



ASX
AUSTRALIAN STOCK EXCHANGE

Grain Options

Price Insurance for your grain



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How can I find out more?

Speak to an ASX Accredited Futures Adviser or contact ASX. A list of ASX Futures Brokers is available on the Grain Futures website.

Phone 1800 028 585
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Visit www.asx.com.au/grainfutures



Important Disclaimer

This document outlines how you can benefit from ASX Grain Options. It is to be used as a guide only and is not intended to be a precise statement of the provisions of the ASX Market Rules or ACH Futures Clearing Rules or the Corporations Act. Whilst every care has been taken in the compilation of this publication, ASX expressly disclaims all liability to any person in respect of any statement in or omission from this guide.

To help explain the Options concept, reference has been made to the term “insurance”. In this document the term “insurance” is used as an analogy for “Grain Options”. The specifics of an insurance contract and an Option contract may differ considerably. The Australian Stock Exchange (ASX) is not a provider of insurance and is not an authority on insurance.



1. Introduction

Since inception, ASX Grain Futures has exhibited steady and consistent market growth. The development of the market has been encouraging and the successful establishment of two commodities Australian Milling Wheat and Australian Feed Barley bodes well for future market development.

ASX Grain Options are Options over ASX Grain Futures. The listing of ASX Grain Options is the next exciting step for this emerging market.

ASX Grain Options offer the market all the advantages available through the ASX Grain Futures market, but they also improve the elements of flexibility and accessibility. ASX Grain Options are dynamic and flexible risk management tools that trade as standardised contracts on ASX. This booklet supplies background information on how ASX Grain Options can be used to protect your business operation from price risk, in much the same way as insurance¹.

Information contained in this brochure is introductory and therefore general in nature. For more specific information regarding certain aspects of the ASX Grain Options market please contact ASX.

You do not need to know every Option strategy before you can benefit from this new market. The simplest Option strategies have the potential to empower your marketing decisions and protect your business through effective price risk management.

As an introduction to Grain Options, much of this booklet concentrates on the buying of Options. Selling Options can incorporate unlimited risk and should not be performed unless you are familiar with the risks involved.

¹ Please refer to the ASX Disclaimer on page 3.



2. ASX Grain Options

Definition	An Option is a contract between two parties giving the Buyer the right, <i>but not the obligation</i> , either to buy or to sell the underlying ASX Grain Future at a set price, on or before a predetermined date.
Concept	Bought Options are similar to price insurance ² .
Benefit	Options, as the name suggests, create alternatives for marketing, trading or hedging grain. Bought Options provide protection against unfavourable price changes while allowing Option owners to benefit from favourable price changes.
Types	Just as there are two types of positions in a Futures market – bought or sold, there are two types of ASX Grain Options, Call Options and Put Options.
Option Strategies	Both types of Option can be traded, that is bought or sold. There are therefore four basic strategies that can be adopted: <ul style="list-style-type: none">• buy a call• sell a call• buy a put• sell a put
Rights / Obligations	Option Buyers pay for the right to either buy or sell the underlying Future. ASX Grain Options can be Exercised on or before the Expiry Date of the Option contract. It is important to note that the Option Buyer is not obligated to Exercise the Option. The Buyer can trade out and sell the Option, or alternatively let the contract lapse.

² Please refer to the ASX Disclaimer on page 3.



2.1. Call Options

Option to buy a Futures contract *Call it from the market = buy it*

Definition	Call Options give the Buyer the right, <i>but not the obligation</i> , to buy the underlying Future at a predetermined price on or before a predetermined date. To acquire this right the Buyer pays a Premium to the Option Seller.
Concept	An insurance policy ³ concerned with establishing a buy price in an underlying grain Future. (If buying the call)
Common Application	A grain consumer would buy a Call Option to lock in a price ceiling. A grower may buy a Call Option if it is envisaged prices will rally post harvest but cash flow requirements dictate a harvest sale.
Benefit	Buying a Call Option allows the Option Buyer to lock in a “bought price” in the underlying grain Future. If the price of the underlying Future declines, the Option Buyer can buy the Futures for much less. If the price of the underlying rallies above and beyond the Exercise Price of the Option, the Buyer can Exercise the Option and receive a long Futures position at that predetermined price.
Seller’s Obligation	If the Option is exercised, the Seller of a Call Option sells the underlying Future at the price stipulated in the Option.

