

# FRO

FIXED RETURN OPTIONS

**Your real-world questions answered**

By Nicole T. Wachs  
Director of Education

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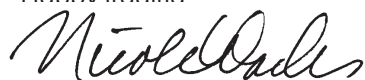
## Welcome to the future of options trading. What's next?

At TradeKing, we're excited to introduce Fixed Return Options (FROs, a type of binary option) to individual investors. In fact, we're even more excited about this product because our CEO, Don Montanaro, is one of the key architects of this newly-listed financial instrument.

This whitepaper covers some real-world Q&A about FROs between members of the TradeKing Community and our staff, including yours truly, as we all place our first FRO trades. Think of it as a "rubber-meets-the-road" guide to the opportunities and pitfalls you might encounter as you begin trading FROs.

If you're brand new to Fixed Return Options, I'd suggest you start with our first whitepaper on this subject. You can download it here: <http://www.tradeking.com/PublicView/home/promo/FRO/FROone001.tmpl>

Happy trading



Nicole T. Wachs  
Director of Education  
TRADEKING

P.S. To keep learning about FROs (and everything else options-related), check out our blogs:

My blog:

<http://community.tradeking.com/members/nicolewachs/blogs>

TradeKing All-Stars:

<http://community.tradeking.com/members/tk-all-star/blogs>

"The Options Guy" by Senior Options Analyst Brian Overby:

<http://optionsguy.tradeking.com>

NOTE: Throughout this paper, I refer to the price of the "stock" that FRO contracts are based on. That's a bit of an oversimplification. Actually, the underlying securities that FROs can be traded on include both stocks and ETFs. So feel free to substitute "ETF" for "stock" to match your preferred style of trading.

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## What exactly are FROs?

Also known as “binary” or “all-or-nothing” options, FROs come in just two flavors: Finish High, or above the strike price, and Finish Low, or below the strike price. You’re making a simple prediction about where the underlying stock or ETF’s price will be upon expiration.

If you are a FRO buyer and predict the outcome correctly, you will earn a fixed return of \$100 at expiration. If you’re wrong, you get nada, and your loss is limited to the premium paid. In a similar fashion, if you are a FRO seller and are right about the result at expiration, you will keep the premium collected when the trade was opened. If you’re wrong, you’ll have to return that premium and kick in additional funds to bring the amount up to \$100.

The terms of FROs are much more straightforward than standard listed options. (In fact, you’re probably already familiar with other kinds of “binary” prediction in the non-financial world: betting on whether or not the Giants will win the Super Bowl is a binary prediction – it only has one of two outcomes.) Plus, with FROs both your max gain and loss are limited and easily calculated when you initiate the position. What could be simpler?

The above is a super-quick definition of Fixed Return Options. If you haven’t already, we’d suggest you get the full skinny by downloading our first whitepaper on this subject.

Get it here: <http://www.tradeking.com/PublicView/home/promo/FRO/FROOne001.tmp>

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## Is there any difference at all between a “Fixed Return Option”, an “FRO”, a “binary option”, a “digital option” or an “all-or-nothing option”?

“Binary”, “digital”, and “all-or-nothing” are generic ways to describe a type of option that can yield only one of two outcomes. Fixed Return Options, abbreviated as FROs, are a specific type of binary option with their own specific underlyings, settlement policies, payout and other contract terms. That is to say, all FROs are binary options, but not all binary options are FROs.

We’ll be discussing only one type of binary option - Fixed Return Options or FROs - throughout this document.

## Are FROs available on all stocks?

Not yet. Currently FROs are available on 20 equities and ETFs: AAPL, C, CSCO, DIA, EEM, GE, GOOG, GS, HD, IBM, INTC, IWM, JPM, MSFT, OIH, QQQQ, SPY, WB, XLE, and XLF. (Check out the Amex website for the most up-to-date list: [www.amex.com](http://www.amex.com).) For the time being, FROs on LEAPS are not yet available for trading.

