Flex options

FLEX options are exchange-traded options that have non-standard customisable contract terms. The main features compared to standard option traded options are the ability to specify the strike price and the expiration date. In contrast, standard exchange traded options trade only for a fixed and limited number of strikes and for specific dates. FLEX options have been mainly developed by exchanges (and more specifically by the CBOE) to get some business from the over-the-counter equity derivatives markets.

HISTORY OF FLEX OPTIONS

FLEX options are acronym for FLexible EXchange Traded option. Launched in 1993 by the Chicago Board Options Exchange (CBOE) for stock index, FLEX options have been broadened to encompass listed equity options. In addition to the CBOE, the American Stock Exchange (AMEX) and the Pacific Stock Exchange (PSE) are also trading FLEX options.

FLEX options are the second attempt after LEAPS option to target the over-the-counter market of equity options by the CBOE and more generally the US option exchanges. FLEX Options are an answer to many problems:

- Attempt to regain some market share from over-the-counter markets. According to the annual reports of ISDA or other report from the CFTC, derivatives markets have grown faster in the over-the-counter markets.

- Better client services with more tailor made products: exchanges have faced the criticism to offer contracts with very little flexibility, lack of transparencies and poor market efficiency.

- Strategic solution to internal competition: growing pressure from new comers, known as electronic communication network (ECNs), have also urged exchanges to offer innovative and flexible products.

DIFFERENCE WITH STANDARD EQUITY CONTRACTS

Standard equity contracts have limited number of strike prices and few expiration dates. In contrast, FLEX options offer the ability to customise key contract terms, like:

- Exercise (strike) price: for stock index FLEX option, any index value, for equity FLEX options, strikes increments of 1/8.
- Option style: put call, European or American
- Expiration date: between 1 business day and 5 years from the trade date. However, it cannot be the 3rd Friday of the month or two-business days date preceding or following that date.

In addition, FLEX options have the following characteristics:

- Settlement: physical for equity FLEX options and cash for stock index ones.
- Minimum size: for stock index, for new series, $10 Mio, existing series $1mio underlying value, for equity FLEX, New series: 250 contracts or $1mio underlying value, existing series: 100 contracts.

DIFFERENCE WITH OVER-THE-COUNTER OPTIONS

Compared to over-the-counter vanilla equity options, FLEX options offers:

- Price transparency and competitive bidding process of exchange auction markets: all FLEX options are quoted publicly daily. Quotations are easily accessible via standard quote systems like Bloomberg (FLEX [Go] for the menu on FLEX options markets) or Reuters (XYZ/FLXA [Enter] for most recent E-FLEX activity for all exchanges)
- lower liquidity risk: the FLEX option market can be seen as a secondary market to offset or alter positions
- Very low counterparty risk: the Option Clearing Corporation, with a AAA credit rating from Standard & Poors', is the issuer and guarantor of all FLEX option traded on American exchanges.

USE OF FLEX OPTIONS FOR PARTICULAR TRADING STRATEGIES

FLEX option offer, like over-the-counter options, the benefit of fine-tuning option strategies according to some target trading objectives. For instance, The CBOE mention the following interesting trades:

- Zero-cost collars, since the strike can be set appropriately. Zero cost collar provide downside protection and limited upside gain at no net cost.
- Ability to close position for large stock option holders with lower market impact.

- Ability for institutions to buy cheap protection on their stock holdings by buying customised puts, limiting downside risk and taking advantage of expanded position limits.
- Ability to create a synthetic short stock position by simultaneously buying customised puts and selling customised calls, avoiding early stock recalls and dividend payment concerns.
- Similarly, ability to create a synthetic long stock position at low cost by simultaneously selling customised puts and buying customised calls.
- Protect market position by buying puts with American style on the S&P500 index FLEX puts.
- Lastly, for corporate stock repurchase program, ability to sell customised puts creating the potential to buy back stock at a predetermined price while generating additional income.

QUOTE SYSTEM FOR FLEX OPTIONS

FLEX options are quoted in a slightly different way compared to standard exchange-listed options. FLEX option series, new or established, are not continuously quoted. Quotes are only generated in response to a Request For Quote (RFQ). The motivation behind this methodology is to ensure that each customer order is exposed to a competitive auction process for price discovery.

In case of a new series, the participating exchange member must submit an RFQ with the specific terms for the new series. The RFQ is translated into a standardised text message containing all the contract terms, referred to as an Administrative Text Message and sent to the Options Price Reporting Authority (OPRA). The details of the ATM are the underlying stock, the size, the type of option, the expiration date, the strike price and the exercise style

For each RFQ, the OPRA assigns a "Request Response Time" (RRT), from 2 to 20 min. It is its estimated time to get an answer to the quote request. When the delay is finished, the best bid and offer (BBO) are reported to the Submitting Member who is free to accept all or part of the BBO, seek to improve the BBO, or reject the entire BBO. There is no obligation for the Submitting Member to accept the BBO.

In case of a decline (partially or completely) by the Submitting Member of the BBO, a member can still accept the best bid or offer up to the size currently represented. If there is no interest both from the Submitting Member and the other member, the market for that RFQ is closed and the quotes are no longer valid. Any member interested in trading the same E-FLEX series must submit a new RFQ.

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Entry category: options

Related articles: Options pricing models, traded options markets

[1] The views and opinions expressed herein are the ones of the author's and do not necessarily reflect those of Goldman Sachs

References

CBOE FLEX ® OPTIONS –Quick Reference Sheet (2000), see the website of the Chicago Board Options Exchange, www.cboe.com

Learn more about Flexible Exchange Options (2000) see the website of the Chicago Board Options Exchange http://quotes.nasdaq.com/options/option_info_flex.stm

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