2.2. Put Options

Option to sell a Futures contract *Put it on the market = sell it*

Definition	Put Options give the Buyer the right, <i>but not the obligation</i> , to sell the underlying Future at a predetermined price on or before a predetermined date. To acquire this right the Buyer pays a Premium to the Option Seller.
Concept	An insurance policy ⁴ concerned with establishing a sale price in an underlying grain Future. (If buying the put)
Common Application	A grower would buy a Put Option to establish a floor price. A trader may buy a Put Option to protect the value of a position.

³ Please refer to the ASX Disclaimer on page 3.

⁴ Please refer to the ASX Disclaimer on page 3.



Benefit	Through the simple application of buying a Put Option, growers can establish a worst-case scenario for the price of their grain and oilseed without having a production obligation associated with the position.
Seller's Obligation	If the Option is exercised, the Seller of a Put Option buys the underlying Future at the price stipulated in the Option.

3. Reasons you should use ASX Grain Options

ASX Grain Options offer all the benefits available in the Futures market as well as a number of additional key benefits that can be utilised in a variety of ways.

3.1. Manage price risk

Options allow you to hedge against a possible unfavourable move in the value of your crop, inventory or grain requirements.

By buying a Put Option, you guarantee the sale price of your grain for the life of the Option, no matter how low the Grain Futures price may go. Without a hedge using Put Options your grain will lose value in a market downturn. The purchase of a Put Option is similar to a form of insurance⁵ against a fall in the commodity price.

By buying a Call Option, you guarantee the purchase price of your grain for the life of the Option, no matter how high the Grain Futures price may go. Without a hedge using Call Options the cost of your grain requirements will increase in a bull market. The purchase of a Call Option is similar to a form of insurance against a rise in the commodity price.

3.2. Manage production risk

Drought weary producers have become increasingly aware of the production risks associated with forward contracting. Buying an Option gives the Buyer a right, not an obligation. If the crop never eventuates there is no obligation to deliver or take delivery against a bought Option position. Buying Put Options gives producers a right, *but not the obligation*, to sell the underlying future at a predetermined price. This will be of particular value to growers that want to take advantage of price spikes but are not willing to forward sell.

3.3. Buy yourself time to decide

By buying (taking) an Option, you are effectively deferring the decision to buy (Call Option) or sell (Put Option) the Underlying Futures Contract.

By buying a Call Option you lock in the purchase price for the underlying grain Futures contract. You then have until the expiry day to decide whether or not to Exercise the Option and create a bought Futures position, you will then have

⁵ Please refer to the ASX Disclaimer on page 3.



approximately two weeks to decide whether you wish to take delivery against your Futures position or trade out of the Future.

Likewise, by buying a Put Option you lock in a selling price, and give yourself time to decide whether or not to proceed with the sale of the grain.

In both cases, the most you can lose is the Premium you have paid for the Option. In fact if you were buying Options as a hedge strategy, you should prefer to lose the Premium. If the hedge position has expired worthless, that would suggest there has been a favourable move in the underlying price.

3.4. Trade the track market and achieve leveraged returns

ASX Grain Options are derivatives based on the underlying physical track market. It follows that ASX Grain Options are a tool that can be used to trade or hedge underlying physical positions in the track market.

Grain industry participants use exchange-traded Options to gain or protect an exposure to a particular grain or oilseed for a limited period of time. Options are flexible instruments because they allow you to tailor the exact exposure and risk you wish to adopt for an anticipated move in the commodity price. You can use Options in isolation, or to complement an existing Futures position.

Speculative traders can use ASX Grain Options to gain leveraged exposure to anticipated movements in grain prices. By applying combinations of the four basic Option trades, traders can construct positions to suit their market view. Whether a Participant is bullish, bearish, directionless, or is expecting greater volatility or less volatility, there is an Option strategy to meet the Participant's needs. By combining strategies, Option traders can construct a scenario that profits from a sideways market, a bull market, a bear market or a significant directional movement.

