CANADIAN ADVISORS AND
THE USE OF OPTIONS

TMX Montréal Exchange

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THE SURVEY

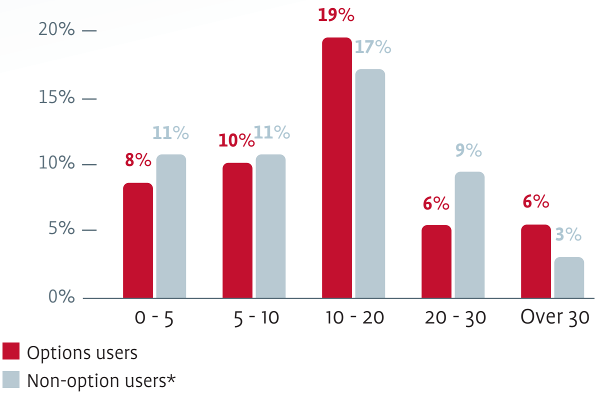
The use of exchange-listed options has experienced tremendous growth over the last decade. A challenging economic environment and a continuously evolving regulatory landscape have been driving forces in the increasing interest in options by institutional and retail investors. This study was conducted in the Fall of 2014 by the Montréal Exchange in an effort to better understand how, when and why Canadian advisors use options and to compare their practices with those who do not.

All Canadian registered investment advisors, whether or not they used options or were options-licensed, were eligible to take the 20-minute online survey. An invitation to complete the survey was sent to 6,000 IIROC-registered advisors, representing approximately 20% of the Canadian advisory community. A total of 478 responses were collected with 12.3% of responses rejected because the survey was either incomplete or did not meet pre-established assumptions and parameters. The results of the study are therefore based on a nationally representative sample of 419 Canadian investment advisors.

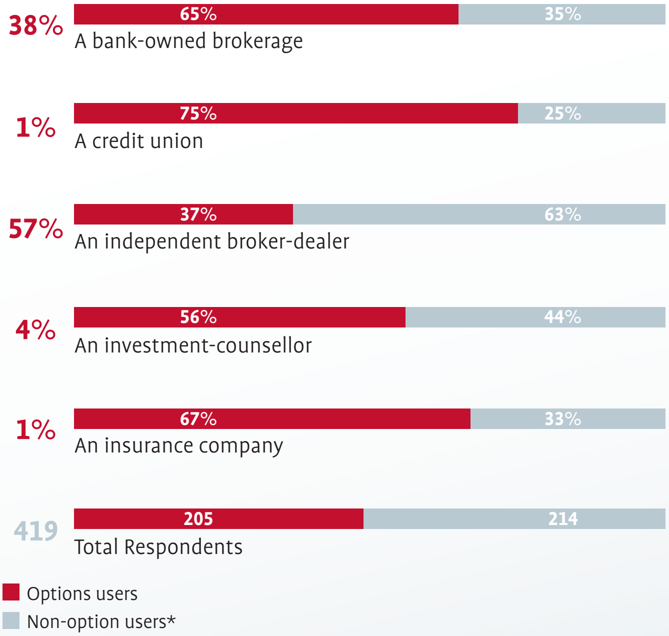
In Canada, investment professionals must complete the Derivatives Fundamental course (DFC) and the Options Licensing course (OLC) in order to meet both regulatory and educational requirements to advise clients on options. The courses are also offered as one single examination, the Derivatives Fundamentals and Options Licensing course (DFOL), since January 31, 2011 in order to make these important risk management tools more accessible to Canadian investors. Although some firms encourage advisors to obtain their options license, it is not mandatory at the moment.

Two-thirds of the sample had completed the DFOL and were options licensed. However, there were 18% of options licensed advisors who were non-options users, creating a sample almost evenly composed of options users (49%) and non-options users (51%). The sample was also diversified in terms of years of experience in the advisory field and their firm of employment.

