LEPOs

Low Exercise Price Options
Explanatory Booklet

ASX
AUSTRALIAN STOCK EXCHANGE

ASX Derivatives
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LEPOs key features

Name	LEPO – Low Exercise Price Option.
Description	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.
Characteristics	• Relatively high premium • A low exercise price • Relatively low outlay • Ongoing margins are payable.
Underlying shares	A complete list is available on our website www.asx.com.au
Contract size	1,000 shares per contract, subject to usual adjustment for rights, bonus issues and other capital adjustment events.
Expiry cycles	Spot (1 month forward) plus quarterly expiries of which next 3 traded at any time. Maximum maturity is usually 9 months, although some classes of LEPOs have other maturities of up to 1 year.
Benefits	• Leverage • Cash efficient • No risk of early exercise • Physical delivery of shares on exercise • Good proxy for share trading • Ease of account opening • Availability of offsets on some margins • Ability to lodge non-cash collateral.
Suitable for	Experienced investors who understand and accept the risks associated with leverage and derivatives.
Risks	• Leverage • Margin payments.

Contents

Derivatives
Division
1800 028 585

Introduction

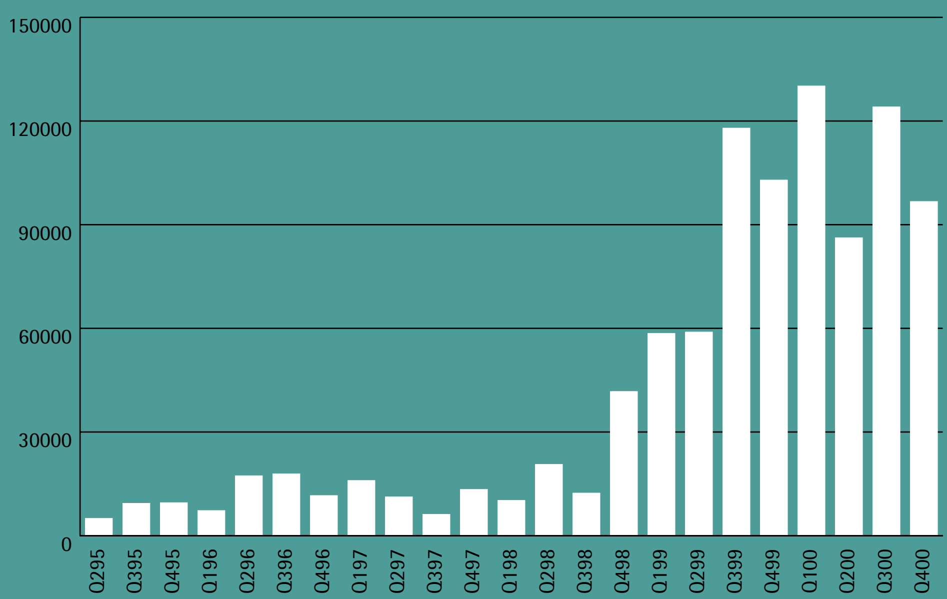
LEPOs are Low Exercise Price Options and this booklet outlines their main characteristics and the key factors that make them a useful addition to a well balanced investment portfolio.

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 Derivatives Division. 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 options which may suit investors with broader risk profiles. This is because LEPOs involve the use of margins. If you are familiar with the booklet **Understanding Option 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.**



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 1,000 shares)
- at a specified future date
- in return for the payment of a premium and exercise price.

1 contract usually refers to 1,000 shares

The 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 strike price 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 call option is only required to deliver the underlying shares if the buyer exercises the option.

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 MIM Holdings Limited (MIM) 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.

Why trade LEPOs?

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.**

LEPOs offer the benefits of leverage. 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 or losses on the LEPO which are only crystallised when the position is closed out or exercised.

