LONG-TERM EQUITY ANTICIPATION SECURITIES®

LEAPS®

September 2000

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This publication discusses exchange-traded options issued by The Options Clearing Corporation. No statement in this publication is to be construed as a recommendation to purchase or sell a security, or to provide investment advice. Options involve risks and are not for all investors. Prior to buying or selling an option, a person must receive a copy of *Characteristics and Risks of Standardized Options.* Copies of this document may be obtained from your broker or from any of the exchanges listed on pages 21-22. A prospectus, which discusses the role of The Options Clearing Corporation, is also available without charge upon request addressed to The Options Clearing Corporation, 440 South LaSalle Street, Suite 908, Chicago, IL 60605, or to any exchange on which options are traded.

September 2000

Introduction

Options

Options are flexible financial tools that assist investors in managing investment portfolios. Options can protect stock holdings from a decline in market price, increase income from current stock holdings and position an investor to buy (sell) stock at a lower (higher) price. Investors can also utilize options to position themselves for large market moves and benefit from a stock price's rise or fall without incurring the cost of buying or selling the stock outright.

A listed option is a standardized contract granting the buyer (holder) the right, but not the obligation, to buy, in the case of a call, or to sell, in the case of a put, a specified amount of the underlying asset at a predetermined price on or before a given date. The seller (writer) of an option is obligated to sell, in the case of a call, or buy, in the case of a put, a specified amount of the underlying asset at a predetermined price upon the holder's exercise.

LEAPS®

Long-Term Equity AnticiPation Securities® (LEAPS®) are simply long-term options. There are two types of LEAPS®, Equity LEAPS® and Index LEAPS®. In general, this booklet focuses on Equity LEAPS®, although Index LEAPS® will be discussed on pages 11-13.

Equity LEAPS® grant the holder, in exchange for the payment of a premium, the right to buy, in the case of a call, or sell, in the case of a put, shares of a stock at a predetermined price on or before a given date. At the date of this booklet, Equity LEAPS® are American-style options, and therefore may be exercised and settled in stock prior to the expiration date. At the date of this booklet, the expiration date for Equity LEAPS® is the Saturday following the third Friday of the expiration month. However, other expiration dates or

exercise styles for Equity LEAPS® may be introduced in the future.

Prior to the expiration of the option, the holder of an Equity LEAPS® call has the right upon exercise to purchase, and the writer has the obligation upon assignment to sell, the underlying stock at a given strike price. The holder of a LEAPS® put has the right upon exercise to sell, and the writer has the obligation upon assignment to purchase, the underlying stock at a given strike price prior to the expiration of the option. The strike or exercise price is the stated price per share for which the underlying stock may be purchased, in the case of a call, or sold, in the case of a put, by the option holder upon exercise of the option contract.

LEAPS® currently are listed on The American Stock Exchange, the Chicago Board Options Exchange, the International Securities Exchange, the Pacific Exchange and the Philadelphia Stock Exchange. LEAPS® are issued and cleared by The Options Clearing Corporation (OCC). OCC's ability to meet its obligations arising from the option contracts it issues has been assigned a 'AAA' rating from Standard & Poor's Corporation.

Benefits and Risks to Investors

■ LEAPS® offer investors an alternative to stock ownership. LEAPS® calls may allow investors to benefit from the appreciation of equities while placing substantially less capital at risk than is required to purchase stock. Should a stock appreciate to a level above the exercise price of the LEAPS®, the LEAPS® call holder may exercise the option and purchase shares at a price below the current market price or the same investor may sell the LEAPS® calls in the open market for a profit (provided the sale price including transaction costs and commissions exceeds the total price paid).

■ Investors can utilize LEAPS® calls to diversify their portfolios. Historically, the stock market has provided investors significant and positive returns over the long term. Few investors purchase shares in each company they follow. A buyer of a LEAPS® call has the right to purchase shares of stock at a specified date and price up to three years in the future. Thus, an investor who makes decisions for the long term can benefit from buying LEAPS® calls.

