes assignments by passing them to member firms that have open short positions and letting *them* figure out which of their customer accounts receive assignments. The brokerage firms must have fair and reasonable ways to distribute assignments, but they do not all have to be the same. Some firms distribute assignments randomly, while others use a first-in/first-out policy.

Receiving an assignment notice from your broker is essentially the same as receiving a trade confirmation for buying or selling shares of stock, except

that you did not have to enter an order—it was generated by the assignment notice. This should occur early in the morning following the exercise, but there is no guarantee on the exact time. The broker receives word during the night from the OCC and will want to let you know as soon as possible the next morning so that you do not unknowingly close your call position or sell your stock in the market that day. (Writers are not allowed to close a position once they have been assigned, even if the broker has not yet informed them of the assignment.) As soon as any of your short options are assigned, that, of course, eliminates those positions.

Say a holder of five Altria Group (MO) June 25 calls decides to exercise them. The OCC informs Charles Schwab that it is being handed an assignment for the calls. You are among the clients at Schwab who are short the MO June 25 calls. As it happens, you have 1,000 shares of the stock and are short 10 calls. Schwab informs you that "you have been assigned on 5 MO Jun 25 calls," and you subsequently receive a trade confirmation that you sold 500 shares of MO at $25. You are left with 500 shares and five short calls—plus $12,500, less commission, added to your account.

- **Exercise:** The action that option holders take when they notify their brokers of their intent to invoke the right to buy (or sell) stock as stipulated in their option. When call holders exercise, they are purchasing the underlying stock at the designated strike price.
- **Settlement:** The process of delivering an underlying security (or other stipulated interest) as a result of an option exercise. Stock options always stipulate physical delivery of the underlying shares.
- **Assignment:** The action that the OCC and your broker take in selecting option sellers (writers) to fulfill the obligation stipulated by the option they sold. When call writers receive assignment notices from their brokers, they are selling the underlying stock at the designated strike price.

Since the OCC is the intermediary for all option transactions and assignments, it is able to keep track of how many contracts are outstanding at all times and determines at the end of each day how many are *open* (remain unclosed). The OCC publishes this number each day as the *open interest.*

- **Open interest:** The number of existing contracts that remain unclosed for a particular option. This figure is usually published each trading day by the OCC and is net of all trades that have occurred up to the close of the previous day. In conjunction with the daily volume of contracts traded, it provides an indication of the option's liquidity (how easily it can be traded).

Expiration is the grand finale of the option opera. Once trading stops at the end of the Friday before an expiration Saturday, the only other actions that can take place are exercise and assignment. By Monday morning, that option is history. You won't even see it among your account holdings anymore, although you will generally see the expiration on your activity screen. If you are short a particular option, however, you will receive notification from your broker confirming whether it expired or was assigned.

By the time expiring options stop trading on Friday afternoon, the ones that are in the money will generally be in the hands of market makers and other professionals, who will exercise them. Most speculators will have traded out and closed their positions. Regardless of who owns the options, however, you can expect them to be exercised. If they are in the money by more than $0.01, they will be exercised automatically (by OCC rules).

By the way, you *do* pay commissions on exercises and assignments, since they are essentially the equivalent of buy and sell orders.

Positions

The buyers of an option are considered *holders.* This is a virtual term only; there is nothing physical to hold. In fact, there are no certificates with options—everything is done by book entry. But since the buyers pay money, they are considered owners of the options. As with stock, when you buy an option, you create a *long* position in your account.

The option seller is also called the *writer.* Again, this is just a label, a holdover from the old days, when put and call contracts were actually written by people who owned stock and offered these options for sale. Writers receive money, and their position is considered *short.* The terms *buying* and *selling* are actions. The terms *long* and *short* describe positions, indicating whether you actually have possession of the asset or not.

As with stocks, you can initiate an option position by buying (going long) or selling (selling short) as your *opening transaction.* With covered writing, your opening transaction is to sell one or more call options short. Once you have become either a holder or a writer of an option, you can close your position anytime before expiration, as long as the option is trading, simply by executing an *offsetting,* or *closing,* transaction at the prevailing market price. The only catch is that you must accept the market price for the option in effect at the time. To close a short position in a call option on XYZ stock, for example, you would simply buy a call on XYZ with the same strike and expiration. When you close your option position, you wipe the slate

clean, completely eliminating any further rights or obligations from prior contracts.

Since you can initiate an option position by either buying or selling, four scenarios are possible when you enter any option order. You may:

1. Buy to open (if you are simply buying a put or call).
2. Buy to close (if you are already short an option and are closing out).
3. Sell to open (if you are initiating a covered write).
4. Sell to close (if you had previously bought an option and are now closing).

It is standard practice throughout the industry to require you to indicate on every option order whether you are opening or closing. (You will also usually be asked whether an opening sale is *covered* or *naked;* for a discussion of these terms, see the next section.) This information does not affect your trade or the price in any way.

