DEFERRED COMPENSATION PLAN
BOARD REPORT 13-30

Date: August 6, 2013

To: Board of Deferred Compensation Administration

From: Staff

Subject: Covered Call and Protective Put Options Trading in Self-Directed Brokerage Option

Board of Deferred Compensation Administration
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Recommendation:

That the Board of Deferred Compensation Administration authorize covered call and protective put options trading in the Deferred Compensation Plan Self-Directed Brokerage Option.

Background

The Deferred Compensation Plan includes a Self-Directed Brokerage Option (SDBO) which provides participants with access to a wide universe of additional investment choices including stocks, bonds, exchange traded funds, and mutual funds. The Board created the SDBO for participants who wish to take a more active role in managing their accounts and/or who wish to have access to more specialized investment choices than would be appropriate for a core investment menu.

The SDBO was introduced to the Plan in 1999 with a mutual funds only provider. That provider was subsequently replaced with the current provider, Charles Schwab, and at that time the Board elected to expand the choices open to participants to include stocks, bonds and exchange traded funds.

As of 03/31/13, there were 2,279 participants in the City's SDBO (5.7% of all participants) and $228.6 million in assets (6.0% of all assets).

The City's Plan does not presently provide for the trading of "options." Options are trading vehicles which allow investors to enter into contracts for the right to buy or sell securities at a set price after a certain timeframe, as specified in the contracts.

A plan participant recently contacted Plan staff and requested that options trading be added to the SDBO. Sporadic interest in options trading by various participants has previously been indicated informally to Plan representatives in the past. Since this issue had not been previously reviewed in depth, staff conducted some research and prepared a recommendation for the Board.

Discussion

Several variations of options trading exist, but the Internal Revenue Service (IRS) permits the trading of only covered calls and protective puts within a retirement program such as the City's Plan. Options are a complex topic. Staff will begin by introducing the concept of options trading and then proceed to describe the limited type of options trading permitted in retirement plans, prevalence in other plans, staff's justification for its recommendation, and the logistics of implementation if the Board elects to permit options trading.

How Options Work – An option is essentially a contract, or agreement, between a buyer and seller regarding the purchase/sale of a security. It differs from the more typical trading of securities in that the contract provides for a certain set of conditions around which the trade can take place.

In the normal trading of a security, a buyer and seller come together and agree to engage in a trade based strictly upon an agreed upon price. As an example, a buyer wishes to purchase 100 shares of XYZ stock at $25 per share; if someone who owns 100 shares of XYZ stock is willing to sell it for $25, then the transaction can be completed. However, with options the investors participate in a contract which allows for the option for one party to engage in a transaction at a *particular price* on or before a *particular date*.

There are some key terms and concepts relating to understanding options:

- The price of the security at which parties agree to create the option for a transaction is called the "strike" price.
- The party creating the option is sometimes called the "writer;" the alternate party entering into the option is sometimes called the "holder."
- The crucial distinction between writers and holders is that writers are obligated to buy or sell, while holders have the choice of exercising the option or not.
- The holder must pay a premium and trading fee for the right to participate in the contract; the writer receives the premium as income and is then obligated to complete the transaction if the option is exercised.
- Options can expire without being exercised.
- The premium and fee must be paid regardless of whether the transaction is completed.

Options Trading in Retirement Plans – There are two fundamental option types: calls and puts. Generally speaking, a call involves structuring a transaction around the potential for the price of a security to rise; a put involves structuring a transaction around the potential for the price of a security to decline.

In retirement plans options trading is limited to lower risk trading strategies which, to a degree, provide a means to help insure an investor's investments. The two types of allowable trades are called "covered calls" and "protective puts." Essentially what this

means is that the writer of the call or holder of the put is required to own the underlying security in order to enter into the contract.