NUMBER OF YEARS OF EXPERIENCE



OPTIONS USAGE BY CHANNEL



* Non-options users in this example are investment professionals that are non-options licensed and/or have not bought or sold options for their clients in the last 12 months

THE IMPORTANCE OF EDUCATION

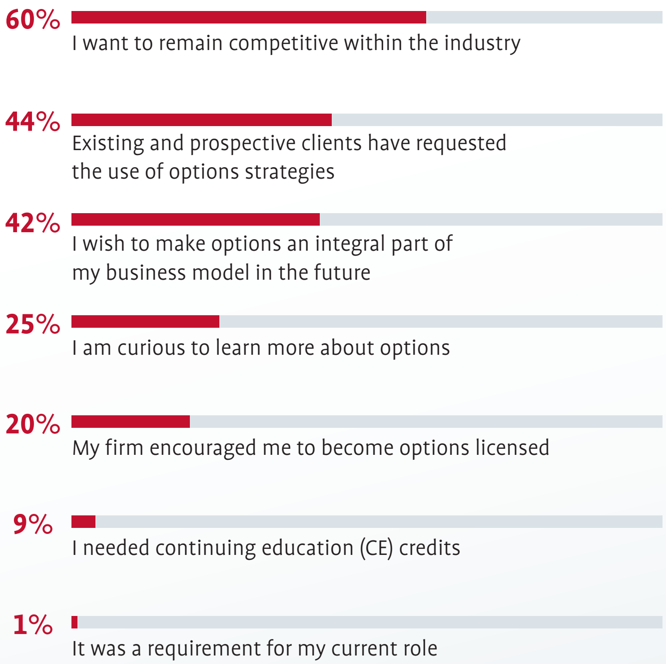
Options users stated that there were various reasons why they elected to complete the Derivatives Fundamentals and Options Licensing course (DFOL) and become options licensed. However, two thirds of options users agreed that the completion of the course was essential for them to remain competitive within the industry.

In fact, half of all options users who participated in the study mentioned that existing and prospective clients have inquired about the use of options strategies in the past. Therefore, advisors felt that adding options to their practice was instrumental in growing their business, retaining their clientele and generating a number of referrals.

The perceived need to remain competitive in the industry was also the main motivator for non-options licensed advisors to pursue the accreditation. In fact, 30% of them did indicate that they were planning on completing the DFOL within the next 12 months.

Other factors encouraging advisors to complete the DFOL included their firm's influence and support, as well as the desire to broaden their investment knowledge.

WHY ADVISORS BECOME OPTIONS LICENSED



Meanwhile, findings also revealed why some advisors, options-licensed and non-options licensed, have chosen not to offer options to their clients. According to non-options users, the main deterrents were that clients consider options too risky, the length of time required to manage options positions as well as their own lack of knowledge.

An unexpected finding was that 85% of advisors, whether they were already options-licensed or not, or planning on completing the course or not, were interested in learning more about how options work, their risks and rewards, as well as strategies for using them.

Options users and non-options users would consult similar sources in order to expand their knowledge although they would favour a colleague or team member as well as industry recourses, like the Montréal Exchange in Canada, and The OIC in the U.S.

RESOURCES USED FOR MORE INFORMATION OR EDUCATION ON OPTIONS

44% Industry resources, like the Montréal Exchange or the OIC (The Options Industry Council)

42% A colleague or team member

31% Your firm's options desk

30% Your firm's continued learning and education department

24% Financial services like Bloomberg or Morningstar

17% Public finance websites like Yahoo Finance or Google Finance

12% An advisor at another firm

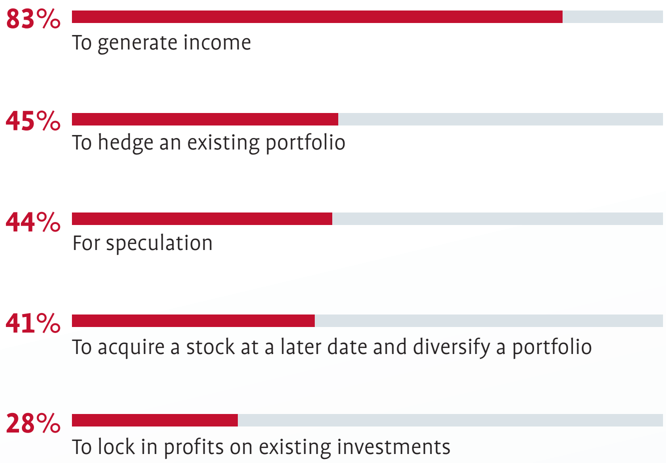
WHY AND HOW ADVISORS ARE USING OPTIONS

In spite of a low volatility environment that persisted throughout 2014, 75% of options-licensed advisors have used options at least once in their client accounts over the past 12 months.

