

# Failure Model

A premium seller's field manual.

How I sell options, in 7 layers.

Edition 2 · September 2026

This is the process I use to sell options premium every trading day through my corporation. No course taught me this, and neither did a textbook. It comes from years of placing real trades, managing real risk, and learning what matters when the money is yours.

My day job is condition monitoring on heavy equipment: find the failure mode before the machine fails. I trade the same way. Each layer in this manual is a check against one specific way that premium sellers blow up.

The **checks are fixed**: the same ones, in the same order, on every trade. The **judgment inside each check is mine**, so this is not a mechanical system you can run blind. And **the model evolves**: every edition is rewritten from the trades that tested it.

— Alvin Khau

## The goal

Steady premium income, compounded. Not home runs. Show up every day, sell premium with an edge, manage risk actively, and survive the bad weeks.

## Before you start

You should already know puts, calls, delta, IV and margin. Running this across several names realistically takes about \$25k to \$50k. I trade US-listed options from Canada, so both Canadian and US accounts are covered.

## The 7 layers at a glance

Work through them top to bottom. If a layer says stop, you stop. Later layers can't rescue a trade that failed an earlier one.

| # | LAYER                         | THE QUESTION IT ANSWERS                       | THE FAILURE IT PREVENTS                                               |
|---|-------------------------------|-----------------------------------------------|-----------------------------------------------------------------------|
| 1 | <b>Regime</b>                 | How much should I be selling right now?       | Selling cheap premium right before volatility expands                 |
| 2 | <b>Underlying</b>             | What am I selling?                            | Getting stuck in a bad name and rolling it forever                    |
| 3 | <b>Sizing</b>                 | How much can I afford?                        | One position sinking the whole account                                |
| 4 | <b>Structure &amp; timing</b> | Which account, which structure, which expiry? | The right trade in the wrong account, with tax or margin consequences |
| 5 | <b>Strikes</b>                | Where do I sell?                              | Strikes sitting inside the move the market expects                    |
| 6 | <b>Management</b>             | Roll, hold, or cut?                           | Rolling a broken thesis because you can't let go                      |
| 7 | <b>Risk &amp; margin</b>      | Can the book survive a vol spike?             | A margin call forcing you out at the worst price                      |

# Regime check

How much should I be selling right now, and how?

Prevents: selling cheap premium right before volatility expands

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Check the environment before you look at a single ticker. Regime anchors everything downstream: it decides how big you are, how wide your strikes are, and how much margin you keep in reserve.

## Hard rules

- **VIX below 15: size down and get ready for the vol explosion.** Premium is thin, and compressed volatility doesn't stay compressed. The spike usually comes fast and from nowhere. Cut your size, go wider on strikes, and keep margin in reserve. When vol does explode, you want dry powder to sell into the spike, not a full book fighting margin calls.
- **Read VVIX next to VIX.** VIX tells you the level. VVIX tells you whether that level is stable. When VVIX is elevated, the market is pricing big swings in volatility itself, so expect wider intraday moves and faster regime shifts.
- **Parabolic underlying: 10-delta puts at most, or sit out.** A stock that has gone straight up, with no pullback and no base, is not a place to sell calls.

## Regime awareness

- Know which regime you're in: low vol, normal, elevated, or crisis. Each one changes what you sell and how aggressively.
- Watch sector rotation. Capital flowing out of a sector changes the thesis on every name in it.
- Regime is more than VIX. Monetary policy, credit conditions, geopolitics and market breadth all count. Read the whole board.

# Underlying selection

What am I selling?

Prevents: getting stuck in a bad name and rolling it forever

## This is the most important layer.

Picking the ticker is the edge. Everything after it is management. Pick the wrong name and no amount of rolling saves you.

A name has to pass all six checks before I open a position:

1. **Tight options liquidity.** A tight bid-ask spread on the chain. If you can't get clean fills, skip it. An illiquid chain costs you on the entry, the exit and every roll.
2. **Higher-priced underlying.** More stable, with more premium per contract. Avoid cheap speculative names where a \$2 move is a 10% gap.
3. **US-listed.** Better liquidity, deeper chains, more transparency.
4. **IV rich to realized vol.** Implied volatility should sit above what the stock has actually been doing. You're selling the gap between fear and reality.
5. **A thesis you can say out loud.** Why this name, and why now? If you can't answer that, move on. The thesis is also what tells you, later, when it has broken.
6. **You know how it moves.** Does it gap on earnings? Does it trend or mean-revert? How does it behave in a rotation? Knowing a name's personality is part of the edge.

## The #1 mistake

Picking a bad underlying and getting emotionally attached to it, then holding a broken thesis because you keep rolling and hoping. If the thesis breaks, cut it. Being willing to walk away from a name is what separates profitable sellers from the ones who blow up.

## Position sizing

How much can I afford?

