

Options

FINRA Modifies the Process for Firms to Designate Their Allocation Methodology for Options Exercise Assignment Notices

Effective Date: August 8, 2011

Executive Summary

FINRA is updating the procedures for firms to designate their method of allocating options exercise assignment notices. Effective August 8, 2011, firms initiating an options business, or changing their allocation method, must use the application form in Attachment A of this *Notice*. FINRA also has updated the designated random selection allocation procedures, which are described in Attachment B.

Questions concerning this *Notice* should be directed to:

- ▶ Max Tourtelot, Director, Options Regulation, at (917) 281-3133; or
- ▶ Casey McMahon, Associate Director, Options Regulation, at (917) 281-3042.

Background & Discussion

FINRA Rule 2360(b)(23)(C) requires member firms conducting transactions in exchange-listed options to establish fixed procedures for allocating options exercise notices to short options positions in its customer accounts. Firms may elect to allocate exercise assignment notices on: (1) a “first in-first out” basis (FIFO); (2) a random selection basis, as described in Attachment B of this *Notice*; or (3) another equally random selection basis determined by the firm. However, firms must receive prior FINRA approval for the method selected. Any changes to a firm’s allocation method must be reported to and approved by FINRA.

Effective August 8, 2011, firms initiating an options business, or changing their allocation method, must use the application form in Attachment A of this *Notice*. The revised form updates FINRA rule references and contact information.

July 2011

Notice Type

- ▶ Guidance

Suggested Routing

- ▶ Compliance
- ▶ Institutional
- ▶ Legal
- ▶ Operations
- ▶ Options
- ▶ Risk
- ▶ Senior Management
- ▶ Systems

Key Topics

- ▶ Exercise Assignment Notice
- ▶ Options

Referenced Rules & Notices

- ▶ FINRA Rule 2360

FINRA also has updated its designated procedures for firms employing a random method of allocating options exercise assignment notices. Firms using the random method must ensure that they follow these updated procedures, or seek approval from FINRA for an alternative allocation method. The revised procedures are described in Attachment B.

FINRA also reminds firms that they must inform customers in writing of the method used to allocate options exercise assignment notices, including explanations of how the system operates and the consequences of that system. Firms also must preserve sufficient work papers and other documentary materials relating to the allocation of options exercise assignment notices to establish the manner in which allocation of the exercise assignment notices is in fact being accomplished.

Attachment A

Market Regulation Department Options Surveillance

Option Exercise Assignment Allocation Method Application

Submit completed form by email to allocation@finra.org or by fax to (301) 339-7687.

Firm Name: _____

Firm CRD No.: _____

Contact Person for Assignment Allocation: _____

Address: _____

Phone Number: _____

Email: _____

Please complete either section 1 or 2, as applicable, below:

1. If your firm has a clearing arrangement on a fully disclosed basis with an OCC member firm, please indicate the OCC member firm name: _____.
2. **A.** If your firm has a clearing arrangement on an omnibus basis with an OCC member firm, please indicate the OCC member firm name _____, and the method of options exercise allocation below:
 - a. First In, First Out (FIFO)
 - b. Random Method as designated in FINRA *Regulatory Notice 11-35*
 - c. Other Random Method (please describe and attach methodology)
- B.** If your firm is a self-clearing member of the Options Clearing Corporation, please list all OCC Allocated Clearing Member No.(s) _____ and the method of options exercise allocation below:
 - a. First In, First Out (FIFO)
 - b. Random Method as designated in FINRA *Regulatory Notice 11-35*
 - c. Other Random Method (please describe and attach methodology)

For firms that have multiple clearing numbers and use different allocation methods, please attach a separate sheet for each Clearing Member Number.

Authorization

Requested by:

Authorized Person (Print or Type)

Title

Signature

Date

CRD No. of Authorized Person

For questions regarding this form, or the allocation process, please contact:

Casey McMahon (917) 281-3042 casey.mcmahon@finra.org

Max Tourtelot (917) 281-3133 max.tourtelot@finra.org

Attachment B

Random Exercise Allocation Procedure

A firm may elect to allocate exercise assignments to its short option holders using a random allocation method. A firm electing a random allocation method must use the methodology outlined below.

Step 1: Sequencing of accounts—Identify and list all customer and firm accounts with open short positions in the option series for which exercise notices have been received.

Step 2: Assigning Sequence Numbers—Assign a range of sequential numbers to each account based on the number of short contracts held in the account. For example:

XYZ Jan 50 Calls

Account No.	# of Contracts Short	Assigned Sequential Numbers
1	5	1 through 5
2	8	6 through 13
3	2	14 through 15
4	10	16 through 25
5	11	26 through 36
Total: 36 Short Contracts		

In this example, all accounts having a short position in XYZ Jan 50 calls, the series for which exercise notices have been received, are arranged in order according to their account numbers. The number of contracts short in each account is noted, and shows that there are a total of 36 contracts short in all customer and firm accounts. Account #1 is assigned a range of numbers that begins with 1 and ends with the number reflecting the total contracts short in that account, which in this case is 5. Thus, the sequential numbers assigned to Account #1 are 1 – 5. The sequential numbers for Account #2 must begin with 6 and encompass eight numbers representing the 8 contracts short in that account. This results in the sequential numbers of 6 – 13 being assigned to Account #2. Account #3 is short 2 contracts and similarly is assigned sequential numbers beginning with 14 and ending with 15. This process continues until all accounts in the sequence have been assigned unique sequential numbers. By assigning sequential numbers in this manner, the likelihood that a particular account will be selected for exercise will be proportional to its share of the total short position.

Step 3: Random Number Generation—After completing the assignment of sequential numbers, choose a random decimal number using either of the methods described below:

- ▶ A firm may use any automated application, including Microsoft Excel, which contains a random number generator, to obtain a random number greater than zero and less than or equal to one that contains four decimal places; or
- ▶ A firm may obtain the NYSE or NASDAQ consolidated stock volume for the previous trading day, and follow these steps:
 - Select the four digits corresponding to the hundred thousands, ten thousands, thousands, and hundreds positions of the volume figure.
 - Place a decimal point to the left of the first digit to create a number ranging from .0000 to .9999. Add .0001 to this number to obtain a random number ranging from .0001 to 1.¹

Using either of the above methods, the firm should now have a number that lies in the range from .0001 to 1.

Step 4: Selection of Starting Point Using the Random Number—Multiply the random number generated above by the total number of contracts short in all accounts and if not a round number, round to the next highest integer. This number will determine the starting point of the exercise assignment.

Returning to the example, assume that there are 13 contracts for which the firm has received exercise notices, and that the random number .4855 is selected. The result of the multiplication of 36 (the total number of short XYZ Jan 50 Calls) and .4855 is 17.478, which is then rounded to the next highest integer, 18. The starting point for the first contract assigned is 18, which falls in Account #4.

Step 5: Allocation of the Exercise Notice—The assignment of exercise notices proceeds until all exercise notices have been assigned by continuing down the list of accounts from the starting point determined in Step 4 (returning to the top of the list if additional notices need to be allocated).

Continuing with the example, since the exercise notice specifies that 13 contracts are to be assigned, and 18 is the starting point, the firm selects the remaining 8 contracts from Account #4. The firm then advances to the next account in the sequence, Account #5, to assign the remaining 5 contracts. If the exercise notice related to more than 13 contracts, the assignment would continue to be absorbed by succeeding accounts in the sequence established in Step 1 until the entire assignment is absorbed. If additional notices need to be allocated after reaching the bottom of the list, continue with the first account at the top to complete the assignment.

1. This number is generated daily and used for all series in which exercise notices have been received.