■ LEAPS® puts provide investors with a means to hedge current stock holdings. Investors should consider purchasing LEAPS® puts if they are concerned with the downside risk of a particular stock that they own. A purchase of a LEAPS® put gives the purchaser or holder the right to sell the underlying stock at the strike price up until the cutoff time for the submission of exercises notices prior to option expiration.

■ Like any option position, if you are a buyer of LEAPS® calls (bullish) or LEAPS® puts (bearish) the risk is limited to the premium paid for the position. If you are an uncovered seller of LEAPS® calls (bearish), there is unlimited risk, or a seller of LEAPS® puts (bullish), significant risk. Risk varies depending upon the strategy followed, and it is important for an investor to understand fully the risk of each strategy he or she might utilize. In addition, there are a number of differences between an investment in common stock and an investment in options that are important to understand. Unlike common stock, an option has a limited life. Common stock can be held indefinitely in the hope that its value may increase, while every option has an expiration date. If an option is not closed out or exercised prior to its expiration date, it ceases to exist as a financial instrument. For this reason, an option is considered a "wasting asset." As a result, even if an investor correctly picks the direction that the value of an underlying interest will move, unless the investor also correctly selects the time frame

within which that movement will take place, the investor will not profit as desired. Finally, investors run the risk of losing their entire investment in a relatively short period of time and with relatively small movements of the underlying interests. Unlike a purchase of common stock for cash, the purchase of an option involves "leverage," whereby the value of the option contract generally will fluctuate by a greater percentage than the value of the underlying interest. An investor should be fully aware of these and other risks involved in options and refer to *Characteristics and Risks of Standardized Options* before entering into any options transaction.

Buying and Selling LEAPS®

Equity LEAPS® trade in units known as contracts, each of which generally represents 100 shares of underlying stock. For example, an investor could purchase five LEAPS® calls representing 500 shares of stock ZYX. Assume these contracts expire in three years and are not subject to an adjustment (e.g., stock splits, stock dividends and special cash distributions). When the price of the underlying stock rises, the LEAPS® calls will generally, but not necessarily, increase in value. If the price of ZYX increases and exceeds the LEAPS® strike price, the investor has two alternatives. The investor can exercise all or some of the call contracts resulting in the purchase of shares of ZYX at the strike price or sell the call contracts in the market resulting in a cash transaction. Importantly, as with all American-style options, the investor can exercise or sell the call contracts prior to expiration.

Strategies

The following strategies demonstrate uses of LEAPS®. For purposes of illustration, dividends, commission and transaction costs, tax considerations and margin requirements have been omitted from the following examples. However, these factors affect a strategy's potential return. Therefore, an investor should consult with a broker and a tax advisor before entering into any options transaction. The numbers included in the following examples are hypothetical and for illustration purposes only.

Buy LEAPS® Calls

An investor anticipates that the price of ZYX stock will rise during the next two years. This investor would like to profit from the increase without having to purchase shares of ZYX.

ZYX is currently trading at $50.50 and a ZYX LEAPS® call option, with a two-year expiration and a strike price of 50, is trading for a premium of $8.50 or $850 per contract. The investor buys five contracts for a total cost of $4,250, which represents the total risk of the call position. The calls give the investor the right to buy 500 shares of ZYX between now and expiration at $50 per share regardless of how high the price of the stock rises. To be profitable, though, at expiration, the stock must be trading for more than $58.50, the total of the option premium ($8.50) and the strike price of 50. The buyer's maximum loss from this strategy is equal to the total cost of the options or $4,250. The break-even point for this strategy is $58.50. The following are possible outcomes of this strategy at expiration.

Stock above the break-even point

If ZYX advances to 65 at expiration, the LEAPS® will have a value of approximately 15 (the stock price of 65 less the strike price of 50). The investor may choose to exercise the calls and take delivery of

the stock at a price of 50, or may sell the LEAPS® calls for a profit.