Because each LEPO corresponds to 1,000 shares, a 10 cent movement in the share price translates to a $100 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. In addition, unlike most share transactions, stamp duty is not charged on LEPO transactions unless you exercise, in which case duty is normally payable on the delivery of the shares. If you were to borrow to buy LEPOs, stamp duty and various other fees and charges may also 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 CHESS 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

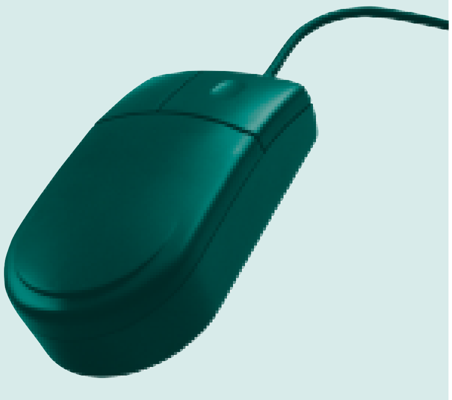
Investors can reduce their initial outlay to the extent that they have offsetting positions for options, whether the offsetting positions are in LEPOs or in ETOs. Only risk margins can be offset, mark to market margins cannot be offset. For an explanation of risk margins and mark to market margins see the section **Margins** in **Getting started** in this booklet.

Ability to lodge non-cash collateral against margin

Investors can lodge a variety of securities with OCH instead of cash to satisfy their risk margin obligations. Details of acceptable securities are listed in the section on **Collateral.** Updates are published by OCH and are available from ASX Derivatives Division. Mark to market margins are payable in cash only, in order to permit refunds 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

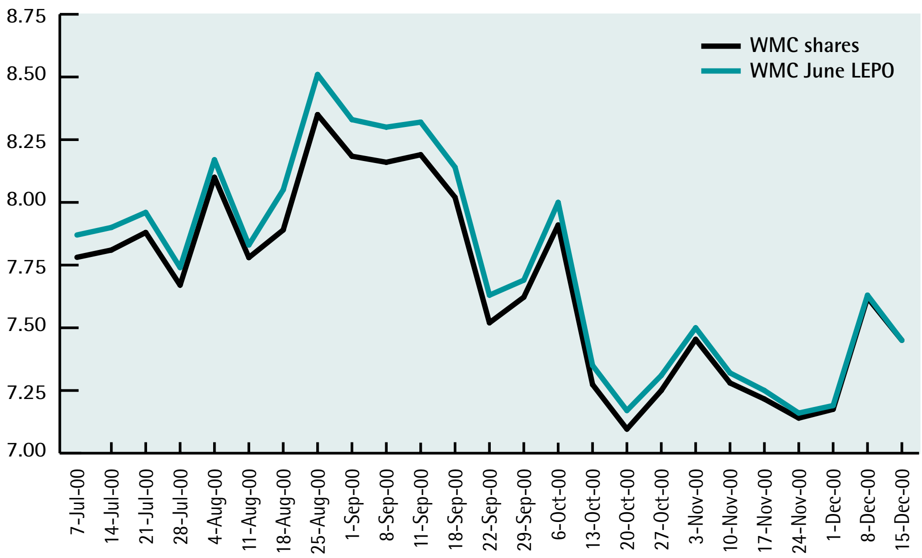


Investing in a LEPO – examples

WMC Share Price v WMC LEPO Price

The chart above compares the actual prices of WMC shares and the January 2001 WMC LEPO premium between July and December 2000. 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 1,000 WMC shares with the purchase of January 2001 WMC LEPO.

Example 1 compares the purchase of 1,000 WMC shares and the purchase of 1 LEPO when the market rises as expected. Investing in the shares would have returned $507 or around 5%, while investing in the LEPO would have returned $690 or over 150%. The main reason for the difference is the lower transaction costs payable on LEPO contracts.

