



ASX

AUSTRALIAN SECURITIES EXCHANGE

# LEPOs

## Low Exercise Price Options Explanatory Booklet



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# LEPOs key features

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<b>Name</b>	LEPO – Low Exercise Price Option.
<b>Description</b>	A LEPO is like a forward purchase of shares for the buyer and a forward sale of shares for the seller. Note that the buyer of a LEPO does not obtain voting rights or dividends until the shares are acquired on exercise. LEPOs are also available on selected indexes.
<b>Characteristics</b>	<ul style="list-style-type: none"><li>• Margins paid</li><li>• Relatively high premium</li><li>• A low exercise price</li><li>• Relatively low outlay</li><li>• Ongoing margins are payable.</li></ul>
<b>Underlying shares</b>	A complete list is available on our website <a href="http://www.asx.com.au/options">www.asx.com.au/options</a>
<b>Contract size</b>	100 shares per contract, subject to usual adjustment for rights, bonus issues and other capital adjustment events or \$10 times the underlying trade.
<b>Contract months</b>	Same expiry months as Exchange Traded Options
<b>Benefits</b>	<ul style="list-style-type: none"><li>• Leverage</li><li>• Cash efficient</li><li>• No risk of early exercise</li><li>• Physical delivery of shares on exercise</li><li>• Good proxy for share trading</li><li>• Ease of account opening</li><li>• Availability of offsets on some margins</li><li>• Ability to lodge non-cash collateral.</li></ul>
<b>Suitable for</b>	Experienced investors who understand and accept the risks associated with leverage and derivatives.
<b>Risks</b>	<ul style="list-style-type: none"><li>• Leverage</li><li>• Margin calls</li></ul>

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# Introduction

LEPOs are Low Exercise Price Options. This booklet outlines their main characteristics and the key factors that make them a useful addition to a well balanced investment portfolio.

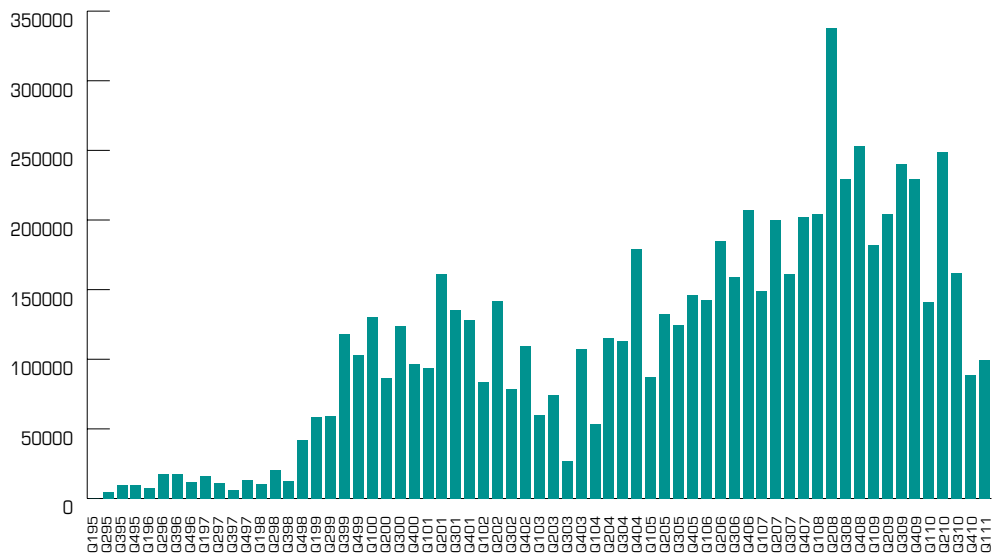
Information in this booklet is designed for people who want an overview of how LEPOs work. Information and booklets on other equity derivative products can be obtained from ASX. Details are listed at the back of this booklet.

The LEPO market has gained in popularity since its introduction in April 1995. The chart below demonstrates the number of contracts traded each quarter since inception.

LEPOs are a more sophisticated style of option which may suit investors with broader risk profiles. If you are familiar with the booklet *Understanding Options Trading*, you will notice that this booklet builds on several of the concepts introduced in that publication. Before trading LEPOs we recommend that you discuss them with a sharebroker who is authorised to give advice on equities and equity derivatives.

As with any financial instrument there is a degree of jargon that needs to be understood. Any new term will be defined as it is encountered but to assist in your understanding you may wish to refer to the *Glossary of Terms*.

## LEPO Volume



# What is a LEPO?

LEPO stands for Low Exercise Price Option. A LEPO is by definition a European call option with a 1 cent strike price\*.

A LEPO is like a forward purchase of shares for the buyer and a forward sale of shares for the seller. As delivery and payment are deferred the LEPO investor is required to pay margins\*\* to take into consideration any change in price over time.

## Buying a LEPO

LEPOs are options to buy shares. When you buy a LEPO you obtain the right to buy:

- an agreed number of shares (1 contract usually equals 100 shares)
- at a specified future date
- in return for the payment of a premium and exercise price.