Stock below the strike price

If ZYX, at expiration, is trading for less than the strike price, or below 50 in this example, the unexercised calls will expire worthless. In this case, the investor will incur the maximum loss of $4,250.

Stock between the strike price and the break-even point

If ZYX, at expiration, has risen to 56, the calls will be valued at approximately 6 (the stock price of 56 less the strike price of 50) and will represent a partial loss given the break-even point of $58.50. The calls purchased by the investor for $8.50 will, upon exercise, then be worth approximately 6, creating a loss of 2.5 points or $250 per contract. If the investor does not exercise or sell these options, the investor will lose all of the initial investment, or $850 per contract.

Prior to expiration, the LEAPS® may trade at a price that is somewhat higher than the difference between the 50 strike price and the actual stock price. This difference is due to the remaining time value of the contract and the possibility that the stock price may increase by expiration. Time value is one of the components of an option premium and generally decreases as expiration approaches.

Buy LEAPS® Puts

The purchase of LEAPS® puts to hedge a stock position may provide investors protection against declines in stock prices. This strategy is often compared to purchasing insurance on one's home or car, and may give investors the confidence to remain in the market. The amount of protection provided by the put and the cost of the protection, sometimes evaluated as a percentage of the stock's cost, should be considered.

For example, ZYX is trading at 45 and a ZYX LEAPS® put with a three-year expiration and a

strike price of 42 is selling for $3.50 or $350 per contract. These puts provide protection against any price decline below the break-even point, which for this strategy is $38.50 (strike price less the premium). The investor's risk or maximum loss is limited to the total amount paid for the put options or $350 per contract. The following are possible outcomes of this strategy at expiration.

Stock above the break-even point

If ZYX is trading at 48 at expiration, the unexercised put would generally expire worthless, representing a loss of the option premium or $350 per contract.

Stock below the strike price

The put would be profitable if the stock closed below $38.50 at expiration. If ZYX is trading at $37.50 at expiration, the 42 put, upon exercise, would have a value of 4.5 or $450, representing a profit of 1 point or $100 per contract. This profit will partially offset the decline in the value of the stock.

Stock between the strike price and the break-even point

If ZYX is trading at $41.50 at expiration, the 42 put would be valued at approximately .50. This means that, upon exercise, a portion of the option premium would be retained and the loss would then be 3 points or $300 per contract. If the contract is not exercised or sold, the investor will lose all of the initial investment, or $350 per contract.

Sell LEAPS® Covered Calls

The covered call, which is selling (writing) a call against stock, is a widely used conservative options strategy. This strategy is utilized to increase the return on the underlying stock and to provide a limited amount of downside protection.

The maximum profit from an out-of-the-money covered call is realized when the stock price, at expiration, is at or above the strike price. The profit is equal to the appreciation in the stock price

(the difference between the stock's original purchase price and the strike price of the call) plus the premium received from selling the call.

Investors should be aware of the risks involved in a covered call strategy. Call writers cannot realize additional appreciation in the stock above the strike price since they are obligated, upon assignment, to sell the stock at the call's strike price. The downside protection for the stock provided by the sale of a call is equal to the premium received in selling the option. The covered call writer's position will begin to suffer a loss if the stock price declines by an amount greater than the call premium received.

The following example illustrates a covered call strategy utilizing an out-of-the-money LEAPS® call. ZYX is currently trading at $39.50, and a ZYX LEAPS® call option with a two-year expiration and a strike price of 45 is trading at $3.25.

An investor owns 500 shares ZYX at $39.50 per share and sells five ZYX LEAPS® calls with a strike price of 45 at $3.25 each or a total of $1,625. The investor's objective is to obtain profits without selling the stock. The break-even point for this covered call strategy is $36.25 (the stock price of 39.50 less the premium received of $3.25). This represents downside protection of 3.25 points. A loss will be incurred if ZYX declines to below $36.25. Possible outcomes of this strategy at expiration are as follows.