4. Other benefits of ASX Grain Options

4.1. Benefit from favourable prices

Hedging with ASX Grain Options enables the benefit of favourable prices to be realised while worst case scenarios are known.

4.2. Increased flexibility

An Option market creates additional flexibility and trading possibilities for the underlying market.

4.3. Reduced counterparty credit risk

As with Futures, the novation role performed by the Australian Clearing House Pty Ltd (ACH) is critical in ensuring the financial integrity of the ASX Grain Options market.



4.4. Reduced foreign exchange risk

Contracts are traded in Australian Dollars thereby removing the need for domestic participants to place secondary currency hedges. Also, hedges and trades on ASX will more closely reflect the underlying market as foreign exchange movements will be factored into the domestic price, the Futures price and ultimately the Options price.

4.5. Price transparency

The prices and volumes traded in the market are widely reported. ASX Grain Options information is disseminated real time through all major data vendors and free data (20 minute delayed) is available at www.asx.com.au/grainFutures

4.6. Market anonymity

The identity of Market Participants remains anonymous.

4.7. Low transaction costs

Exchange charges are low, and are the only costs incurred apart from brokerage, which is negotiated with your broker. Low transaction costs further enhance the leverage available.

5. Risks of trading Grain Options

You can use Options to tailor the exact exposure and risk you wish to adopt for an anticipated move in the commodity price. In planning any Options strategy, it is important to consider the risks of Options trading. These risks include:

- an Option is a wasting asset
- you may still suffer a loss even if your view on the underlying is correct
- as an Option Seller, you face potentially large and unlimited losses
- leverage can be a double edged sword

5.1. An Option is a wasting asset

Part of an Option's Premium represents time value, which can be described as the amount you are prepared to pay for the possibility that you could make a profit from your Option position. As time passes, the opportunities for your Option to become profitable decrease, and the Option's time value declines. This erosion of time value is called time decay. Time decay becomes more rapid as the expiry of the Option nears.

Time decay always works against the Buyer of an Option. As the Buyer of an Option, you need the commodity price to move far enough in your favour to outweigh this loss of time value.



5.2. A correct view may still incur a loss

There are several factors that influence the price of an Option. These include time to expiry, volatility and interest rates. How the underlying Futures price moves is important, however it is not the only influence. This means that even if the underlying Futures price moves in the direction you expect it to, other factors may mean that your Option drops in value.

5.3. Uncovered Option Sellers are exposed to unlimited risk

While the risk faced by the Buyer of an Option is limited to the Premium paid for the Option, the risk profile for the Option Seller is potentially unlimited if the Futures contract has a significant move in an unfavourable direction.

If a Call Option you have sold uncovered is Exercised, you now have a short Futures position. The term uncovered means that you do not have an offsetting long position in the underlying Future or physical market. To close out your short Futures position, you will have to purchase the Future at the prevailing market price prior to the Delivery Period. If the Futures are trading a long way above the Exercise Price of the Call Option, you may make a substantial loss.

If a Put Option you have written is Exercised, you must buy the underlying Future at the strike price of the Option. If the Futures price has fallen a long way, you will be buying the Future for considerably more than prevailing market value.

5.4. Leverage, a double-edged sword

Leverage means that you can make large percentage profits from Option trades when your view on the Underlying Commodity proves correct. However, it also means that if your view is incorrect, your losses in percentage terms will be correspondingly large.

6. The key features of an Option

Grain Options are exchange traded. They have standardised features and the only negotiated aspect is the Premium, which is the market price of the Option. In describing an Option contract, there are four features that must be specified. They are the:

- Underlying Future
- Expiry Date
- Exercise Price
- Option Premium



6.1. Underlying Future

Expiry	Future	Exercise Price	Type	Premium
Nov	AWM	200	Put	\$10
Jan	ACM	400	Put	\$20
July	AFB	170	Call	\$15

ASX Grain Options are Derivative instruments based on ASX Grain Futures. An Option Contract Size is standardised at one Underlying Futures Contract (20 tonnes). Initially, grain Options will be listed over;

- Australian Milling Wheat (AWM)
- Australian Feed Barley (AFB)
- Australian Canola (ACM)

6.2. Expiry Date

Expiry	Future	Exercise Price	Type	Premium
Nov	AWM	200	Put	\$10
Jan	ACM	400	Put	\$20
July	AFB	170	Call	\$15

The Expiry Day is the day on which all unexercised Options in a particular series expire. It is also the Last Trading Day for that particular contract month. For Grain Options the Expiry Date is the fifteenth Business Day of the month immediately preceding the Underlying Futures Contract month. For example, the Last Trading Day and Expiry Date for a January Option will be the fifteenth Business Day in December.