Date	BUYING 1,000 SHARES Purchase price = $7.40		BUYING A LEPO Premium = $7,490 per contract or $7,49 per share		
5 July	Buy 1,000 WMC @ $7.40 Commissions Stampduty **Total outlay**	$7,400 $111 $11 **$7,522**	Risk margin (@ 5% of $7,490) Commissions Stampduty **Total initial outlay**	$375 $60 – **$435**	(pay) (pay) **(pay)**
12 July	Share price @ $7.87		LEPO price $7.96 Risk margin (@5%)=$398 ($398-$375) Mark to market margin ($7,490-$7,960) Daily settlement ($470-$23)	 $23 $470 $447	 (pay) (return) (receive)
19 July	Share price @ $7.96		LEPO price $8.05 Risk margin (@5%)=$403 ($403-$398) Mark to market margin ($8,050-$7,960) Daily settlement ($90-$5)	 $5 $90 $85	 (pay) (return) (return)
26 July	Share price @ $8.06		LEPO price $8.14 Risk margin (@5%)=$407 ($407-$403) Mark to market margin ($8,140-$8,050) Daily settlement ($90-$4)	 $4 $90 $86	 (pay) (return) (return)
2 August	Share price @ $7.54		LEPO price $7.60 Risk margin (@5%)=$380 ($380-$407) Mark to market margin ($7,600-$8,140) Daily settlement ($540-$27)	 $27 $540 $513	 (return) (pay) (pay)
7 August	Sell Shares @ $8.23 Commissions Stampduty Total income	$8,230 $124 $12 $8,094	Sell LEPO @ $8.30 Risk margin reversed Mark to market reversed ($7,600-$7,490) LEPO gross profit ($8,300-$7,490) Commissions Daily settlement ($380-$110+$810-$60)	 $380 $110 $810 $60 $1,020	 (return) (pay) (return) (pay) (return)
	Total profit	**$572**	LEPO value less LEPO value less Commissions (2x$60)	**$8,300** $7,490 $120	
	Cost of funding	$65	No cost of funding		
	Adjusted profit	**$507**	**Total profit**	**$690**	

Notes and assumptions:

1. Based on actual share prices and LEPO prices for WMC in the period June 2000 to December 2000.
2. Does not include dividends or imputation credits which would improve share trader's position.
3. Does not include any interest earnt on the risk margin which would improve LEPO trader's position slightly.
4. Commission levels may vary. Commission used on LEPO: $10 contract, minimum $60 per trade.
5. Risk margin assumed in this example is 5% of the current share price. This represents the largest likely daily movement in the value of the underlying share. For more information refer to the booklet "Understanding Margin Obligations".
6. "Pay" means the amount the investor pays. "Return" means the amount the investor receives.
7. Margins are payable/refundable daily. The examples depict weekly margins for brevity.
8. "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 earnt would substantially offset any interest on a borrowing to fund the LEPO transaction.
9. Brokerage rate: 1.5%. Stamp Duty rate: 0.15%. Interest rate: 10%pa.
10. Cash used for initial margin.
11. LEPO price for the day doesn't change after the trade is executed.
12. All fractions have been rounded up for examples only.

Example 2

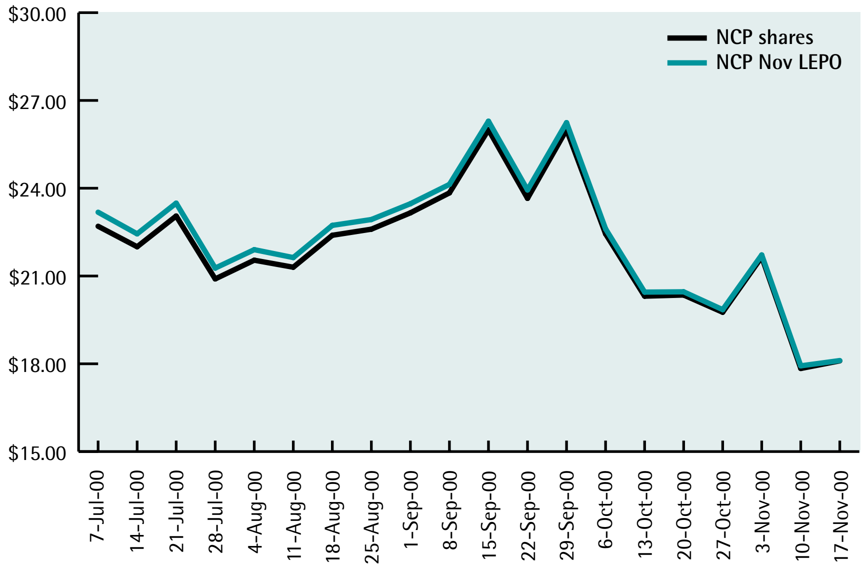
Another comparison of a purchase of 1,000 WMC shares with the purchase of January 2001 WMC LEPO.