## 1 contract usually refers to 100 shares

The main difference between a LEPO and a standard exchange traded option is that with a LEPO you don't pay the full amount of the premium upfront. Rather, with a LEPO you pay a margin during the life of the LEPO and pay the balance of the premium if and when you exercise your LEPO. The exercise price is usually 1 cent per share or \$10 per contract. As with other options, you do not have to exercise your right to buy the shares.

Because a LEPO is so deep in the money, purchasing a LEPO gives similar exposure to a stock purchase. The advantage of a LEPO over a stock purchase is that you only pay a margin upfront rather than the full stock value.

It is important to note that the buyer of a LEPO is not obliged to exercise the option. The LEPO trader can elect to close out at any time prior to expiry by simply selling the same series as initially purchased, or buying the same series as initially sold.

## Selling a LEPO

When you sell a LEPO you commit to sell:

- an agreed number of shares to the buyer
- at a specified future date
- in return for receipt of the premium and exercise price.

As with other options, the seller of a LEPO is only required to deliver the underlying shares if the buyer exercises the option. Exercise can only occur at expiry.

There are several things that LEPOs are not. They are not the same as buying or selling shares. Although the exposure with LEPOs is similar to owning the shares, you don't receive dividends directly. The value of the dividend is factored into the LEPO price. This is advantageous for investors who are unable to use franking credits. The key differences between standard exchange traded options (ETOs) and LEPOs are summarised for you in the section *Differences between LEPOs and standard exchange traded options*.

LEPOs over the same underlying share are termed classes of LEPOs. For example all LEPOs listed over BHP Billiton Limited (BHP) shares, regardless of expiry date, form one class of LEPO.

## You pay an initial margin upfront and you pay daily margins during the life of the LEPO

\*Strike price may change as a result of adjustment for corporate actions.

\*\*All references to margin and collateral in this document reflect the practices of ASX Clearing Corporation in risk managing their Clearing Participants. Individual clients may be risk managed differently - in terms of, for example, the type and quantity of margin applied, the type of collateral accepted, and the interest paid on cash collateral by their ASX Clearing Participant or broker and should contact their ASX Clearing Participant or broker to establish their practices.

# Why trade LEPOs?

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LEPOs can offer the experienced investor:

- the benefits of leverage
- a cash efficient method of trading
- no risk of early exercise
- physical delivery of shares on exercise
- a good proxy for share trading
- ease of account opening
- the availability of offsets on margins
- the ability to lodge non-cash collateral.

These benefits are outlined for you in greater detail below.

## LEPOs provide a great way to leverage your share market position

### Leverage

LEPOs provide a great way to leverage your share-market position. For experienced investors, they provide a means of trading according to the investor's views about short-term movements in the underlying share price. LEPOs are leveraged because the investor only outlays a margin to a small proportion of the total share value. Movements in the share price lead to gains on the LEPO position which are credited to the investor's account or losses on the LEPO position which are debited from the investor's account, via the Mark to Market process, on a daily basis. The total profit or loss is only crystallised when the position is closed or exercised.

Because each LEPO corresponds to 100 shares, a 10 cent movement in the share price translates to a \$10 movement in the LEPO profit or loss. Leverage has the effect of increasing both the profit potential and the risk profile of an investor's portfolio.

### Cash efficient

LEPOs are cash efficient because of their leverage. Investors have a lower cash outlay for the same level of exposure to the market than with a direct investment in shares. Using a LEPO can be a cost-effective alternative to borrowing to fund a purchase of shares. If you were to borrow to buy LEPOs, various fees and charges may be payable if security is given to the lender.

Investors in LEPOs have a lower cash outlay for the same level of exposure to the market than with a direct investment in shares

### Good proxy for share trading

Movements in LEPO premiums closely match movements in the underlying shares. This makes LEPOs a good substitute for share trading as the price of LEPOs is adjusted for dividends. Refer to the section “*Investing in a LEPO*” – Examples, for examples comparing share and LEPO values.

### Physical delivery of shares

When LEPOs are exercised, settlement is by physical delivery of shares rather than cash settlement. This provides an advantage where an investor wishes to acquire or dispose of shares. Natural links with CHES mean that payment and delivery of shares following the exercise of a LEPO is as simple as a normal share transaction.

### No risk of early exercise

LEPOs provide a good complement to a share portfolio or a standard exchange traded options portfolio. Being European options, that is, only exercisable at expiry, they do not carry the risk of exercise before expiry. This can be helpful for traders who wish to lock in a sold position without the risk of early exercise. For example, holders of underlying shares may believe that the share value is likely to fall. By selling LEPOs they can make a profit if that view is correct, and can elect to close out the LEPO position at any time before expiry. With an American option, which is exercisable at any time prior to expiry, once the buyer exercises the option, it is too late for the seller to close out the position.