ASX Grain Options are based on the Deliverable ASX Grain Future contracts. Option expiry occurs during the month immediately preceding the underlying Delivery Period. A description of the delivery process can be found at www.asx.com.au/grainFutures.

The above table has listed the Underlying Futures Contract. It is industry practise to quote the Option in terms of the underlying. Therefore, if you were looking to perform an Option trade over the November Milling Wheat Future, the Option would be referred to as the November Option. This Option actually expires in October.

ASX lists Options over grain Futures for the nearest three contract months and new crop contract. For Expiry Date details, refer to the maturity calendar on the website.



6.3. Exercise Price

Expiry	Future	Exercise Price	Type	Premium
Nov	AWM	200	Put	\$10
Jan	ACM	400	Put	\$20
July	AFB	170	Call	\$15

This is the price at which you may buy or sell the underlying Future if you Exercise your ASX Grain Option. The contract value is expressed in Australian Dollars per tonne.

ACH lists a range of Exercise Prices for all grain Options listed. Typically, the range of Exercise Prices includes one Exercise Price close to the current market price of the Underlying Futures Contract with one Exercise Price above and one Exercise Price below the commodity's current Futures price. New Exercise Prices list as the underlying Future moves.

6.4. Premium

Expiry	Future	Exercise Price	Type	Premium
Nov	AWM	200	Put	\$10
Jan	ACM	400	Put	\$20
July	AFB	170	Call	\$15

The Premium is the price of the Option, determined by market forces. When buying Options, Buyers pay the Premium in full. The settlement of Premium is the same as Futures and must be paid the Business Day immediately following the transaction date.

The Premiums for Grain Options are quoted on an Australian dollars per tonne basis. To calculate the full Premium payable for a Grain Option, multiply the Premium by the tonnage involved. For example, a Premium of \$20 for 5 January Australian Canola (ACM) 400 Put Options equals a total Premium cost of AUD \$2000 (\$20 * 100 tonnes).

Contract specifications for ASX Grain Options can be found on the website.



7. The Premium – value of the Option

The Premium = Intrinsic Value + Time Value

Expiry	Future	Exercise Price	Type	Premium
Nov	AWM	200	Put	\$10
Jan	ACM	400	Put	\$20
July	AFB	170	Call	\$15

Market forces determine the price (Premium) of an Option. When the Option Buyer and the Option Seller agree on a price for the Option contract, the trade takes place.

7.1. Intrinsic value

Intrinsic value is the difference between the Exercise Price of the Option and the market price of the underlying Future at any given time. If an Option has intrinsic value, it is said to be ‘in-the-money’.

For example, a January Feed Barley \$200 Put Option is ‘in-the-money’ if the underlying January Feed Barley Futures market is less than \$200. If the Option was a Call Option, and the Futures market was less than the Exercise Price, the Option would be ‘out of the money’. Options are also referred to as ‘at-the-money’, that is the exercise price is the same or very near to the underlying futures price.

Option Type	Exercise Price less than Futures Price	Exercise Price equal to Futures Price	Exercise Price greater than Futures Price
Call Option	In the money	At the money	Out of the money
Put Option	Out of the money	At the money	In the money

7.2. Time value

Time value represents the amount an option buyer is prepared to pay for the possibility that the market might move in their favour during the life of the Option. The amount of time value will depend on whether the Option is in the money, at the money or out of the money. At any given time, the at-the-money Option will have the greatest time value. The further in or out-of-the-money the Option is, the less time value it will have. An Option's time value is affected by the following factors:

7.2.1. Time to expiry

Time value increases with the length of time to expiry and decreases as Option expiry draws closer. This erosion of time value is called time decay. It is not constant, but increases rapidly towards expiry.