## What are the key similarities and differences between FROs and standard listed options?

Excellent question. If you’re familiar with standard options already, then the compare-and-contrast information below should get you up-to-speed quickly. Of course, Fixed Return Options were introduced as a way for stock traders to try options without all the extra hassle of understanding standard listed options – so read on. You’ll definitely get the hang of it.

### A FEW WAYS FROs ARE SIMILAR TO CALLS AND PUTS ON STOCKS

- FROs will usually have the same strike prices as calls and puts traded on the same underlying stock.
- FROs will usually share the same expiration months as calls and puts traded on the same underlying stock, with the exception of LEAPS for the time being. LEAPS will probably become available later.
- FROs are traded in the same price increments as calls and puts traded on the same underlying stock. In other words, if call and put prices are quoted in penny increments (instead of a nickel), the FRO price will be as well.
- Like calls and puts, there is a listed marketplace and FROs can be bought or sold at any time during the life of the contract.

### A FEW WAYS FROs DIFFER FROM CALLS AND PUTS ON STOCKS

- FROs are always cash-settled. Stock does not change hands.
- FROs always have European-style settlement (they can’t be exercised early).
- The last day to trade FROs is the third Friday of the month, whereas most European-style options stop trading on the third Thursday of the month.
- In-the-money FROs are always automatically exercised (because they’re cash-settled, there’s no reason not to exercise).
- FROs have a limited and known profit and loss potential.
- The settlement price for FROs is determined by calculating the Volume Weighted Average Price; it is not the stock price at the end of the trading session. (This is probably the only slightly tricky part of understanding FROs – to learn more, keep reading.)

## Why do FROs use the Volume Weighted Average Price (VWAP) to settle? Why not just use the last stock price at expiration?

Using the final closing price before expiration might seem like a simpler way to determine whether an option is in- or out-of-the-money. But believe us: there's a very good reason why Fixed Return Options use the VWAP instead.

Settlement for calls and puts is usually determined by the underlying stock's price when the market closes on the expiration date. With FROs things work a little differently: whether an FRO is in- or out-of-the-money is determined by calculating the stock's AMEX FRO Settlement Index value, an official name for what is basically a Volume Weighted Average Price, or "VWAP," on the day the option expires.

You calculate the VWAP (pronounced "VEE-whop") by adding up the dollar value of all trades on a given stock on a given day, and dividing that sum by the total number of shares traded. In other words, VWAP is a fancy way of saying "the average dollar price of a specific stock on a particular trading day."

The VWAP is calculated and disseminated at 15-second intervals throughout every trading day. Only trades that occur while the markets are open factor into the VWAP. Pre-market trading and after-hours activity don't affect the figure.

The AMEX FRO Settlement Index value is the final VWAP calculated on the FRO expiration date. It's usually posted within two hours after the close. You can look this up just as you would any other quote using the FRO ticker symbol.

The AMEX FRO Settlement Index value will usually not equal the stock's closing price at expiration - and that serves an important purpose. Using VWAP for settlement at expiration instead of the last closing price prevents any large (and possibly unscrupulous) financial entities from manipulating the stock price near the end of the trading session. Since FROs are an all-or-nothing trade, and a one-cent increase or decrease in share price can potentially make the difference between receiving \$100 per contract or receiving nothing, it's essential to guard against price manipulation.

## What options approval level do I need to buy (go long) and sell (go short) FROs?

For all TradeKing clients, in order to buy ("go long") or sell ("go short") FROs, first you need to obtain Level 2 options approval from TradeKing. You can get that ball rolling by logging in to your TradeKing account, then going to Services > Settings > Trading > Options Trading Level. You'll see your current options approval level, if you have one, plus a link to download our Options Approval Form to request a higher level.

Complete and fax this form back to TradeKing, and we'll inform you when you've been approved. You should read The Characteristics and Risks of Standardized Options available at <http://content.tradeking.com/wiki/display/tkservice/Characteristics+and+Risks>.