Example 2 compares the purchase of 1,000 WMC shares and the purchase of 1 LEPO when the market moves against expectations and falls in value. Purchasing the shares would have resulted in a loss of $920 or approximately 10% on the amount invested while the purchase of the LEPO resulted in a loss of $760 or over 150% of capital invested. While the share investment results in a lower percentage loss on capital invested than the LEPO, the loss on the LEPO is a lower dollar amount.

Date	BUYING 1,000 SHARES Purchase price = $8.24		BUYING A LEPO Premium = $8,370 per contract or $8,37 per share		
12 Sept	Buy 1,000 WMC @ $8.24 Commissions Stampduty **Total outlay**	$8,240 $124 $13 **$8,377**	Risk margin (@ 5% of $8,370) Commissions Stampduty **Total initial outlay**	$419 $60 - **$479**	(pay) (pay) **(pay)**
19 Sept	Share price @ $8.00		LEPO price $8.12 Risk margin (@5%)=$406 ($406-$419) Mark to market margin ($8,120-$8,370) Daily settlement ($250-$13)	 $13 $250 $237	 (return) (pay) (pay)
26 Sept	Share price @ $7.71		LEPO price $7.81 Risk margin (@5%)=$390 ($390-$406) Mark to market margin ($7,810-$8,120) Daily settlement ($310-$16)	 $16 $310 $294	 (return) (pay) (pay)
3 Oct	Sell Shares @ $7.63 Commissions Stampduty Total income	$7,630 $114 $12 $7,504	Sell LEPO @ $7.73 Risk margin reversed Mark to market reversed ($7,810-$8,370) LEPO gross loss ($7,730-$8,370) Commissions Daily settlement ($390-$560-$640-$60)	 $390 $560 $640 $60 $870	 (return) (pay) (pay) (pay) (pay)
	Total loss	**$873**	LEPO value 3 Oct less LEPO value 12 Sept less Commissions (2x$60)	**$7,730** **$8,370** $120	
	Cost of funding	$47	No cost of funding		
	Adjusted loss	**$920**	**Total loss**	**$760**	

Notes and assumptions: As for previous example, except dates used are September 2000 to October 2000.

Example 3



Comparison of a short sale of 1,000 NCP shares with the sale of January 2001 NCP LEPO.

Example 3 compares the short sale of 1,000 NCP shares and the sale of 1 LEPO when the market falls as expected. Short selling the shares returned $1128 or about 4% on the amount invested while the sale of the LEPO returned $1940 or about 160%. Once again the lower transaction costs make the LEPO investment more attractive than the shares.

Notes and assumptions: As for previous example, except dates used are September 2000 to October 2000.

Date	SHORT SELLING 1,000 SHARES Sale price = $22.55		SELLING A LEPO Premium = $22,720 per contract or $22.72 per share		
9 Oct	Sell 1,000 NCP @ $22.55	$22,550	Risk margin (@5% of $22,720)	$1,136	(pay)
	Commissions	$338	Commissions	$60	(pay)
	Stampduty	$34	Stampduty	-	
	Total income	**$22,178**	**Total initial payment**	**$1,196**	**(pay)**
16 Oct	Share price @ $21.75		LEPO price $21.88		
			Risk margin (@5%)=$1,094		
			($1,094-$1,136)	$42	(return)
			Mark to market margin		
			($21,880-$22,720)	$840	(return)
			Daily settlement ($42+$840)	$882	(return)
23 Oct	Share price @ $20.62		LEPO price $20.72		
			Risk margin (@5%)=$1,036		
			($1,036-$1,094)	$58	(return)
			Mark to market margin		
			($20,720-$21,880)	$1,160	(return)
			Daily settlement ($58+$1160)	$1,218	(return)
30 Oct	Buy Shares @ $20.58	$20,580	Buy LEPO @ $20.66		
	Commissions	$309	Risk margin reversed	$1,036	(return)
	Stampduty	$31	Mark to market reversed		
			($20,720-$22,720)	$2,000	(pay)
			LEPO gross profit		
			($20,660-$22,720)	$2,060	(return)
			Commissions	$60	(pay)
	Total payment	$20,920	Daily settlement		
			($1,036-$2,000+$2,060-$60)	$1,036	(return)
	Total profit	$1,258	LEPO value 3 Oct	$22,720	
			less LEPO value 12 Sept	$20,660	
			less Commissions (2x$60)	$120	
	Cost of funding	$130	No cost of funding		
	Adjusted profit	$1,128	Total profit	$1,940	

Notes and assumptions: As for previous example, except dates used are September 2000 to October 2000.