7.2.2. Volatility

In general, greater volatility of the Underlying Commodity creates greater time value. This is due to the fact that the Option Seller is exposed to a greater probability of incurring a loss, and will require a higher Premium income to compensate for the increased risk.

7.2.3. Interest rates

The risk free rate that matches the life of the Option is usually used when using Option pricing models. So, for example, for a three-month Option the three-month bank bill rate would be used.

7.2.4. Market expectations

Ultimately, the forces of supply and demand determine the value of Options.

8. Option pricing models – how options are ‘theoretically’ valued

An Option pricing model is a mathematical formula or model into which the following key parameters are inputted:

- Underlying Future
- Exercise Price of the Option
- Expiry Date of the Option
- expected risk free interest rate over the life of the Option
- expected volatility of the Underlying Commodity over the Option’s life

When the formula is applied, the result is the *theoretical fair value* of the Option. The two main models used for pricing Options are the binomial model and the Black Scholes model.

8.1. The relationship between fair value and market price

Although the fair value may be close to where the market is trading, other pricing factors in the marketplace mean fair value is used mostly as an estimate of the Option’s value. Moreover, fair value will depend on the assumptions regarding volatility levels and interest rates that are made by the person using the pricing model. Different expectations of volatility or interest rates will alter the fair value result. This means that at any one time there may be many views held simultaneously on what the fair value of a particular Option is.

In practice, supply and demand will often dictate at what level an Option is priced in the marketplace. Traders may calculate fair value on an Option to get an indication of whether the current market price is higher or lower than fair value, as part of the process of making a judgment about the market value of the Option.



8.2. Volatility

The volatility figure input into an Option-pricing model reflects the assumptions of the person using the pricing model. Volatility is defined technically in various ways, depending on assumptions made about the underlying Future's price distribution. For the regular Option trader it is sufficient to know that the volatility a trader assigns to a commodity reflects expectations of how the commodity price will fluctuate over a given period of time. Volatility is usually expressed in two ways: historical and implied.

8.2.1. Historical Volatility

Volatility observed in a commodity over a given period of time. Price movements in the commodity are recorded at fixed time intervals (for example every day, every week, or every month) over a given period. More data generally leads to more accuracy. Be aware that a commodity's past volatility may not necessarily be reproduced in the future. Caution should be used in basing estimates of future volatility on historical volatility. If you want to price a three-month Option, you should use three-month historical volatility.

8.2.2. Implied Volatility

The volatility implied from the Option's current market price, using a standard Option-pricing model. Keeping all other inputs constant, you can put the current market price of an Option into any theoretical Option price calculator and it will calculate the volatility implied by that Option price.



9. Grain Option strategies

One of the main benefits of Options is the flexibility they provide in terms of trading different market directions. You can use Options in strategies to reflect just about any market view over a variety of time periods.

As has been previously mentioned, there are two types of ASX Grain Options

- Put Option
- Call Option

Because Grain Options can be bought and sold in their own right, there are four possible trades that can be performed. The numerous strategies to trade or hedge a commodity price are essentially combinations of these four strategies. For more in depth discussion of Option strategies visit the 'Option strategy' link on the ASX Grain Futures website.

Type of Option	Type of Order	
	Buy	Sell
Put	Buy a Put	Sell a Put
Call	Buy a Call	Sell a Call



10. How do I hedge with ASX Grain Options?

One great benefit of hedging with Options is that while hedging with Futures effectively locks in a price, when hedging with Options you can benefit from favourable price movements and at the same time have no associated production risk.

10.1. Producer Put Hedge

Assume you are a producer of Milling Wheat. You are looking to lock in a worst-case price scenario for your wheat. You would also like to realise better prices if the market rallies. Buying Put Options over the January AWM Futures will enable you to achieve this flexible solution.

In July, wheat is trading in the track (cash) market at \$220 per tonne while January AWM Futures are trading at \$230 per tonne. You believe that is a good price for wheat. You have 1000 tonnes to hedge.