Call Sellers/Writers are hoping to profit from the stock they own by collecting premiums from call holders. Assume that an investor owns 100 shares of XYZ stock presently valued at $50 per share, for a total investment of $5,000. Further assume that the investor thinks the near-term prospects for the stock are not good but the long-term prospects are good. The investor may then write a covered call option for the stock with a strike price of $55 and a premium of $100. If the stock trades flat or declines and never hits the $55 strike price, the Call Seller/Writer collects the premium and still retains ownership of the stock. If the stock price meets or exceeds the strike price, the Call Seller/Writer may have lost some potential additional upside, but minimally has still collected the $100 premium as well as the appreciation from $50 to $55 per share.

Put Buyers/Holders are hoping to establish a floor price for a security they own. In some cases they may be attempting to protect gains they already have realized. Assume that an investor owns 100 shares of XYZ stock which jumped from a $50 purchase price to $70 per share. The investor thinks additional upside is possible but wants to protect a portion of the gains in case the stock declines. The investor buys a protective put option for the stock which provides the right to sell the stock at $60 per share, and costs the investor a $100 premium. If the stock trades flat or continues to rise, the investor is only out the $100 premium cost. If, however, the stock falls sharply to $50, the investor can exercise the option to sell at $60, protecting half his paper gains (less the cost of the premium).

Thus, the primary benefit to an investor for writing a **covered call** is to gain income from his/her investment, while the primary benefit for an investor purchasing a **protective put** is risk management to guard against the potential loss of a paper gain.

The following table provides a summary of the benefits and risks of trading covered calls and protective puts:

Selling Covered Calls	
Benefit:	Gain of the premium as additional income.
Risk:	Much of the upside potential of holding a potential security is eliminated, and may suffer an opportunity cost if the price appreciates beyond expectations.
Purchasing Protective Puts	
Benefit:	Insurance against a sharp decline in value of the underlying security.
Risk:	Loss of premium if underlying security does not decline below the exercise price.

Prevalence in Other Plans – The Board's consultant, Mercer Investments Consulting, conducted a brief survey of governmental state section 457 plans and provided the following results:

- 27 of 50 plans offer a brokerage window
- 6 of the 27 offer options trading, 13 do not offer options trading (the status for the remaining 8 entities are at present unknown)

Plans that offer options trading include:

- California
- Delaware
- Florida
- Hawaii
- New Mexico
- Utah

Staff is completing some additional outreach to these other plans and may have additional information to share at the Board meeting.

Staff Analysis and Recommendation - Though there are risks involved with allowing options trading, in staff's view the trading of covered calls and protective puts are actually more focused on income-producing and risk-management strategies. The broader, less definable risk may lie in the fact that options trading is an inherently complex topic and some participants may choose to use them without fully understanding how they work and what they represent. However, this risk is present with all of the investment choices available in the brokerage window. Investors may misunderstand or not fully appreciate the risks of investing in an individual stock, an exchange-traded-fund, a bond fund, etc.

The Board has historically approached the brokerage window as an investment platform offered to knowledgeable investors to utilize investments which are not appropriate for a core investment menu. Allowing the trading of options appears to be consistent with this philosophy.

As such, staff recommends that the Board authorize the trading of covered calls and protective puts through the self-directed brokerage.

Implementation – If the Board adopts staff's recommendation, the Plan would notify Great-West and Charles Schwab to allow trading of covered calls and protective puts. Interested participants could submit an Options Application. Upon submission and approval, Schwab would send a disclosure document to the participant, *Characteristics and Risks of Standardized Options.*

To initiate a trade, the participant would pay a transaction fee of $8.95 and $0.75 per contract, or for each 100 shares. As indicated previously, the participant is required to

own the shares of stock or purchase the underlying stock at the time of the transaction. For any transactions not completed electronically but via a broker over the telephone, an additional $25 fee would apply.

Participants would have a listing of options to choose from, with varying strike prices and terms of contract, with premiums priced accordingly by Schwab. The quantity of options to be purchased or offered to be sold would only be restricted by the amount of shares a participant owns (and that each contract is for 100 shares). Upon purchase of an option, Schwab would place a hold on the shares involved with the contract.

Submitted by ______________________________
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