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Getting started

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 arrangements with your broker to lodge cash or collateral to cover your risk margin obligations.

Margins

The margining process for all options, including LEPOs, is quite sophisticated. A full outline of the margining process is given in the ASX Derivatives publication Understanding Margin Obligations.

In this section a simplified outline of the margining requirements for LEPOs is given.

The Total Margin payable by both the buyer and seller of the LEPO is comprised of two parts, the risk margin (otherwise known as initial margin) and the mark to market margin.

An outline of each appears in the table.

TOTAL MARGIN = RISK MARGIN + MARK TO MARKET MARGIN

	Risk Margin	Mark to Market Margin
Description	This is levied against both the buyer and the seller of the LEPO and is calculated as a percentage of the value of the underlying shares.	As the value of the LEPO moves with the market, a mark to market margin is levied against the party whose position is in loss (debit margin) in favour of the other party whose position is gaining (credit margin).
Why are they required?	They are held by OCH and act as a security bond to ensure that an investor's obligations to the market are met.	Allow investors to profit from favourable movements in the value of the LEPO, and require them to make incremental payments of any losses.
How are they determined?	OCH sets the percentage level for the risk margin based on past performance of the underlying share price. This percentage level is maintained as the value of the underlying share changes.	Changes with the market value of the LEPO. For every 10 cent rise in the value of one LEPO contract, the seller of the LEPO is required to pay $100*. Conversely the buyer will receive a $100 credit.
How can they be paid?	Cash or any of the other collateral accepted by OCH for standard ETOs.	Cash only.
Payments of interest	OCH pays interest on risk margins that are covered with cash.	Offsets are not applicable as mark to market margins.
Offsets	Risk margins may be offset with margins from ordinary ETOs.	
When are they paid?	Risk margins are payable the day after the LEPO position is opened and are maintained for the life of the LEPO.	Mark to market margins are only charged when the value of the LEPO changes. They are payable the day after the value changes.

* assumes contract size is normally 1,000 shares.

Collateral for risk margins

Instead of paying the risk margin in cash, investors may lodge other collateral. This section outlines the types of collateral which are currently accepted. This can change. For an updated list of acceptable collateral, consult your broker or ASX Derivatives Division.

Shares

Shares are usually valued at 70% of current market value for collateral purposes. The shares which currently are acceptable include shares of the 55* companies over which exchange traded options are available. Included in these 55 are all shares which currently have LEPOs.

Bank guarantee

A total of 28 banks are approved by OCH for bank guarantees. Collateral cover will be given up to the full face value of any guarantee lodged.

Austraclear pledged securities

The following securities are currently acceptable:

- Bank Negotiable Certificates of Deposit
- Bank Transferable Certificates of Deposit
- Non-bank Promissory Notes or Certificates of Deposit
- Bank Bills of Exchange
- Non-bank Bills of Exchange.

Warrants

Some Instalment Warrants have been approved as acceptable collateral. The haircut applied is 40%. For more information consult your broker or ASX Derivatives.

Encumbered Securities

Under certain circumstances encumbered securities may be used to cover the LEPO risk margin. Consult your broker or ASX Derivatives for more information.

Collateral cover will be allowed to the extent of the mark to market value of the security. OCH may give less than 100% cover in certain circumstances.

*As at January 2001.

Offsets

The risk margin payable for a LEPO can be reduced if the LEPO buyer or seller has offsetting LEPO or standard exchange traded option positions. OCH will only calculate the net risk margin. For example, if an investor sells a BHP LEPO and has purchased a call, the risk margin payable will be reduced.