Prevents: one position sinking the whole account

Your capital decides which names are available to you. Take the share price and multiply by 100. That's the cash needed to secure one put, or the value of the shares behind one covered call. The number has to fit inside your capital without maxing out margin or concentrating the account in one name.

| SHARE PRICE | CASH TO SECURE 1 PUT | REALISTIC ACCOUNT MINIMUM |
|-------------|----------------------|---------------------------|
| \$50        | \$5,000              | \$25,000+                 |
| \$150       | \$15,000             | \$50,000+                 |
| \$300       | \$30,000             | \$75,000+                 |
| \$500       | \$50,000             | \$100,000+                |

### Scaling up

**Start with one contract.** Learn the name, how it moves, and how the rolls feel. Learn what it's like to manage it through a red day, a gap and a vol spike. Get the reps in before you size up.

Scale your contract count with experience, not with account size. Being able to sell five contracts doesn't mean you should. More contracts means more margin, more exposure and harder rolls when things go wrong. Earn the right to size up by managing one contract cleanly first.

#### Capital is a filter.

If a name doesn't fit your account at one contract, it isn't available to you yet. Don't force it. Plenty of liquid names trade in the \$50 to \$150 range. Trade what fits.

## Structure & timing

Which account, which structure, which expiry?

Prevents: the right trade in the wrong account, with tax or margin consequences

Your account type decides what you're allowed to sell. Put your most active trading where you have the most flexibility.

### Canadian accounts

| ACCOUNT                            | WHAT I SELL THERE                          | NOTES                                                                                 |
|------------------------------------|--------------------------------------------|---------------------------------------------------------------------------------------|
| RRSP                               | Covered calls, cash-secured puts           | Defined risk only.                                                                    |
| TFSA                               | Long-term shares, occasional covered calls | Keep trading frequency low (see below). Cash-secured puts are allowed, but sparingly. |
| Non-registered or corporate (CCPC) | Strangles, the wheel, naked puts and calls | Full margin flexibility. My active book lives here.                                   |

#### TFSA business-income risk

CRA has audited TFSAs with high trading volume and reclassified the gains as business income. Keep frequent selling in a non-registered or corporate account. I keep my own TFSA to long-term shares with infrequent covered calls.

### US accounts

| ACCOUNT                       | WHAT YOU CAN SELL                          | NOTES                                                    |
|-------------------------------|--------------------------------------------|----------------------------------------------------------|
| IRA (Traditional or Roth)     | Covered calls, cash-secured puts           | No naked or undefined risk. Keep Roth activity moderate. |
| Taxable margin, LLC or S-Corp | Strangles, the wheel, naked puts and calls | Full flexibility. Active selling belongs here.           |

### Timing

- **My default in the corporation: short strangles at about 7 days to expiry.** Short-dated premium decays fastest, and weekly cycles give me more decision points a year. The ceiling is 45 days, and only in registered accounts where I trade less often.
- **Why not the popular 45/21 approach?** I backtested my 7-day cycle against the common "open at 45 days, manage at 21" method. For how I trade, the higher cycle count captured short-dated premium more efficiently. The cost is attention: you're making decisions every week.

## Strike selection

Where do I sell?

Prevents: strikes sitting inside the move the market expects

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**Start at 20 delta, on both sides.**

A 20-delta option has roughly a 20% chance of finishing in the money. That's the starting point, not a rule.

### Tilting strikes

- **Go wider (lower delta) when risk is elevated:** a binary event, macro uncertainty, a weak sector, an extended underlying. You get more room and less premium. That's the trade-off.
- **Go tighter (higher delta) only with higher conviction,** when the premium at 20 delta is too thin to justify the margin and the attention.

### Earnings

Check the implied move. Most brokers show it as the "expected move", or you can estimate it from the at-the-money straddle. Sell outside that range and let the market price the event. Don't be a hero inside the expected move.

# Position management

Roll, hold, or cut?

Prevents: rolling a broken thesis because you can't let go

Every roll is a new decision. You aren't pushing the same trade forward in time. Each time, ask: does the thesis still hold, is the regime intact, and is the risk/reward still there?

## Core rules

1. **Roll before the strike is breached.** If price is approaching your short strike, roll early. Waiting leaves you fewer options and worse fills.
2. **Keep rolling while the regime and thesis hold.** Adjust the strikes each time for how much cushion you need and how much premium you want.
3. **Treat every roll as a new trade.** Don't push the same strikes out mechanically. Re-check the delta, the width and the premium against today's setup.
4. **Hold to expiry by default.** Don't close early because you're anxious; let time decay work. The exceptions are margin management, or closing a position at nearly full profit to free up capital.
5. **Cut when it's time to rotate.** If liquidity dries up, a better opportunity appears or the thesis breaks, close it.

| CONDITION                           | ACTION        |
|-------------------------------------|---------------|
| Regime intact, thesis intact        | Roll          |
| Regime breaking, thesis weakening   | Cut or reduce |
| Better use of the capital elsewhere | Cut           |
| Liquidity deteriorating             | Cut           |

### Advanced: manage the book, not just the positions

Once you're running several names, stop thinking one position at a time and watch the whole book's net delta. I adjust strikes and expiries across positions to keep the book close to neutral. This is delta-hedging a short-gamma book, and it isn't free: as the stock moves against my short strikes, rebalancing means buying after rallies and selling after drops. That hedging cost is part of what the premium pays for. The book is steered toward neutral, not locked there. It won't be perfectly flat, and it doesn't need to be.