The study also revealed that options are now considered an asset class of their own as they represent an important component of the asset allocation mix. Active options users allocate up to 20% of their assets under management (AUM) to options strategies. For the majority, less than 5% of their portfolio is invested in options because they focus on tactical allocation in order to achieve specific financial objectives. These figures are significant considering the financial leverage options provide to investors.

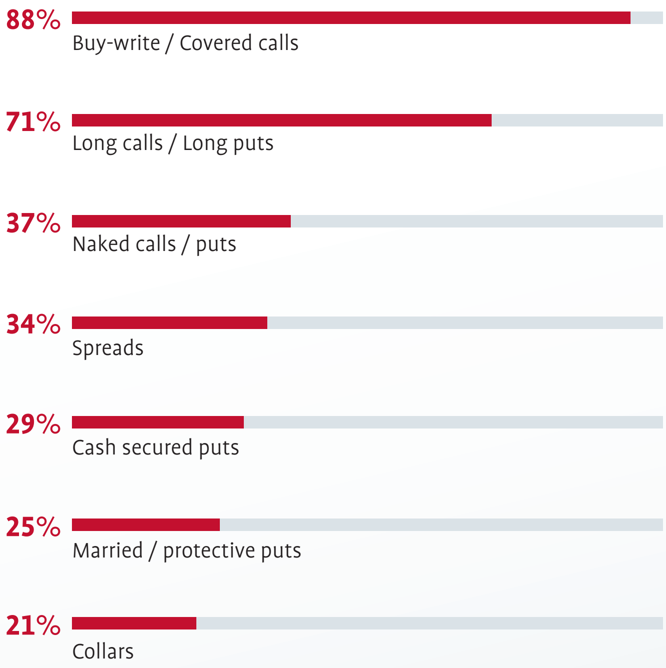
The array of options strategies being used was broad and designed to meet various investment objectives. Income generation and protection were the primary focus for investment professionals.

THE REASONS WHY USE OPTIONS



The most popular strategies used by advisors were aligned with their objectives and included covered call writing as well as long calls and long puts. These strategies, with limited risk exposure, demonstrate that advisors are conservative in the way they use options in their clients' portfolios.

OPTIONS STRATEGIES USED IN CLIENT PORTFOLIOS



Advisors relied on various sources to elect which strategy to use to meet their clients' financial objectives. Although the majority of option users stated that they develop their own strategy, they mentioned consulting other sources such as print and social media.

The findings also indicated that 10% of options users were implementing options strategies only when client driven. In fact, almost a third of options users said they only discuss the use of options with existing or prospective clients if the clients initiate the discussion.

HOW ADVISORS SELECT OPTIONS STRATEGIES

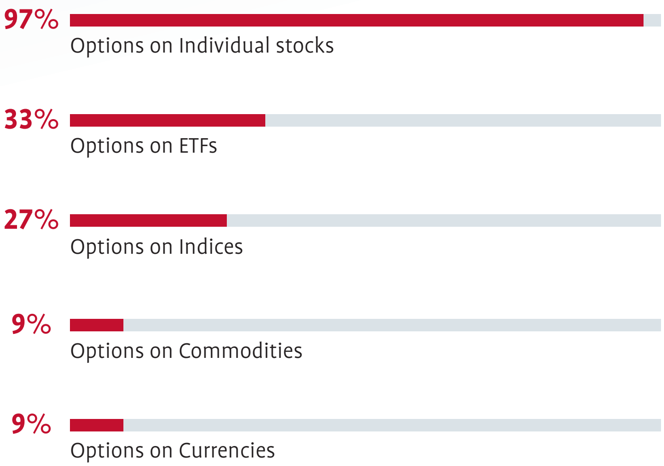
In terms of usage, the size and number of options orders executed yearly varied considerably amongst advisors, from what could be qualified as sporadic use to more systematic applications.

One out of five options users reported that, on average, their options order size exceeded 100 contracts. Those advisors also indicated that they traded 4 times more contracts on a yearly basis, which suggests that the majority of the volume is executed by a minority of advisors. These findings are also reflective of the overall advisory community with a few advisors tailoring to a niche market segment composed of more sophisticated investors.

Only a limited number of options users (5%) stated that they lean on their trading desk in order to obtain better execution, which is specifically designed to assist with large orders. The majority of options users said that they place options trades on their own or that a designated member of their team handles the options trading on their behalf.