**LEPOs are European style exercise. That is, you can only exercise at expiry**

### Ease of account opening

Account opening procedures are straightforward and do not involve lodgement of a large sum of money for investors. Access to the LEPO market is readily available. If you already have an exchange traded option account, you can use it for LEPOs as well, provided you complete the necessary documentation (see your broker).

### Offsets on margins for other option positions held

Participants can reduce their initial outlay to the extent that they have offsetting positions for options, whether the offsetting positions are in LEPOs or in ETOs. Only risk margins can be offset, mark to market margins cannot be offset. For an explanation of risk margins and mark to market margins see the publication “Margins” which can be viewed on the ASX website at [www.asx.com.au/understandingmargins](http://www.asx.com.au/understandingmargins).

### Ability to lodge non-cash collateral against margins

ASX Clearing Participants can lodge selected stocks or bank guarantees (limited to A1+ providers) with ASX Clear instead of cash to satisfy their risk margin obligations. Details are listed in the brochures and web publications page. A current list of eligible brochures can be found at [www.asx.com.au/brochures](http://www.asx.com.au/brochures). Mark to market margins are payable in cash only, in order to permit daily debits/credits where required to investors during the life of the LEPO.

### Which shares have LEPOs?

A complete list is available from the ASX website [www.asx.com.au/options](http://www.asx.com.au/options)

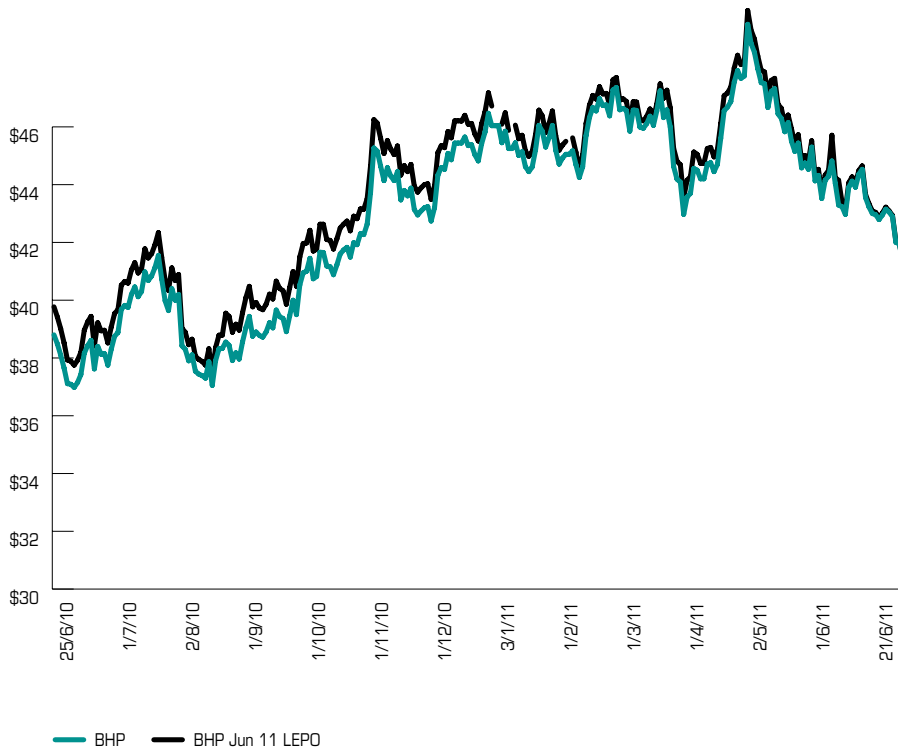


# Investing in a LEPO – examples

## BHP Share Price v BHP LEPO Price

The chart below compares the actual prices of BHP shares and the March BHP LEPO premium between November and March. The examples that follow compare trading shares with buying and selling LEPOS. In Example 1 the share and LEPO premium rise over the period, in Example 2 they fall.

Note: The examples in this booklet are based on historical information and should not be relied upon as a representation as to the future performance of either the companies concerned, or LEPOs over shares in those companies.



# Example 1

## Comparison of a purchase of 100 BHP shares with the purchase of May BHP LEPO

Example 1 compares the purchase of 100 BHP shares and the purchase of 1 LEPO when the market rises as expected. Investing in the shares would have returned \$755 or around 18%, while investing in the LEPO would have returned \$842 or around 223%. The lower initial outlay results in leveraged returns on the LEPO. Transaction costs such as brokerage are also likely to be lower on the LEPO trade.

