KEY TAKEAWAY – WHAT IS PAPER

PAPER

is a trading term that refers to order flow or trades that are on the opposite side of a market maker. If paper is selling the Jan24 55 SPX calls 10,000 times at $1.50, that means that a market maker/makers on a trading floor bought the Jan24 55 SPX calls 10,000 times paying $1.50. Market makers talk in terms of what paper is trading as opposed to the trades they did. If paper is buying, we know market makers are selling, and vice versa.

1 WAY PAPER

refers to paper trading one direction. For example, paper was selling calls all day, or paper was buying upside call spreads.

2 WAY PAPER

Refers to paper trading both directions, in an out of the same position throughout the trading session. For example, paper was two way on the 110 calls. Paper sold 1,000 110 calls at $0.95 and bought them back for $0.80. Market makers prefer to interact with two-way paper because they do not need to carry the risk over a long period of time and they usually collect a fair amount of edge on those trades.

WHAT IS EDGE

refers to the theoretical value that a market maker collects based on the pricing of an option. A market maker posts bids and offers for paper to trade with. A market maker makes their market around their theoretical value for the option. For example, if a market maker believes the 55 call is worth $2.25, their market might be $2.15 at $2.40. That means they will buy the 55 call for $2.15 or sell it at $2.40. If a market maker pays less than the theoretical value they collected edge. If a market maker receives more than the theoretical value they collected edge.

Let's say paper sold the 55 call at $2.15, that means the market maker paid $2.15 for the 55 call, and collected $0.10 in edge ($2.25-$2.15). In theory, if their pricing turned out to be accurate and they hedged the position properly, the $0.10 in edge should turn into real money by the options expiration.