Covered Call Options
&
Income

Introduction

Brokerage firms sometimes recommend that clients sell call options to generate *income* from concentrated positions. For example, Merrill Lynch targets holders of concentrated stock positions with its ROMS™ call option program. http://www.rampartservices.ml.com

Unsophisticated investors are misled when brokerage firms use such option traders' jargon to communicate with the public. Selling call options does not generate *income* as we typically use that term. Selling call options just converts one form of asset into another. Converting a security interest into cash – that is, selling it – no more generates income than purchasing an asset with cash would generate expense.

Selling Options Doesn't Generate Income

An investor selling call options agrees to sell shares, at the option buyer's discretion in exchange for an upfront payment.

For example, an investor might sell a call option expiring in six months with an exercise price of $120 on a stock. If the stock price is above $120 at expiration, the option buyer will pay $120 to the option seller and receive stock worth something more. If the stock is worth less than $120, the option buyer will abandon the worthless option and the option seller will have profited by the upfront payment.

Sellers of exchange-traded options initially take on liabilities (the short option positions) equal in value to the value of the cash received. Thus, option sellers are simultaneously increasing their assets and liabilities by exactly the same amount without any change in their net assets. It is abuse of language to describe these transactions as generating *income*.

Covered Call Options and Income

In covered call writing, investors sell options on shares they own. For example, an investor who owns 10,000 shares currently worth $100 might sell call options on 10,000 shares. Before selling the call options, the investor had contractual rights to 10,000 shares regardless of the future price. By selling the options, the investor sells part of his rights in the shares.

The option seller is effectively agreeing to sell a fraction of the 10,000 shares covered by the options at a price below the prevailing market price in the future - with the fraction which must be sold at disadvantageous prices sadly increasing with the prevailing future market price.

Tax Code Doesn't Support Jargon

The IRS treats the sale of an option as any other opening short position. The transaction generates neither income nor expense. If the option is bought back at a profit or expires worthless, the investor reports capital gain. Buying back the option at a loss may or may not produce a deductible capital loss under the complicated straddle rules.

If the option is exercised the covered call option seller adds the option premium to the amount she would otherwise report as sale proceeds on the sale of the covered shares.

Conclusion

Brokers owe it to their customers to fairly and accurately describe all material attributes of a proposed transaction. It is misleading to describe the sale of call options as generating income since the payments received by the investor are exactly offset by a reduction in their other assets or by an increase in their liabilities.

The industry's misuse of jargon is not benign. Investors, who hold concentrated positions, in part in reliance on the industry's misleading descriptions of covered call writing, may continue to be imprudently exposed to substantial diversifiable risk.

April 30, 2005

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