- **Holders:** Those who initiate a position by buying an option. They do not actually hold anything physical. What they hold is the right to buy or sell stock.
- **Writers:** Those who initiate a position by selling an option. Writers are obligated to fulfill the buyers' right to buy or sell stock. They do not actually write anything, though in the very early days of option contracts, it would generally have been the seller who would have written a contract and offered it for sale.
- **Long**: Term used to describe the position of an option holder.
- **Short:** Term used to describe the position of an option writer.

Covered versus Naked

When you write a call option, you are contractually obligated to deliver (sell) the underlying stock if assigned. If you own enough of the underlying stock to make good on this obligation, then your option is considered *covered.* It's like saying it is *secured* in the banking world. Since you own the underlying stock, writing a covered call option entails no additional risk: You can deliver the stock upon being assigned, regardless of the share price at the time. If, on the other hand, the stock is not in your account when you write the call, your option position is considered uncovered, or *naked.* An uncovered call option exposes you to a theoretically unlimited loss if the stock goes way up, because you will have to buy it to fulfill your obligation to the OCC and the option holder when the contract is exercised.

TABLE 1.3 Covered versus Naked Examples

Stock Position	Option Position	Status
Long 500 ABC	Short 5 ABC calls	Fully covered
Long 600 DEF	Short 4 DEF calls	Fully covered
Long 800 GHI	Short 10 GHI calls	8 calls covered; 2 calls naked
Long 0 JKL	Short 4 JKL calls	4 calls naked

The fact that one option contract represents 100 shares of stock means that you must remember this *multiplier* (100) when figuring how many contracts to buy or sell. To sell (write) options on more than 100 shares, you would simply sell multiple option contracts. For 300 shares, you could sell up to three contracts. For 1,000 shares, you could sell up to 10 contracts, and so on. There are no fractional option contracts, and thus no way to buy or sell a listed option for fewer than 100 shares. (Occasionally, however, some options that have been adjusted for splits may be for 150 shares, and that will be made known to you.) So if you happen to have an odd number of shares, such as 458, you will only be able to write covered calls against 400 shares.

You can certainly have *more* than the required amount of shares in your account than you need to deliver if your calls are assigned. Say you own 1,000 shares of DEF and sell six DEF calls. You would at most have to deliver 600 shares if assigned, so you're completely covered. But if you have 1,000 shares and sell 12 calls, then two of those calls are naked. See Table 1.3 for examples.

How Options Are Traded

While customized, over-the-counter options do exist, they are entirely the province of institutions. This book discusses only the standardized options that are listed on one or more U.S. exchanges. As listed securities, options are subject to many of the rules associated with listed stocks, but there are differences worth noting.

The Exchanges

Today, options trade on as many as a dozen different exchanges, some of which are electronic. There are two types of trading systems employed by

the stock and option exchanges: the *specialist system* and the *market-maker system.* In the specialist system, a single person (actually a single firm) facilitates the market. When there are no external buyers or sellers, the specialist is responsible for providing both a bid and an offer from his or her own account, at which the public can transact. In the market-maker system, several competing market makers perform the same function. Stocks on the NYSE and American Exchange trade under a specialist system, while those on the NASDAQ exchange trade through remotely located market makers who are connected electronically. Options on the Amex or Philadelphia exchanges trade by specialist, whereas the Chicago Board Options Exchange (CBOE) uses an exchange-based market-maker system. At the CBOE, the order book is handled by an exchange employee called an *order book official* (OBO). If there is a discrepancy on a CBOE option trade, your broker will contact the OBO to resolve it.

For the most part, a covered call writer does not need to be overly concerned with the type of trading systems on the various exchanges. In almost all instances, it will be invisible to you. But there are slight differences that may become apparent if you are dealing with a fast-moving or relatively illiquid option. The biggest issue is that in a market-maker system, if you place a *limit order*—one specifying a price that must be met or bettered for execution to occur—the option can trade at your price without your order being filled if the trade is between market makers. This means that even if you see the option trade at your price after you have placed your order, it may not necessarily have been filled. If the option passes your price, then your order should be filled unless the print is from an earlier transaction out of sequence.

Options can trade on multiple exchanges and through multiple market makers. When you see an online quote, you are generally (though not always) looking at a *composite quote,* meaning the best bid and best offer from all available sources. However, when you enter an order, you do not know which exchange your brokerage firm's computer will direct it to or that it will always be to the exchange with the best price at the time. To illustrate, consider the following hypothetical scenario for quotes on a particular option.

Source	Bid	Offer
A	1.10	1.30
B	1.05	1.25
C	1.05	1.20
D	1.10	1.25

A composite quote for this option would show a bid of 1.10 and an offer of 1.20. A market order to buy *should* return an execution at 1.20. But if your order is routed to sources A, B, or D, you might get executed at 1.25 or 1.30. If you placed a limit order to buy at 1.20, that order should be executed immediately, but if your order doesn't go to source C, then it might not.