If you're granted Level 2 approval, you'll be able to trade any FRO position - that is, you'll be allowed to buy/go long FROs as well as sell/short FROs. That's a little different from standard listed options, where Level 2 approval only allows you to buy (long) calls or buy (long) puts. There's a little more flexibility allowed for Level 2 traders with FROs because their risk is defined and limited to \$100 per contract (less any premium you receive for selling an FRO). That's not the case with standard listed options, where risk can be unlimited in some cases.

## If I'm already approved to sell Covered Calls (Level 1), can I short a Finish High FRO if I own the underlying shares?

Sorry, but because the settlement values of the stock and VWAP may differ, you must have Level 2 options approval to place any FRO trade.

Think of it this way: in a covered call position, the risk created by shorting a call is covered by the underlying stock. Because FROs are settled in cash and their value is determined by the VWAP (not the stock's closing price at expiration), FROs cannot be covered by shares of the underlying – only by cold hard cash. See “What options approval level do I need to buy and sell FROs?”

## How are FROs priced?

An FRO's price depends on several factors, including the underlying stock price, the FRO's strike price, and current market demand for that particular FRO. Like standard listed options, if an FRO is in-the-money, it'll usually cost more than if it is out-of-the-money.

Since FROs have a maximum value of \$100 per contract, an FRO will most likely have a premium of less than \$1.00. At-the-money Fixed Return Options will usually be around \$0.50, reflecting their 50/50 probability of going either way. (“At-the-money” simply means your FRO's strike price is about equal to the current market price of the underlying. If your stock is at 60, for example, and you're long an FRO with a strike price of 60, that's an “at-the-money” option.)

## Can I sell (short) an FRO without actually owning the underlying security?

Yes. You can “cover” your FRO sale by simply having enough cash in your account to cover the trade. Let's walk through a quick example.

Let's say you've sold a January 50 “Finish High” FRO on stock XYZ, which is currently trading at 52. You collect \$0.55 for that sale, or \$55. (Each Fixed Return Option contract has a multiplier of 100.) This \$55 must remain in your account, plus you need to kick in an additional \$45 as collateral. Just in case you are completely wrong and the stock finishes above 50, your maximum risk is covered by this extra cash.

In a nutshell this trade suggests you don't believe XYZ will finish above 50 at expiration. If you're right, the FRO will expire worthless – good for you as the seller - and you'll get to keep the \$55. If you're wrong, you will forfeit the extra \$45 previously mentioned. No stock changes hands, no “calling” or “putting” – compared to standard listed options, it's pretty no-fuss.

## How do I enter an FRO order on TradeKing?

If you've entered an order for a Fixed Return Option and have never traded an option before, there are two parts of the order screen that may be new to you: the Action and the Finish High / Finish Low sections.

**Buy to Open** - Buys a Finish High or a Finish Low and creates a long position in your account.

**Sell to Close** - Closes out an existing long position that was created by buying to open.

**Sell to Open** - Sells a Finish High or a Finish Low and creates a short position; this is also known as "writing" an option contract.

**Buy to Close** - Closes out an existing short position that was created by selling to open.

When you've entered your number of contracts, you can either use the Symbol Lookup tool or enter your underlying stock or ETF's symbol in the section marked "Underlying". You then choose an expiration date (when the contracts will expire) and a strike price (your "target" price for the underlying to finish above or below). Then click **FH** for "**Finish High**" or "**FL**" for "**Finish Low**."

Check out the TradeKing help page on Fixed Return Options orders for more information:

<http://www.tradeking.com/PrivateView/main/HelpPage/fixReturnOptionsHelp.tmpl>

## How can I maximize the chances of getting my FRO order filled?

New investment products can be a little tricky to trade when they first come out, and Fixed Return Options are no exception. You may notice bid and ask spreads on FROs are wider than for standard listed options; you may also want to watch trading patterns in your FRO first before diving in to trade. Bumps like these tend to smooth out as liquidity in the product increases.