DATE	BUYING 100 SHARES PURCHASE PRICE = \$41.65	BUYING A LEPO PREMIUM = \$4,178 per contract or \$46.78 per share		
14-Apr	Buy 100 BHP @ \$41.65 = \$4,165	Total Initial Outlay = Risk Margin = 9% x \$4,178	\$376	pay
21-Apr	Share Price up to \$43.99	LEPO price up to \$44.50 Risk Margin = 9% x (\$43,990 - \$41,650) Mark to Market Margin = \$4,450 - \$4,178 Daily Settlement	\$21 \$272 \$251	debit credit Receive
28-Apr	Share price down to \$43.60	LEPO price up to \$44.05 Risk Margin = 9% x (\$4,360 - \$4,399) Mark to Market Margin = \$4,405 - \$4,450 Daily Settlement	-\$3.50 -\$45 -\$41.50	credit debit pay
5-May	Share price up to \$44.12	LEPO price up to \$44.70 Risk Margin = 9% x (4,412 - 4,360) Mark to Market Margin = \$4,470 - \$4,405 Daily Settlement	\$4.70 \$65 \$60.30	debit credit receive
12-May	Share price up to \$46.85	LEPO price up to \$47.40 Risk Margin = 9% x (\$4,685 - \$4,412) Mark to Market Margin = \$4,740 - \$4,470 Daily Settlement	\$24.57 \$270 \$245.43	debit credit receive
19-May	Sell shares @ \$49.55 = \$4,955	LEPO price up to \$50.20 Risk Margin Reversed Mark to Market reversed \$4,740 - \$4,178 LEPO gross profit \$5,020 - \$4,178 Daily Settlement	\$422 \$562 \$842 \$702	credit debit credit receive
	Total Profit = \$4,955 - \$4,165 = \$785	LEPO value T6	\$5,020	
	Cost of Funding	\$29.78	LEPO value 14 April	\$4,178
	Adjusted Profit	\$755 18.13%	Total Profit	\$842 223.92%

### Notes and assumptions:

1. Based on actual share prices for BHP in the period April to May.
2. Does not include dividends or imputation credits which would improve share trader's position.
3. Does not include any interest earned on the risk margin which would improve LEPO trader's position slightly.
4. Risk margin assumed in this example is 9% of the current share price. This represents the largest likely daily movement in the value of the underlying share in normal market conditions. For more information refer to the booklet "Understanding Margin Obligations".
5. "Pay" means the amount the investor pays. "Receive" means the amount the investor receives.
6. Margins are payable/refundable daily. The examples depict weekly margins for brevity.
7. "Cost of Funding" refers to the interest cost associated with borrowing the purchase price of the shares. No cost of funding is shown for LEPOs, since any interest earned would substantially offset any interest on a borrowing to fund the LEPO transaction. Interest rate: 7.25% pa.
8. Cash used for initial margin.
9. LEPO price for the day doesn't change after the trade is executed.
10. Brokerage costs are not included in the example.

## Example 2

### Comparison of a short sale of 100 BHP shares with the sale of March BHP LEPO

Example 2 compares the short sale of 100 BHP shares and the sale of 1 LEPO when the market falls as expected. Short selling the shares returned \$555 or about 14% on the amount invested while the sale of the LEPO returned \$600 or about 168%. Once again the low initial outlay on the LEPO results in leveraged returns. Transaction costs are also likely to be lower on the LEPO trade.

DATE	SHORT SELLING 100 BHP SHARES SALE PRICE = \$39.58	SELLING A LEPO PREMIUM = \$4,080 PER CONTRACT OR \$40.80 PER SHARE		
29-Feb	Sell 100 BHP @ \$39.58 = \$3,958	Risk Margin = 9% x \$3,958	\$356	Pay
3-Mar	Share price down to \$38.88		LEPO price \$39.90	
		Risk Margin = 9% x (\$3,888 - \$3,958) Mark to Market Margin = (\$3,990 - \$4,080) Daily Settlement	\$6.30 \$75 \$81.30	Credit Credit Receive
14-Mar	Share price down to \$37.92		LEPO price \$38.90	
		Risk Margin = 9% x (\$3,792 - \$3,888) Mark to Market Margin = (\$3,890 - \$3,990) Daily Settlement	\$8.60 \$100 \$108.60	Credit Credit Receive
20/3/08	Buy shares at \$33.87	Buy LEPO @ \$34.80 Risk Margin reversed Mark to Market reversed (\$3,890 - \$4,080) LEPO gross profit (\$3,480 - \$4,080) Daily Settlement	\$3,413 \$190 \$600 \$7,512.80	Credit debit credit
Total Profit	\$571	LEPO Value 29 Feb 08 LEPO Value 20 Mar 08	\$4,080 \$3480	
Cost of Funding	\$165.10	Cost of Funding	0	
Adjusted Profit	\$555	Total Profit	\$600	
% Return	14.01%		168.44%	

**Notes and assumptions:**

As for previous example, except dates used are February – March.

# Getting started

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## Documentation

Starting to trade LEPOs is easy. Once you have decided that LEPOs are suitable you simply need to:

- sign a client agreement with your broker to act as your broker for LEPO transactions
- sign a Risk Disclosure Declaration obtained through your broker
- make enquiries with your broker regarding what collateral is acceptable to cover your risk margin obligations.