As one contract equals 20 tonnes of wheat and you want to hedge 1000 tonnes, you buy 50 Jan AWM 220 puts, paying a Premium of \$10 per tonne. The total cost of the Premium will be 50 contracts x 20 tonnes x \$10 = \$10,000. At the time of the trade you will be required to pay the Premium upfront.

As maturity approaches, the track price and Futures price should converge and be close to equal⁶ at the close of the market on the Maturity Day. If there is any mismatch in prices, market participants can take advantage of these arbitrage opportunities to help force price convergence.

Assume that a week before maturity of the January Options contract you have harvested your milling wheat and want to either sell it on the cash market or sell it through the Futures market. At this stage, the track price has fallen to \$170 per tonne and the January Futures price is also \$170 per tonne.

You have two choices you can either:

- sell the 50 Jan AWM 220 puts at market value which has at least \$50 intrinsic value and sell the grain elsewhere,
- or Exercise the Option contracts and establish a short position in the January AWM Futures at \$220, which you can then trade out of, or deliver against.

If you had not hedged your position your sale price would simply have been the cash price available in December of \$170.

Had the market price for milling wheat rallied to \$250 in December, you would forego your \$220 Put Option and benefit from the higher cash price.

⁶ Assumes no transactions costs



10.2. Consumer Call Hedge

Assume you are a consumer of Feed Barley.

The risk for a grain consumer is price increases before inventories are purchased. Because of the very competitive nature of the agri-food industry, increased input costs are very difficult to pass on to the consumer. It is therefore imperative that consumers minimise their grain price risk.

Buying a Feed Barley Call Option can help protect business from increased input costs, but also allow the benefit of cheaper grain prices.

You believe there will be a post harvest bounce in feed grain prices as the sorghum crop is not receiving favourable weather conditions. You need cover for Feed Barley purchases that will occur between January and July on an even spread basis.

You look to buy Call Options for the following Feed Barley contract months, March 2005, May 2005 and July 2005. If the price of feed grain does rally you will have locked in a price ceiling. If the crop conditions improve for the sorghum crop and prices soften you will forego the call options and benefit from the cheaper grain prices.

11. Setting up a Trading Account

The first step to trading ASX Grain Options is to contact your ASX Futures broker. Once you have signed a Client Agreement Form your broker will open your Futures trading Account with ASX. Before you can place an order, your broker will require you to deposit cash or Collateral to cover potential margin obligations.

When taking advice from a broker, you should ensure that the adviser is accredited by ASX Futures. The accreditation requirement is designed to ensure that advisers give quality advice and service on ASX Derivatives products.

12. Where are ASX Grain Options traded?

ASX Grain Options trade on the same platform as ASX Grain Futures. Orders placed through your broker are traded on a screen based trading system called the Derivatives Trading Platform (DTP). Developed by the Swedish company OM, the CLICK™ system⁷ is used by many exchanges around the world.

⁷ The OM CLICK Exchange system and OM CLICK Trade are trademarks of OM AB.



13. Cost of trading Options

Options, by providing leverage, are a cost effective way to trade your view on a market. The costs involved in trading ASX Grain Options are:

Exchange Fees

Trade Registration	\$2.50 per contract per side, excluding GST
Exercise / Assignment	\$2.50 per contract per side, excluding GST

Brokerage

Brokerage charged by brokers varies but is most likely to be a flat fee, charged on a per contract, per side basis.

14. Margins

Option Buyers pay the premium for the Option upfront. Option Buyers therefore have no margin obligations for their Option position.

However, if you sell (write) an Option contract, you have a potential obligation to the market because the Buyer of the Option may Exercise their position. A margin is an amount calculated by the Australian Clearing House (ACH) as necessary to ensure that you can meet that obligation and cover the risk of financial loss on an Options contract due to an adverse market movement. Margins are essential to preserve the financial integrity of the ASX Grain Option market.

Margin obligations may arise from:

- sold Call Option contracts
- sold Put Option contracts
- any Futures positions

To find out more about margining please read, “Grain Options – Margins”.

15. Like to know more?

Speak to an ASX Accredited Futures Adviser. A list of ASX Futures brokers is available on the Grain Futures website.

Or contact ASX:

- Phone 1800 028 585
- Email grainfutures@asx.com.au
- Visit www.asx.com.au/grainfutures