The golden rule of liquidity works like this: the more liquid the stock, the more liquid the FROs based on that stock should be. That's why the Amex limited their FROs pilot to 20 extremely liquid stocks with good volatility and high investor interest. As additional institutional traders and brokerages bring more order flow to the product, liquidity should continue to improve. Increased liquidity usually has the effect of narrowing spreads, and making it easier to get your order filled, at tighter prices.

That said, staring down the barrel of a wide bid-ask spread or waiting to have your order filled can be frustrating. As markets in FROs grow, I'd suggest you stick to limit orders and adjust them as often as necessary. You might also have to experiment a little to see how close to the midpoint the market makers in your given FRO will move off their own bid and ask. Think of it from a market maker's perspective when setting bids and asks: their sell price is the ask and their buy price is the bid. So if a trader like yourself sends a buy price out there that's better than the market maker's buy price (bid), then the bid moves up to your buy price – you are indeed in this case moving the published quote. This then means that if a sell order were to come in, you would be the first in line to get your buy order filled.

Here's another way to think about bids and asks. If you see the bid move after a buy order is entered, it usually means the market maker is not willing to trade at your price, but wonders if someone else in the world will. Usually they'll test that theory by displaying your price to the rest of world to see if there are any sellers out there at the new bid price. It's a dance in many ways between you, other traders, and the market maker or specialist – but you'll get the rhythm if you observe things over time.

In all cases, though, the more volume the better the chances of getting a fill. Volume doesn't usually arrive overnight with new products. While many brokerage firms are working to be able to offer access to FROs, right now, TradeKing is one of a very few leading firms that offer retail clients access to these securities today.

## What happens if the FRO underlying expires exactly at my strike price? Is that considered “finishing high” or “finishing low”?

If the settlement value is “pinned” exactly at the strike price at expiration, FROs are considered to be out-of-the-money and they expire worthless. Obviously, that will favor the FRO seller over the buyer. However, since the settlement value and the strike price will rarely be exactly equal, it’s only a small advantage for the seller.

## Is FRO trading similar to any standard option strategy?

Many of you who’ve traded standard listed options in the past have noticed how FROs are similar to other, more “traditional” options strategies. If you’re someone who picked up on that, nice work.

For example, because FROs have a limited and known profit and loss potential, trading them long or short can also be compared to trading vertical spreads with strikes that are \$1 wide.

Here’s another example: if you were to sell a Finish High (FH) and sell a Finish Low (FL), this would be very similar to the more traditional Iron Condor strategy. In both cases, you’re hoping the underlying stays between the two strikes prices.

Why use FROs, then, if these trades already exist with standard listed options? The answer is simple: you may save yourself both commissions and headaches by using FROs. An iron condor is a four-legged options trade. With FROs you can make a similar move but with only two legs and therefore two fewer commissions. Plus because you are only trading two options instead of four, you only need to deal with two bid/ask spreads.

## Here are a few relationships to keep in mind:

FRO Position	Similar strategy with standard listed options
Long 1 XYZ 110 Finish High (debit trade)	Long 1 XYZ Jan 110 call and Short 1 XYZ Jan 111 call (long call debit spread)
Short 1 XYZ 110 Finish High (credit trade)	Short 1 XYZ Jan 110 call and Long 1 XYZ Jan 111 call (short call credit spread)
Long 1 XYZ 110 Finish Low (debit trade)	Long 1 XYZ Jan 110 put and Short 1 XYZ Jan 109 put (long put debit spread)
Short 1 XYZ 110 Finish Low (credit trade)	Short 1 XYZ Jan 110 put and Long 1 XYZ Jan 109 put (short put credit spread)
Short 1 XYZ 110 Finish High and Short 1 XYZ 100 Finish Low (two credit trades)	Short 1 XYZ Jan 110 call and Long 1 XYZ Jan 111 call PLUS Short 1 XYZ Jan 100 put and Long 1 XYZ Jan 99 put (short call credit spread PLUS short put credit spread creates an Iron Condor)