Stock above the strike price

If ZYX advances to 50 at expiration, the covered call writer, upon assignment, will obtain a net profit of $875 per contract (the exercise price of 45 less the price of the stock when the option was sold plus the option premium received of 3.25 X 100).

Stock below the break-even point

If ZYX is trading at 34 at expiration, the unexercised LEAPS® calls would generally expire worthless and the unassigned covered call writer would have a theoretical loss of $1,125 (a present

theoretical loss of $2,750 on the stock position less the $1,625 premium received). This investor will incur additional losses in his/her stock position if ZYX continues to decline in value.

Stock between the strike price and the break-even point

If ZYX advances to 40 at expiration, the LEAPS® calls will be out-of-the-money. Therefore, the call writer will generally not be assigned and will retain the 500 shares of ZYX and the option premium of $3.25 per share.

Index LEAPS®

Index LEAPS® are long-term index options based either on a fractional value of one-tenth of the value of the underlying index or on the full value of the underlying index. Unlike Equity LEAPS®, Index LEAPS® are cash-settled based on the difference between the exercise settlement value of the index on the exercise date and the exercise price of the option. Index LEAPS® are either European-style options or American-style options. European-style options may be exercised only during a specified period of time immediately prior to expiration, whereas American-style options may be exercised at any time between the date of purchase and the expiration date. Like other options, Index LEAPS® can be sold in the open market as an alternative to being exercised.

Index LEAPS® based on one-tenth the value of the underlying index offers investors the ability to control their market exposure in finer increments since this type of Index LEAPS® represents options with substantially smaller underlying values than full-size options. For example, if the XYY Index's value is 290, representing an underlying value of $29,000 (290 X 100), the one-tenth value XYY

Index LEAPS® would be based on an underlying index value of 29, representing an underlying value of $2,900 (29 X 100). Investors can utilize Index LEAPS® to tailor their positions in the market to reflect their market expectations and investment philosophies.

Index LEAPS® Strategy

An XYY Index LEAPS® put with a two-year expiration, a strike price of 30 and an underlying value equal to one-tenth of the index value is trading at $3.50. An investor, concerned about a possible market decline during the next two years, decides to buy Index LEAPS® puts to benefit from the potential decline. The investor purchases ten of the XYY Index LEAPS® puts for $3,500 (3.50 X 100 X 10). The puts will become profitable when the XYY Index drops below the break-even point of $26.50 (the strike price less the cost of the puts or 30 - $3.50). The investor's risk or maximum loss from this strategy is equal to the total cost of the options or $3,500. The following are possible outcomes of this strategy at expiration.

Index above the strike price

If the XYY Index increases in value to 35 at expiration, the Index LEAPS® puts would generally expire worthless and the unexercised put holder would incur a maximum loss equal to the total premium paid for the puts or $3,500.

Index below the break-even point

If the XYY Index declines in value to 24 at expiration and the put holder exercises the puts, the holder will receive $600 (the strike price less the current XYY Index value X 100) per contract. The put holder would realize a profit of $250 (6 less the $3.50 premium paid X 100) per contract or a total profit of $2,500 ($2.50 X 100 X 10).

Index between the strike price and the break-even point

If the XYY Index is valued at 28 at expiration, the holder may choose to exercise the puts and receive $200 (the strike price less the current value of the XYY Index X 100) per contract or $2,000. However, this amount is less than the amount originally paid for the puts. Therefore, the investor's total loss is equal to $1,500 ($3,500 - $2,000). If the holder does not exercise or sell the put, the holder will lose the initial investment, or $3,500.

Contract Specifications

Equity LEAPS®

Unit of Trade: Generally 100 shares of stock per unadjusted contract.

Premium (Price) Quotations: Stated in points and fractions; one point equals $100. The minimum price variation (MPV) for series trading below 3 is .05 and for all other series is .10 per contract.