## Margins

The margining process for all options including LEPOs, is quite sophisticated. For more information contact your broker or Clearing Participant or refer to the full outline of the margining process given in the ASX publication "Margins", which can be viewed on the ASX website at [www.asx.com.au/understandingmargins](http://www.asx.com.au/understandingmargins)

## While the LEPO position is open

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Once you are trading LEPOs there are a number of factors to be aware of:

- you need to know how to track the value of your LEPO positions
- you will need to understand the costs of LEPO trading
- you will be required to pay margins and you may be eligible to receive refunds of margin
- in some circumstances, there will be an adjustment to the number of underlying shares.

### Costs

One LEPO contract usually represents 100 shares, but the investor only outlays a small margin as compared to the value of the shares. Brokerage is payable at a flat rate or based on the full premium. For more information contact your stockbroker.

### Margins

As mentioned earlier, throughout the life of the LEPO, margins may be payable by both the buyer and the seller. Refer to the publication "Margins" which can be viewed on the ASX website at

[www.asx.com.au/understandingmargins](http://www.asx.com.au/understandingmargins)

### Adjustment to the number of underlying shares

If there is a rights issue, bonus issue, reconstruction or other event, the number of underlying shares that the LEPO refers to may change. Adjustments are generally the same as for standard exchange traded options. More information about adjustments can be found at [www.asx.com.au/options](http://www.asx.com.au/options)

### Dividends and voting

The buyer of a LEPO does not receive dividends on the underlying shares until the shares are transferred after exercise. Nor does the buyer obtain any voting rights in relation to the shares until that time.

### Closing out

The LEPO trader can elect to close out at any time prior to expiry, by simply selling the same series as initially purchased, or buying the same series as initially sold. In each case the total profit (or loss) (before allowing for costs) will be the difference between the premium of the LEPO in the initial transaction and the premium of the LEPO in the closing transaction. Margins will be reversed and any surplus (or deficit) will be credited (or debited) back to the investor the day after close out.

## Exercise and settlement

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LEPOs are a European style option contract and so can only be exercised on the last trading day of the LEPO before they expire. **Exercise is not automatic**, unless arrangements have been made with your broker for automatic exercise.

Exercising a LEPO is a simple procedure.

**Trade Date** If you are the buyer of a LEPO, you notify your broker that you wish to take delivery of the underlying shares. The broker delivers an exercise notice to ASX Clear no later than 7pm or such other time as ASX Clear determines (check with your broker before expiry) on the last trading day before they expire.

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**Day 2** This generates an automatic ASX TradeMatch transaction for the transfer of the underlying shares with the Trade Date as the effective date. You, the buyer of the LEPO, must pay the balance of the premium to your broker. You are refunded the amount of any excess margin payments.

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**Day 3** Settlement is via CHESS with T + 3 settlement. Shares are delivered on Day 3.

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- The LEPO should be either exercised or closed out prior to expiry.
- The seller of the LEPO must deliver the specified number of underlying shares if assigned an exercised LEPO contract.
- Brokerage may be payable on the securities transaction.

# Differences between LEPOs and standard exchange traded options

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LEPOs are different from standard ETOs because LEPOs:

- are only available as call options
- are European style options, meaning they are exercisable on the last trading day before they expire, while standard ETO's are American style options exercisable at any time before expiry
- have a very low exercise price and a much higher premium – close to the initial value of the underlying shares and the subject of the LEPO
- have only one exercise price per expiry month, unlike other options which offer a range of exercise prices
- do not require an amount equal to the full premium to be paid on purchase. Instead the buyer pays a margin which represents a small percentage of the value of the underlying shares
- involve ongoing margin payments from both seller and buyer of the option.

## LEPO risk profile

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### Risk profile

The ASX booklet “Understanding Options Trading” explains how the risk profile of the buyer and seller of a standard option are different, with the buyer having a limited downside and the seller having a potentially unlimited loss position (unless they own the shares or an offsetting option position). In the case of LEPOs, the buyer has a higher risk profile than they would with a standard exchange traded option because the premium is larger. However the risk is still limited to the full amount of the LEPO premium. The seller of the LEPO has the same potentially unlimited loss position as the seller of a standard exchange traded call option.

### Margining

The margining system is different for LEPOs than for normal exchange traded options. Normally the buyer of an option pays an amount equal to the full premium at the time the option is purchased and the seller can either use cash or acceptable forms of collateral to meet their margin obligations. LEPOs are quite different. Both the buyer and the seller of a LEPO pay margins and non-cash collateral can be used to cover only part of these margins. For more information on margining, refer to the publication “Margins” which can be viewed on the ASX website at [www.asx.com.au/understandingmargins](http://www.asx.com.au/understandingmargins)