Sometimes, your quote source may be showing only one market's quote, not the composite quote. And you may be viewing quotes and trades that are delayed 20 minutes rather than in real time. All option exchanges have a procedure at the beginning of the day called the *opening rotation.* This was devised to help provide orderly markets in all of the options on a particular stock at the beginning of a trading session and to insure that all options open at a single price. (Listed stocks all open at a single price, though futures actually open in a range of prices.) The process operates in accordance with the following rules:

- Trading in the underlying stock must begin before any options on the stock can be traded. Thus, when a stock has a delayed opening or is halted during the day, option trading is suspended as well.
- Trading in each option on a given stock opens in an established order, with the farthest expiration months and lower strike prices opening first and the nearest expiration month and higher strike prices opening last.
- Once an opening trade (or quote) is established, no additional trades in that option can take place until trading on all other options on the same underlying security has opened.
- To be eligible as the opening transaction on any option, an order must be placed before the opening rotation.
- Public orders are given priority over those of market makers.

The rotation process is an efficient, orderly way of opening the markets on listed options, but it is not perfect. Even with the help of computers, it cannot be instantaneous, and orders received during the rotation cannot be processed until after the entire process is complete.

Liquidity

Liquidity refers to the trading activity in a listed security, and it is of greater concern in dealing with options than with stocks. There is no hard number that distinguishes liquid options from illiquid ones, but if an option trades thousands of contracts per day, it is considered quite liquid; if it trades only a few or none at all, it is considered illiquid.

The important issue is whether there is enough activity to get a fair execution. The less liquid the option, generally the wider the spread and the more you will pay for a purchase (or the less you will receive from a sale) if you use market orders. If less than a few hundred contracts of a particular option trade on an average day, the spread between the bid and the offer will probably be very wide, a consideration in deciding whether to initiate a position in that option.

Along with average daily trading volume, you should also check the open interest when evaluating an option to sell. Open interest tells you how many outstanding contracts exist for any option, as of the previous night's close. It's helpful to see an open interest of more than 1,000 options, although here, too, there is no magic number. If a stock has moved recently, you could be looking at a newly issued strike price that has almost no open interest at all yet. That does not mean you should necessarily avoid the option. It just tells you that it may be a bit more difficult to get it at the price you are interested in.

The option exchanges now post *size* with each option quote, indicating how many option contracts can be executed at the stated bid or offer, and you can see this if your quote service provides it. For instance, if you see that 30 contracts of a particular call option are bid for at a particular price, you know that you can sell up to 30 at that price—regardless of volume or open interest considerations. It may be possible to sell *more* than 30, but you know you can sell at least 30. This figure is now available because of the electronic execution capabilities of the options market. When specialists or market makers place their markets in the electronic system, they must state how many contracts they are "good for" at the stated bid and ask prices. Consequently, size is now available to individuals, much as it has been for professional traders for a number of years.

Options in Your Account

Industry regulations require that brokerage firms preapprove all customers who wish to buy or sell options. There are no exceptions to this process, and you cannot buy or sell a single option until you are approved. Even if you are just going to write covered calls, which does not entail nearly the same risk as buying options or selling naked options, you will still have to be approved by your firm. It will require you to fill out and sign an Option Agreement, separate from your new account form, and provide you with a copy of the booklet, *Characteristics and Risks of Standardized Options,* also referred to as the options disclosure document. You can trade options in multiple accounts,

but you must be approved in each account. If you have a joint account with someone else, that person will also need to sign the Option Agreement.

The Internal Revenue Service does not forbid Individual Retirement Accounts (IRAs) and other qualified retirement accounts such as defined benefit or profit-sharing plans from using options. However, different brokers have set up their own rules and some will permit it while others will not. At most, such accounts will be permitted to buy puts or calls, sell covered calls, and buy or sell spreads. Other strategies that may involve margin, such as put writing or ratio spreads, would not be possible, since retirement accounts cannot be set up as margin accounts. As with regular accounts, an Option Agreement is required.

When you fill out an Option Agreement, you are required to indicate which strategies you intend to use, and you will be approved for specific strategies only. Some firms combine the various strategies into two or three general risk categories and approve you for one of them. Covered call writing will always be in the lowest risk category. However, it may be lumped together with a strategy like option buying, which carries much more risk but still not as much as strategies such as writing naked calls.

To initiate a naked option position, you must not only acquire preapproval but also secure the position with a hefty amount of cash or margin. If you are approved for covered writing but not naked writing, then you must always have or purchase the stock before selling calls against it. If you want to sell the call first and try to buy the stock at a lower price sometime later, your broker will not let you unless you are approved to sell naked options (which is not a recommended practice, anyway).