The following table shows how offsets apply to exchange traded option (ETO) and LEPO positions in the same class.

LEPO Position	Offset applies where
Bought	Investor has sold a call ETO
Bought	Investor has purchased a put ETO
Bought	Investor has sold a LEPO
Sold	Investor has purchased a call ETO
Sold	Investor has sold a put ETO
Sold	Investor has purchased a LEPO

The margin required reflects the net position of all the investor's options and LEPOs. The above table details the impact for some simple combinations only.

OCH calls and refunds margins directly from your Clearing participant. The Clearing participant is responsible for calling margins from you and may require you to pay margins above those which it must pay OCH.

OCH accepts cash and other forms of collateral to lever the risk margin

While the LEPO position is open

Once you are trading LEPOs there are 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.

How to track the value of your LEPO

Current LEPO prices are available from your broker. Details of the previous day's trading are published daily in The Australian and on the internet at http://www.asx.com.au.

Costs

No stamp duty is payable on LEPO transactions unless they are exercised in which case duty would normally be payable when the underlying shares are acquired or sold. One LEPO contract usually represents 1,000 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. Refer to the previous examples for an indication of the cost levels.

Margins

As mentioned earlier, throughout the life of the LEPO, margins may be payable by both the buyer and the seller. Refer to the section on Margins in Getting Started in this booklet for an overview of margins.

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.

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.

No stamp duty is payable on LEPO transactions unless you exercise

Exercise and settlement

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 OCH no later than 7pm or such other time as OCH determines (check with your broker before expiry)on the last trading day before they expire.
Day 2	This generates an automatic SEATS 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.
Day 3	Settlement is via CHESS with a T + 3 settlement. Shares are delivered on Day 3.

- The LEPO should be either exercised or closed out prior to expiry.
- The seller of the LEPO must deliver the agreed number of underlying shares if assigned an exercised LEPO contract.
- Stamp duty is payable by both buyer and seller, calculated as 0.15% of the full premium.
- Brokerage may also be payable.

Differences between LEPOs and standard exchange traded options

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 ETOs 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 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.

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

Refer to the section Margins in Getting Started in this booklet for an explanation of margins on LEPOs. 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.

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Contract Specifications

Name	LEPO – Low Exercise Price Option.
Underlying shares	A complete list is available on our website www.asx.com.au
Security code	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.
Contract size	1,000 shares per contract, subject to usual adjustment for rights, bonus issues and other capital adjustment events.
Tick size	1 cent.
Exercise style	European, ie. exercisable only on the last trading before expiry day.
Exercise price	1 cent per share.
Type	Call option only.
Contract months	Same expiry months as options stock class.
Last trading day	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.
Expiry day	The Thursday before the last Friday in the expiry month unless OCH determines another day.
Trading hours	10:00am to 12:30pm; 2:00pm to 4:15pm; late trading 4:15pm to 5:00pm and overseas trading in accordance with the ASX Business Rules.
Settlement	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.

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

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 CHESS system
  - trading convenience by using the same, proven and internationally accepted Derivatives Trading Facilty on which stock options are also traded.

To fully capitalise on these 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.

What are Index LEPOs?

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[1]. 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[3].

1 The amount of the profit will also depend on transaction costs, including exchange fees and broker commission.

2 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. So 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 4 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.

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 4 – Exercise

Let's say a buyer purchases a March Index LEPO with a premium of 3344. To simplify the example, it does not include exchange fees ($0.40 per contract) or broker commission, or the effect of margins.

Assume that the closing level (as adjusted)[3] of the index on the expiry date is 3360. This means that the Settlement Amount will be $33,590 ($10x(3360 points index – 1 point strike)). So the buyer will receive a net amount calculated as follows:

Example 4		
Premium	(3344 points x $10)	$33,440
Settlement Amount	(3359 points x $10)	$33,590
Profit	(15 points x $10)	$150

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

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3 The level of the index may be subject to minor adjustments from the level displayed at the end of the trading day.

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 OCH pays cash for any mark to market margin refunds.

Example 5 shows how margins work for Index LEPOs. To simplify the example, it does not take account of exchange fees ($0.40 per contract) or broker commission. The example also assumes that the Index LEPO price does not change between execution of the trade and close of trading on that day.