# Contract Specifications

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<b>Name</b>	LEPO – Low Exercise Price Option.
<b>Underlying shares</b>	A complete list is available on our website <a href="http://www.asx.com.au/options">www.asx.com.au/options</a>
<b>Security code</b>	The first three characters will be the ASX code, eg. BHP, the fourth character the expiry month eg. K=May, and the fifth character will always be numeric. Certain codes contain a sixth character which is always numeric.
<b>Contract size</b>	100 shares per contract, subject to usual adjustments for rights, bonus issues and other capital adjustment events.
<b>Tick size</b>	1 cent.
<b>Exercise style</b>	European, ie. exercisable only on the last trading day before expiry day.
<b>Exercise price</b>	1 cent per share.
<b>Type</b>	Call option only.
<b>Contract months</b>	Same expiry months as exchange traded options.
<b>Last trading day</b>	Thursday preceding the last Friday of the settlement month or, if the Thursday falls on a public holiday, the last business day before expiry day.
<b>Expiry day</b>	The Thursday before the last Friday in the expiry month unless ASX Clear determines another day.
<b>Trading hours</b>	Normal trading from 10.00am – 4.20pm (Sydney time); Late trading from 4.20pm – 5.00pm; Overseas trading in accordance with the ASX Market Rules.
<b>Settlement</b>	Physical delivery of the underlying shares.



# Index LEPOs

An Index is based on the prices of the shares of major listed companies, weighted according to market capitalisation.

## What are Index LEPOs?

Index LEPOs give forward style exposure to the sharemarket. They allow investors to execute investment and risk management strategies at a low cost.

An Index LEPO is a European call option over an Index with a 1 point strike price.

Buyers of Index LEPOs notionally buy the underlying Index on the expiry date. Sellers of Index LEPOs commit to notionally selling the index on the expiry date. For buyers, profit at expiry depends on whether the level of the underlying Index on the expiry date (less the 1 point strike price) is greater than the premium<sup>2</sup>. For sellers, profit depends on whether the level of the underlying Index on the expiry date (less the 1 point strike price) is less than the premium<sup>3</sup>.

For cost-effective exposure to the broad market, Index LEPOs provide many opportunities for the smart investor.

- **added leverage** – improve cash management by using a fraction of the cost of share trading to gain exposure to the broad market.
- **hedging** – control market risk, help protect your share portfolio from an expected decline in the broad market.
- **lower transaction costs** – obtain broad sharemarket exposure with lower transaction costs than a direct investment in shares.

- **affordability** – tailor exposure to your requirements. At a value of \$10 per point Index LEPOs can be tailored to the requirements of smaller investors and institutions alike.
- **efficiency** – minimise risk margin by offsetting against other exchange traded index option positions. Any net credit premium margin can be used to offset the risk margin for Index LEPOs.
- **convenience** – listing on ASX provides:
  - access via the wide network of ASX brokers also providing sharemarket and option and warrant services.
  - capability to conveniently utilise securities for margin collateral using ASX's CHES system.
  - trading convenience by using the same, proven and internationally accepted Derivatives Trading Facility on which stock options are traded.

To fully capitalise on the opportunities, it is important to have a sound understanding of the concepts and risks involved. Index LEPOs are likely to suit experienced investors who understand and accept the risks associated with leverage and derivatives.

The principles of buying and selling share LEPOs also apply to index LEPOs.

<sup>2</sup> The amount of the profit will also depend on transaction costs, including exchange fees and broker commission.

<sup>3</sup> Again, the amount of the profit will also depend on transaction costs.

## Contract value and tick size

Index LEPOs are quoted in whole numbers of points. Each point of the index has a value of \$10. This means that the minimum price fluctuation, or tick size, is \$10.

Investors should note that the value of an Index LEPO may depend on a number of factors and not just the level of the index. The Index LEPO price may not move completely in line with movements in the underlying Index.

## Premium

As with all options, the buyer of an Index LEPO has an obligation to pay the premium, whether or not the buyer exercises. However, because the full premium amount is effectively deferred until expiry, and because the exercise price is very low (1 point), an Index LEPO has an economic effect similar to a forward purchase of the index for the buyer and a forward sale of the index for the seller.

Unlike standard options, the buyer of an Index LEPO does not effectively pay the full amount of the premium up front. This is because the margining system for LEPOs allows the value of the premium to be offset by the mark to market value of the LEPO. When the Index LEPO is exercised, the buyer effectively pays the balance of the premium. Please refer to Example 3 to see how exercise works.

## Exercise and cash settlement

Because investors cannot actually buy or sell an Index directly, Index LEPOs are cash settled on exercise.

The Index LEPO settlement price is based on the opening price of each stock in the underlying index on the morning of the expiry date. It is not based on the closing index level. As the stocks in the index open, the first traded price of each stock is recorded. Once all stocks in the index have opened, an index calculation is made using these opening prices. This process is called the Opening Price Index Calculation (OPIC). Shortly afterwards the OPIC is confirmed to the Exchange and the Clearing House and announced to the market.

This method of calculating the index level for settling index LEPOs is used by several major exchanges internationally. It is regarded as an effective way to manage potential volatility around the expiry of index options and futures contracts.