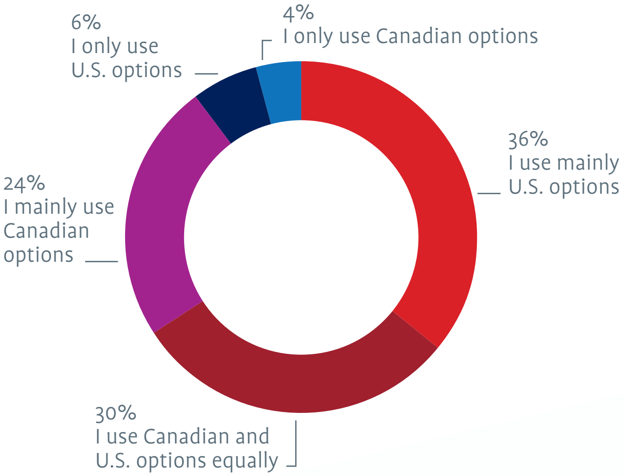
Options on individual stocks were the most common type of options used by advisors; but the accelerating growth of exchange traded funds (ETFs) over the last few years has propelled one out of three advisors to use options on ETFs. Other underlyings of interest included indices as well as commodities and currencies.

OPTIONS USED IN CLIENT PORTFOLIOS



Canadian advisors benefit from unlimited access to the U.S. options market. The ability to transact in both the Canadian and U.S. market reduces the number of advisors who trade exclusively in one country. In fact, the findings revealed that 30% of advisors used Canadian and U.S. options equally.

OPTIONS USAGE: CANADIAN VS U.S.



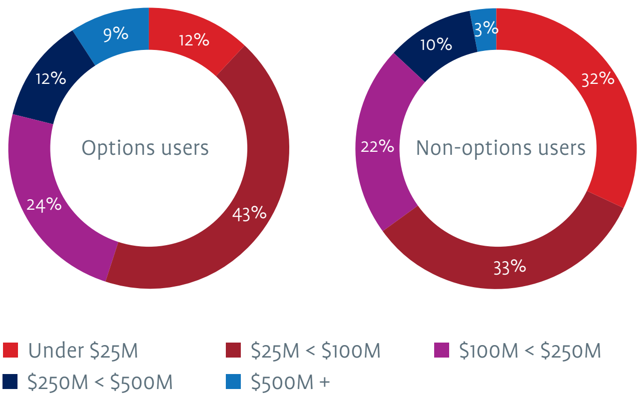
Some options classes are dually listed and can be traded in Canada or in the U.S. The survey revealed that 72% of advisors traded options on interlisted securities and that one in five executed more than 60% of their options trades on interlisted stocks in Canada. On the other hand, three in five advisors favoured the U.S. as over 80% of their options trades on interlisted stocks were executed in the U.S.

THE IMPACT OF OPTIONS ON THE ADVISORY BUSINESS

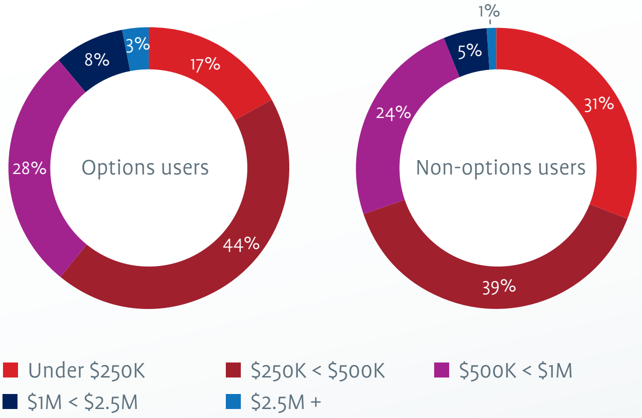
Although options users and non-options users oversee on average the same number of clients, options users had larger, more successful practices in terms of assets under management (AUM).

In the survey, 45% of options users had books over $100 million compared with 35% of non-options users. Options users had significantly less client accounts below $250,000 (17% vs. 31%) and almost twice as many client accounts valued at $1 million or more (11% vs. 6%).

OPTIONS USAGE BY BOOK SIZE



OPTIONS USAGE BY AVERAGE ACCOUNT SIZE



Options users managed a greater percentage of accounts that were fee-based than non-options users. In fact, advisors with 40% or more of their AUM in fee-based accounts corresponded to 69% of options users vs. 44% of non-options users.