## Risk & margin

Can the book survive a vol spike?

Prevents: a margin call forcing you out at the worst price

**Margin is the hard constraint. It overrides everything.**

Know your margin usage at all times. If you don't understand how your broker calculates margin, stop and learn that first.

### Stress-test before you add

Before opening a new position, ask one question: if my biggest name gaps hard overnight, what happens to my margin? If one position can force you to liquidate everything else, it's too big. Concentration, not any single bad trade, is what turns a bad week into a blown account.

### Freeing margin in a vol spike

When volatility spikes, margin requirements expand across the whole book at once. Don't react; follow the playbook:

1. **Close positions at nearly full profit first.** They use margin while holding almost no premium. Closing them frees room for the positions that need it.
2. **Roll the rest wider.** Strikes further out mean lower margin requirements, and the position stays alive.
3. **Buy protection rarely.** Paying for hedges eats into the premium you're collecting. I manage risk through sizing and rolling, not by adding long legs. I'm almost never long volatility.

### Other rules

- **Make your collateral earn.** Treasury bills are ideal margin collateral because they keep earning interest while they're posted. If you hold cash instead, use a broker that pays interest on idle balances. Idle capital should always be earning.
- **The gap rule.** If any position gaps 5% or more at the open, make no changes for 60 minutes. Let it settle. Decisions made in the first hour of a gap are almost always wrong, and the urge to act right away is exactly what this rule overrides.

# The decision flow

The whole framework on one page. Run it top to bottom for every new position.

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**01 Is VIX below 15?**

**YES** → size down, go wider and keep margin in reserve for the spike. **NO** → normal size.

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**02 Is the underlying parabolic?**

**YES** → 10-delta puts at most, no calls, or sit out. **NO** → continue.

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**03 Does it pass all six underlying checks?**

Liquidity, price, US-listed, IV above realized, a clear thesis, known behaviour. **NO** → skip it.

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**04 Does one contract fit your capital?**

Share price × 100, without maxing margin. **NO** → it's not available to you yet.

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**05 Which account?**

**RRSP / IRA** → covered calls or cash-secured puts. **TFSA / Roth** → the same, rarely. **Non-reg / corp** → strangles or the wheel, about 7 days to expiry.

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**06 Where are the strikes?**

Start at 20 delta. Go wider when risk is up; tighter only with conviction. Around earnings, sell outside the implied move.

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**07 Does the book survive a gap in its biggest name?**

**NO** → size down before adding anything.

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**08 Managing it**

Roll before the strike is breached. Roll while the regime and thesis hold. Cut if the thesis breaks or the capital is better used elsewhere. Otherwise hold to expiry. Keep the book's net delta near neutral.

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**09 Vol spike?**

Close near-full-profit positions first, then roll the rest wider. After a 5%+ gap, no changes for 60 minutes.

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# Scope & definitions

## What this framework is

- An active-management process for selling options premium.
- A decision structure for strikes, rolls and risk.
- A way to think about regime, conviction and capital.

## What it is not

- A mechanical system with fixed entries, fixed profit targets or auto-closes.
- The 45/21 approach. It runs shorter cycles, and more of them.
- Directional betting or earnings gambling.
- Buying premium or building complex multi-leg spreads.

## Definitions

**Covered call:** Sell a call against shares you own. You collect premium; your upside is capped at the strike.

**Cash-secured put:** Sell a put while holding enough cash to buy the shares if assigned. You're paid to take on the obligation to buy at the strike.

**Strangle:** Sell a put and a call on the same name and expiry, at different strikes. It profits if the stock stays between the two.

**Wheel:** Sell puts until you're assigned shares, then sell calls on those shares until they're called away. Repeat.

**Delta:** How much an option's price moves per \$1 move in the stock. Also a rough proxy for the chance of finishing in the money: 20 delta is about 20%.

**Net delta:** The combined delta of every position in the book: how much the whole book gains or loses when the market moves.

**Short gamma:** What a short-option book is. Its delta moves against you as the stock moves, so staying hedged means buying high and selling low. The premium collected is the payment for carrying that.

**IV / RV:** Implied volatility is the move the market is pricing in; realized volatility is the move that actually happened. IV above RV means the market is pricing more fear than has shown up.

**DTE:** Days to expiry.

**VIX / VVIX:** VIX is the expected 30-day volatility of the S&P 500, a broad fear gauge. VVIX is the volatility of VIX. When VVIX is elevated, the regime is unstable.

## I publish the receipts. You check my work.

Every trading day is public on my site, red days included. Don't take this manual on faith. Watch how it actually plays out.

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