Index LEPOs cannot be exercised before the expiry date. Investors should note that if they do not exercise the Index LEPO, or do not trade out of their position before the expiry date, they will lose their premium without receiving any amount from the seller.

## Example 3 – Exercise

Let's say a buyer purchases a March Index LEPO with a premium of 5086. To simplify the example, it does not include exchange fees, broker commission, or the effect of margins.

Assume that the OPIC on the expiry date is 5138. This means that the Settlement Amount will be \$51,370 (\$10 x (5138 points index – 1 point strike)). So the buyer will receive a net amount calculated as follows:

### EXAMPLE 3

<b>Premium</b>	(5086 points x \$10)	\$50,860
<b>Settlement Amount</b>	(5137 points x \$10)	\$51,370
<b>Profit</b>	(51 points x \$10)	\$510

Unlike standard options, the buyer of an Index LEPO does not effectively pay the full amount of the premium up front

## Margin Obligations

Because LEPOs are forward style products, both buyers and sellers must pay risk margin and any mark to market margin during the life of the LEPO. This makes them different from standard options (including Index Options), where only sellers are required to pay margins.

Buyers and sellers of Index LEPOs should note that they must use cash to make any mark to market margin payment. This is because ASX Clear pays cash for any mark to market margin refunds.

## Offsetting Risk Margin

Investors in Index LEPOs can reduce the amount of risk margin by offsetting them against other exchange traded option positions. Any net credit premium margin can be used to offset the risk margin for Index LEPOs.

## Risks

An Index LEPO has a different risk profile from a standard option over the Index. As the exercise price of LEPO is only 1 point, buyers cannot limit their risk to a smaller premium value, as is possible with standard options which are not so deep in the money. LEPOs will also respond to the passage of time and changes in market volatility in a different way from options which are not deep in the money. Unlike ordinary options, the buyer of an Index LEPO is liable to daily margin calls throughout the life of the Index LEPO.

As with ordinary call options, the seller has a potentially unlimited loss position.

Index LEPOs are likely to suit a sophisticated investor who fully understands the risks associated with a leveraged product. You should consult with a Level Two Accredited Derivatives Adviser before trading Index LEPOs.

**Buyers and sellers of Index LEPOs should note that they must use cash to make any mark to market margin payment**

## Closing out the Index LEPO

Investors who wish to realise a profit early, or realise a loss, can "close out" their position. A buyer of an Index LEPO would close it out by selling an Index LEPO on the same terms. Conversely, a seller would buy an Index LEPO.

### Example 4 – Closing out an Index LEPO

Assume that an investor bought the March LEPO on 6 Feb at 5650 and the index is at 5609 and the March LEPO is at 5440. The buyer wants to realise their loss by closing out the contract. Ignoring fees and commissions, the buyer has made a loss of 210 points (5440-5650). In cash terms, the investor's loss is \$2100 (210 x \$10).

# Contract Specifications<sup>4</sup>

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<b>Name</b>	Index LEPO – Low Exercise Price Option.
<b>Underlying index</b>	Any index approved by ASX (currently the S&P/ASX 200 Index)
<b>Contract size</b>	\$10 times the underlying Index.
<b>Tick size</b>	Quoted as the number of points of the underlying Index. The minimum fluctuation is 1.0 index point.
<b>Exercise style</b>	European ie. exercisable only on the last trading day.
<b>Type</b>	Call options only.
<b>Contract months</b>	Contracts available in the first two serial months and March/June/Sept/Dec up to six quarter months ahead.
<b>Expiry day</b>	The third Thursday of the contract month, providing this is a trading day.
<b>Last trading day</b>	All trading in expiring contracts will cease at 12.00pm on expiry day. Non-expiring contracts will continue to trade as per the trading hours below.
<b>Settlement</b>	Index LEPOs are cash settled using the opening price index calculation (OPIC) on expiry day.
<b>Settlement day</b>	The second business day following the last trading day.
<b>Trading hours</b>	6:00am to 5:00pm and 5:30pm to 8:00pm (Sydney time).

<sup>4</sup> ASX may change the contract specifications.

# Risks of LEPOs trading

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LEPOs are not suitable for all investors. In light of the risks associated with trading LEPOs, you should use them only if you are confident that you understand them and the risks. Before you invest, you should carefully assess your experience, investment objectives, financial resources and all other relevant considerations, and consult your broker.

## Market risks

The market value of LEPOs is affected by a range of factors. Changes in the price of the underlying may result in changes to the price of the LEPO, but the change can sometimes be in a different direction or of a different magnitude to the change in the price of the underlying.

## Effect of 'Leverage' or 'Gearing'

The initial outlay of capital may be small relative to the total contract value with the result that LEPO transactions are 'leveraged' or 'geared'. A relatively small market movement may have a proportionately larger impact on the value of the contract. This may work against you as well as for you. The use of leverage can lead to large losses as well as large gains.

## LEPO buyers and sellers face potentially unlimited losses

If your market view is incorrect, you are able to close out your position whether you are a long or short holder in order to avoid unlimited losses. If you hold a short LEPO position and you do not own the underlying shares at expiry or have an offsetting position, you face unlimited losses.