Note: The securities industry is converting from quoting options premiums in fractions to decimals. Options premiums will be quoted in different minimum price variations (e.g., $.01, $.05, $.10) which will be published by each options exchange. Readers are encouraged to contact the listing exchange(s) to determine the minimum price variation for a particular series of options (p. 21).

Exercise: As of the date of this booklet, Equity LEAPS® are American-style options. The option may be exercised prior to the expiration date.

Exercise Settlement: As of the date of this booklet, a holder that tenders an exercise notice on any business day will receive delivery of the underlying

stock on the third business day following the date of exercise. The exercise settlement price equals the strike price multiplied by 100 (multiplier).

Expiration Cycle: Equity LEAPS® expire in January of each year.

Expiration Date: As of the date of this booklet, expiration occurs on the Saturday following the third Friday of the expiration month.

Position Limits: LEAPS® positions are aggregated with other options with the same underlying asset. Limits vary according to the number of outstanding shares and trading volume. Hedge exemptions may be available. Contact exchanges for details.

Trading System: Market Maker/Designated Primary Market Maker/Lead Market Maker/Specialist/Registered Option Trader (depending on the exchange).

Trading Hours: 8:30 A.M. to 3:10 P.M. (Central Time)
9:30 A.M. to 4:10 P.M. (Eastern Time)

INDEX LEAPS®

Index Value: $100 multiplied by the value of the underlying index or by a fraction, usually one-tenth, of the value of the underlying index.

Premium (Price) Quotations: Stated in points and fractions; one point equals $100. The minimum price variation (MPV) for series trading below 3 is .05 and for all other series is .10 per contract.

Note: The securities industry is converting from quoting options premiums in fractions to decimals. Options premiums will be quoted in different minimum price variations (e.g., $.01, $.05, $.10) which will be published by each options exchange. Readers are encouraged to contact the listing exchange(s) to determine the minimum price variation for a particular series of options (p. 21).

Exercise: Each Index LEAPS® is designated as either American-style or European-style. American-style options may be exercised on any business day prior to expiration. European-style options may be exercised only during a specified period of time immediately prior to the expiration date.

Exercise Settlement: Settlement generally occurs the next business day following the exercise. Index LEAPS® are cash settled based on the difference between the exercise settlement value of the index on the exercise date and the exercise price of the option.

Expiration Cycle: Index LEAPS® expire in January, June or December of each year.

Expiration Date: As of the date of this booklet, expiration occurs on the Saturday following the third Friday of the expiration month. Index LEAPS® with A.M. settlements cease trading on the Thursday prior to the Friday before expiration (sometimes referred to as “Expiration Friday”).

Position Limits: All Index LEAPS® must be aggregated. Hedge exemptions may be available. Contact exchanges for details.

Trading System: Market Maker/Designated Primary Market Maker/Lead Market Maker/Specialist/Registered Option Trader (depending on the exchange).

Trading Hours: 8:30 A.M. to 3:15 P.M. (Central Time), 9:30 A.M. to 4:15 P.M. (Eastern Time) for Broad-Based Indexes, 8:30 A.M. to 3:10 P.M. (Central Time), 9:30 A.M. to 4:10 P.M. (Eastern Time) for Narrow-Based Indexes.

Glossary

American-style option: An option contract that may be exercised at any time between the date of purchase and the expiration date. Most exchange-traded options are American-style.

Assignment: The receipt of an exercise notice by an option writer (seller) that obligates the writer to sell (in the case of a call) or purchase (in the case of a put) the underlying security at the specified strike price.

At-the-money: An option is at-the-money if the strike price of the option is equal to the market price of the underlying security.

Call: An option contract that gives the holder the right to buy the underlying security at a specified price for a certain, fixed period of time.

Class of options: Option contracts of the same type (call or put) and style (American or European) that cover the same underlying security.

Closing purchase: A transaction in which the purchaser's intention is to reduce or eliminate a short position in a given series of options.