Example 5 – Index LEPO cash flows using cash for margin

On 15 December an investor buys one September Index LEPO. The LEPO is trading at 3344, so the contract price is $33,440 (3344x$10). The Index is at 3320.

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Example 5

Date	Price[4]	Risk Margin	Net Mark to Market Margin	Daily Cash Flow[5]
15 Dec	LEPO 3344 Index 3320	$996.00 (@3% of $33,200)	Nil	$996.00 (pay)
16 Dec	LEPO 3341 Index 3316	$994.80 (@3% of $33,160) Net $1.20 (return) ($996.00-$994.80)	$30 (pay) ($33,410-$33,440)	$28.80 (pay)
17 Dec	LEPO 3346 Index 3321	$996.30 (@3% of $33,210) Net $1.50 (pay) ($994.80-$996.30)	$50 (return) ($33,460-$33,410)	$48.50 (return)

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

4 Closing price on relevant date.

5 "Pay" means the amount the investor pays. "Return" means the amount the investor receives.

Using Securities as Collateral

One of the benefits of trading Index LEPOs is that investors can use existing securities portfolios to cover risk margin. Approximately 80 ASX listed securities are acceptable to Options Clearing House Pty Ltd (OCH) as collateral. OCH will allow up to 70% of the value of securities lodged with it to cover risk margins.

For more detail on collateral, please refer to the ASX publication, Understanding Margin Obligations or speak to your Level Two Accredited Derivatives Adviser.

Example 6 shows how the investor in Example 5 could lodge equities as collateral and reduce cash outlay.

Example 6 – Index LEPO cash flows using collateral to cover risk margin

Assume that the buyer in Example 4 has equities lodged with OCH. Assume also that, throughout the period shown in Example 5, the equities have a market value of at least $2,000. The buyer can use approximately 70% of the market value ($1,400) to cover risk margin. Because the highest risk margin for this period is $996.30, the investor is fully covered for risk margin.

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.

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 7 – Closing out an Index LEPO

Take the investor in Example 5. Assume that on 22 March the Index is at 3320 and the March Index LEPO is at 3323. The buyer wants to realise the buyer's loss by closing out the contract. Ignoring fees and commissions, the buyer has made a loss of 21 points (3323-3344). In cash terms, the investor's loss is $210 (21x$10).

Risks

An Index LEPO has a different risk profile from a standard option over the Index. As the exercise price of a 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 erosion of time and changes to market volatility in a different way from options which are not deep in the money. And 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.

Contract Specifications[6]

Name	Index LEPO – Low Exercise Price Option
Underlying Index	A complete list is available on our website www.asx.com.au
Contract Size	$10 times the underlying Index
Tick Size	Quoted as the number of points of the underlying Index. The minimum fluctuation is 1.0 index points
Exercise style	European ie. exercisable only on the last trading day
Type	Call options only
Contract Months	Calendar quarters
Last Trading and Expiry Day	The last business day of the contract month
Settlement	Cash settled at the closing quotation of the underlying Index on the Last Trading Day as finally determined by the Australian Stock Exchange on the business day following the Last Trading Day and calculated to one decimal place
Settlement Day	The second business day following the Last Trading Day
Trading Hours	10.00am to 12.30; 2.00pm to 4.15pm

6 ASX may change the contract specifications.

Glossary of terms

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 LEPOs, 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 1,000 shares, movements in share price are multiplied or "leveraged" by a factor of 1,000 when calculating changes to the LEPO's value.

Margins amounts of collateral required to be lodged with OCH from time to time to secure the obligations of each party 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.

OCH an acronym for Options Clearing House, the clearing house for most derivative transactions conducted on ASX.

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 exercise a right 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 the largest most likely daily move in the value of the underlying share based on an historical study and current market conditions.

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

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Further Infomation

Other explanatory booklets available:

- Understanding Options Trading
- Understanding Margin Obligations
- Understanding Options Strategies
- Understanding Trading & Investment Warrants

For further information on educational courses available, or for complimentary copies of these booklets, please contact the Derivatives Division of ASX.

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