## Additional margin calls

You may sustain a total loss of margin funds deposited with your broker in relation to your positions. Your liability in relation to a taken or written LEPO contract is not limited to the amount of the margin paid. If the market moves against your position or margins are increased, you may be called upon to pay substantial additional funds on short notice to maintain your position, or upon settlement. If you fail to comply with a request from your broker for additional funds within the time prescribed, they may close out your position and you will be liable for any loss that might result.

## Liquidity and Pricing Relationships

Market conditions (for example, lack of liquidity) may increase the risk of loss by making it difficult to effect transactions or close out existing positions.

Normal pricing relationships may not exist in certain circumstances, for example, in periods of high buying or selling pressure, high market volatility or lack of liquidity in the underlying security.

## Orderly market powers

Australian Securities Exchange and ASX Clearing Corporation have broad powers under the ASX Operating Rules to take action in the interests of maintaining fair and orderly markets or of providing services in a fair and effective way. These powers include the ability to suspend trading, impose position limits or exercise limits and terminate open contracts. In some circumstances, this may affect your positions. Similarly, regulatory authorities such as ASIC may give directions to ASX or ASX Clear, for example, to suspend dealings in products.

## Trading disputes

You should be aware that all LEPO transactions on ASX are subject to the rules, procedures, and practices of ASX and ASX Clear. Under the ASX Market Rules, certain trading disputes between market participants (for example errors involving traded prices that do not bear a relationship to fair market or intrinsic value) may lead to ASX cancelling or amending a trade. In these situations the client's consent is not required for the cancellation of a trade.

## Trading Facilities

As with all trading facilities and systems, there is the possibility of temporary disruption to, or failure of the systems used in ASX's LEPO Market, which may result in your order not being executed according to your instructions or not being executed at all. Your ability to recover certain losses may be subject to limits on liability imposed by the system provider, ASX, ASX Clear or your broker.

# Glossary of terms

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**ASX Clear** an abbreviation for ASX Clear Pty Limited, the clearing house for LEPO, a subsidiary of ASX Clearing Corporation.

**Adjustments** are made when certain events occur that may affect the value of the underlying securities. Examples of adjustments include changing the number of shares per contract and/or the exercise price of options in the event of a new issue or a reorganisation of capital by the issuer of the underlying securities.

**American** refers to an option that is exercisable at any time prior to expiry.

**Brokerage** a fee or commission payable to a sharebroker for buying or selling on your behalf.

**Call** an option that gives the right to buy the underlying shares.

**CHESS** an acronym for Clearing House Electronic Sub-Register System.

**Close out** a transaction in which a party liquidates a position by entering into the opposite position, eg. the buyer of a LEPO closes out by selling a LEPO of the same class and expiry date.

**Collateral** security used to meet margin obligations. Can be cash, shares or other securities.

**Derivative** a financial agreement where the value of the rights of the parties is derived from, or varies according to, the value of another asset or the level of a rate or index and where at least one party could be required to provide cash or other consideration during or at the termination of the contract.

**ETO** an acronym for Exchange Traded option.

**European** refers to an option that is only exercisable at expiry.

**Exercise price** the price at which the underlying shares may be bought or sold on the exercise of the option. In the case of LEPO's the exercise price is a nominal amount.

**Expiry date** the date on which all unexercised options in a particular series expire.

**LEPO** an acronym for Low Exercise Price Option.

**Leverage** because a single LEPO contract corresponds to 100 shares, movements in share price are multiplied or "leveraged" by a factor of 100 when calculating changes to the LEPO's value.

**Margins** amounts of collateral required to be lodged with ASX Clear from time to time to secure the obligations of each Clearing Participant to the LEPO contract.

**Mark to market** the daily revaluation of positions to current market values from the previous day's closing price. Mark to market margins must always be cash settled.

**Offsets** a reduction in margin requirements as a result of holding positions in LEPOs or options of the same class.

**Option** a contract which confers on the buyer the right but not the obligation to buy or sell a security or other asset.

**Physical delivery** settlement results in the transfer of ownership of shares. Can be contrasted with cash settlement in which a payment is made instead of a transfer occurring.

**Premium** the price of an option contract. This is the price as agreed between the buyer and seller.

**Put** an option which gives the right to sell the underlying shares.

**Risk margin** an amount representing an estimate of the largest potential daily move in the value of an option or LEPO in normal market conditions.

**Short selling** the practice of agreeing to sell shares without owning the shares at the time the sale contract is entered into.

## Further information

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For ASX explanatory booklets on options, please phone 131 279, or download the booklets from the ASX website [www.asx.com.au/options](http://www.asx.com.au/options)

### Online Classes

Online options classes include interactive exercises that will aid your learning and a quiz at the end of each section to show your progress.

### Website

[www.asx.com.au/options](http://www.asx.com.au/options)

### Email

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