The difference between options users and non-options users was marginal when comparing advisors managing accounts on a discretionary basis, and the proportion of assets held in registered vs. non-registered accounts.

Although options usage may not dictate the type of account where assets are held, findings revealed that it did impact the amount of assets gathered from referrals.

One in four advisors said that they actively promote options as an integral part of their business and will systematically mention options and options strategies when meeting with prospective clients. Moreover, more than half of options users obtained at least one referral over the last 12 months based on their options offering.

CHALLENGES

One in three options users said that they were experiencing difficulties in growing their options business. Those challenges varied considerably from one advisor to another.

Client education was by far the most significant obstacle according to surveyed options users. Overcoming the stigma that options are risky and speculative requires patience and time. Resistance from clients is recurrent making their education a continual process. To that effect, advisors believed that educational resources and tools would facilitate client education.

Compliance is also perceived as a roadblock because similarly to clients, training shortcomings cause an important lack of understanding of options strategies. Also, the documentation for suitability is said to be extensive, investment policies are often limited to a handful of strategies and advisors say compliance is often reluctant to approve options use even for sophisticated clients keeping them from expanding their options activities.

Liquidity in the Canadian market was also identified as a challenge in increasing their use of options. The lack of liquidity on certain options classes increases the difficulty of executing complex strategies, discouraging options users. Because of this constraint, some options users limit their use of Canadian options to actively traded classes, while others simply elect to transact in an alternative, larger and more liquid market, namely the U.S.

Although they were considered less significant, time and cost were also identified by advisors as obstacles when trying to scale their options business. Those were particularly important for commission-base advisors.

CANADA VS. UNITED STATES

Although there are close cultural ties between Canadian and U.S. advisors, they have very distinct investment realities. These important differences are key influencing forces on the advisors' use of options.

In the U.S., the Series 7 grants aspiring financial advisors the power to deal with all types of securities, excluding commodities and futures, but including options. In Canada, the Derivatives Fundamentals and Options Licensing course (DFOL) must be completed in addition to other courses in order to be able to advise clients in options. This additional and elective step of the licensing process is often overlooked by advisors, creating an important disparity in professional qualifications with their U.S. counterpart.

Once advisors complete the DFOL and are options licensed, they have the ability to trade Canadian and U.S. options without limitations. In fact, the most active Canadian stocks are dually listed in Canada and the U.S., which creates a competitive disadvantage for the Canadian options market. The higher level of activity in the U.S. market is mainly responsible for the transfer of liquidity south of the border. Conversely, U.S. investors who would like to trade options on Canadian stocks in their natural market are prohibited from doing by regulatory constraints.

Although both economies are heavily weighted in financials, Canada relies considerably more on energy and materials whereas the United States focuses more on information technology and consumer discretionary, sectors including more companies in the media spotlight. In fact, some Canadian advisors who use mainly U.S. options often do so because the United States is home to some of the largest publicly traded companies around the world, such as Apple Inc., and more recently, a considerable number of IPOs, which have been some of the most anticipated in the U.S. history, including Alibaba, Facebook and Twitter, creating investor frenzy.

In spite of these differences, the use of options is gaining traction in both countries. As they develop their options business, Canadian and U.S. advisors are experiencing similar difficulties such as client education and compliance. Regardless of the hurdles, advisors have recognized the benefits of using options as a risk management tool and are investing time, effort and money in their education so they can better navigate today's challenging economic environment and continue to meet their clients' investment objectives and needs.

KEY FINDINGS

- **The increasingly competitive financial industry is the key motivation for advisors to use options.**
  The ability for advisors to expand their product offering is likely to facilitate retaining existing clients as well as acquiring new clients.

- **Options are a niche product.**
  Although advisors wish to differentiate themselves, options are offered by only a limited number of advisors who tailor to a more sophisticated clientele.

- **The array of options strategies employed by advisors is very broad.**
  However, the use of conservative strategies, such as covered call writing, is prevalent.

- **Advisors who use options have larger practices.**
  45% of options users had books over $100 M compared to 25% of non-options users.

- **Clients are requesting the use of options for income generation and risk management.**
  Advisors are implementing options strategies because an increasing number of clients inquire about them.

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