Closing sale: A transaction in which the seller's intention is to reduce or eliminate a long position in a given series of options.

Covered call option writing: A strategy in which one sells call options while simultaneously owning an equivalent position in the underlying security.

Covered put option writing: A strategy in which one sells put options and simultaneously is short an equivalent position in the underlying security.

Derivative security: A financial security whose value is derived in part from the value and characteristics of another security, the underlying security.

Equity options: Options on shares of equity securities.

European-style option: An option contract that may be exercised only during a specified period of time just prior to its expiration.

Exercise: To implement the right under which the holder of an option is entitled to buy (in the case of a call) or sell (in the case of a put) the underlying security.

Exercise price: See Strike price.

Exercise settlement amount: The difference between the exercise price of the option and the exercise settlement value of the index on the day an exercise notice is tendered, multiplied by the index multiplier.

Expiration cycle: An expiration cycle relates to the dates on which options on a particular underlying security expire.

Expiration date: The last day in which holders of options must indicate their desire to exercise, if they wish to do so.

Hedge: A conservative strategy used to limit investment loss by effecting a transaction which offsets an existing position.

Holder: The purchaser of an option.

In-the-money: A call option is in-the-money if the strike price is less than the market price of the underlying security. A put option is in-the-money if the strike price is greater than the market price of the underlying security.

Intrinsic value: The amount by which an option is in-the-money (see above definition).

LEAPS®: Long-Term Equity AnticiPation Securities® or LEAPS®, are long-term stock or index options. LEAPS®, like all options, are available in two types, calls and puts, with expiration dates of up to three years in the future.

Long position: A position wherein an investor's interest in a particular series of options is as a net holder (i.e., the number of contracts bought exceeds the number of contracts sold).

Margin requirement (for options): The amount an uncovered (naked) option writer is required to deposit and maintain to cover a position. The margin requirement is calculated daily.

Naked writer: See Uncovered call writing and Uncovered put writing.

Opening purchase: A transaction in which the purchaser's intention is to create or increase a long position in a given series of options.

Opening sale: A transaction in which the seller's intention is to create or increase a short position in a given series of options.

Open interest: The number of outstanding option contracts in the exchange market or in a particular class or series.

Out-of-the-money: A call option is out-of-the money if the strike price is greater than the market price of the underlying security. A put option is out-of-the-money if the strike price is less than the market price of the underlying security.

Premium: The price of an option contract, determined in the competitive marketplace, which the

buyer of the option pays to the option writer for the rights conveyed by the option contract.

Put: An option contract that gives the holder the right to sell the underlying security at a specified price for a certain, fixed period of time.

Secondary Market: A market that provides for the purchase or sale of previously sold or bought options through closing transactions.

Series: All option contracts of the same class that also have the same unit of trade, expiration date and strike price.

Short position: A position wherein an investor's interest in a particular series of options is as a net writer or seller (i.e., the number of contracts sold exceeds the number of contracts bought).

Strike Price: The stated price per share for which the underlying security may be purchased (in the case of a call) or sold (in the case of a put) by the option holder upon exercise of the option contract.

Time Value: The portion of the premium that is attributable to the amount of time remaining until the expiration of the option contract. Time value is whatever value the option has in addition to its intrinsic value.

Type: The classification of an option contract as either a put or a call.

Uncovered call option writing: A short call option position in which the writer does not own an equivalent position in the underlying security represented by his/her option contracts.

Uncovered put option writing: A short put option position in which the writer does not have a corresponding short position in the underlying

security or has not deposited, in a cash account, cash or cash equivalents equal to the exercise value of the put.

Underlying security: The security subject to being purchased or sold upon exercise of the option contract.

Volatility: A measure of the fluctuation in the market price of the underlying security. Mathematically, volatility is the annualized standard deviation of returns.

Writer: The seller of an option contract.

For More Information

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Notes

Notes

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