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Market Structure

A uniform approach to corporate actions

Corporate actions can have major impacts on options prices, yet there's still considerable uncertainty about how these events will affect options contracts. Using a recent Petrobras dividend announcement as an example, we argue for a way US markets can better manage corporate actions.

Decisions or activities taken by a company's board or management that may affect the company's securities and/or capital structure are often referred to as "corporate actions." These events impact shareholder value and can lead to material changes in the securities of the issuing company. Corporate actions can include the issuance of cash or stock dividends, a (reverse) stock split, merger, spinoff or any other re-organization of the company. Understanding how these corporate actions may impact a company's valuation and its related securities is a critical component to any investing or liquidity-providing strategy.

The most common of these events, and the most likely to impact the broadest set of market participants including retail investors, is the issuance of cash dividends. The issuing company has a fiduciary duty to its shareholders to manage corporate actions, such as the issuance of cash dividends, in an accurate, transparent and timely manner, including their announcement.

Unfortunately, the process by which the industry, including the issuing firms, communicates, manages and treats these corporate actions can be uncoordinated and lack uniformity. This can have a detrimental effect on market liquidity and market participants who invest in derivative securities like equity options. This paper will examine the impact that a lack of standardization and transparency in handling corporate actions can have on the US equity options markets. The principles articulated here on how to improve management, treatment, and communication are applicable to all corporate actions.

Optiver believes that equal access to and consistent application of transparent and clearly defined rules and processes make for a strong and healthy market structure. This is especially true with regard to corporate actions. Uniform and standardized language across all entities should be mandated to reduce confusion and promote consistency in the treatment and interpretation of corporate actions. Frictionless access to dedicated information resources would provide investors the ability to make better-informed investment decisions. When these principles are jeopardized, liquidity in securities markets can become compromised and put all market participants at risk.

Recent events in certain option symbols have demonstrated how important adhering to the principles of standardized rules and procedures and a dedicated information flow are to preserving

the integrity of options markets. The industry as a whole should align to formally standardize the language and process by which corporate actions are communicated and processed.

Our Recommendations

01

Listing exchanges should require issuing firms to use standardized, uniform language in corporate action announcements and communications.

Industry should agree to apply this language across all entities including listing exchanges, issuing firms, custodians, media and the OCC.

02

The OCC should have clearly defined rules including a decision tree with relevant decision inputs to aid investor understanding.

No party should be able to make exemptions.

03

All information should be made publicly available in an accurate, transparent and timely manner.

A high-stakes game of Telephone

Managing corporate actions can resemble the childhood game of “Telephone.” As the number of players increases, the final message received can diverge significantly from the initial message delivered. Now, imagine if that initial message could be delivered differently each time. Far too often, this “Telephone” effect occurs in the communication and interpretation of corporate actions.

For corporate actions, specifically as they relate to dividend announcements, we see two discrete parts that interact with each other: issuing companies that use non-standardized language, and entities, like the OCC, that are dependent on these communications to make decisions that impact investors.

There are a number of links in the chain of communication for corporate actions. Investor relations teams for both the issuing companies and custodian banks (when ADRs are involved) lead the initial communication to the investing public. In the US, listing exchanges have standards which dictate how an issuing company must manage corporate action announcements. Unfortunately, the listing exchanges do not mandate that the language used be uniform or in line with the issuing firm’s own Shareholder Remuneration Policies. Relying on these announcements, media and market intelligence providers ingest, process, and communicate this information to the investing public.

As this paper’s case study highlights, an issuing firm can refer to a dividend as “extraordinary” and yet still consider that dividend “regular” as part of its Shareholder Remuneration Policy. This phenomenon can lead to a cascading effect where each reference to a specific corporate action leads to further misinterpretation. The language used in these communications can become problematic the more participants there are in a chain. This is important because the initial

declaration from the issuing firm may influence how investors value the company, its share price and derivative contracts. The OCC is the last step in this chain and its interpretations, based on the prior communications, can be the most impactful to US options market participants.

In the US, the OCC is the central counterparty to every listed option trade. The idiosyncrasies of this particular game of Telephone are centered on the OCC because it determines how a company's listed options will be treated following a corporate action. The OCC provides a set of guidelines and provisions that are defined and included in its by-laws designed to navigate this process. These allow it to decide, on a case-by-case basis, how to adjust an option series.

For cash dividends, the goal of the adjustment is ensure that the intrinsic value of the option contract is unchanged before and after the corporate action. The OCC can do this in two ways. They can adjust an option's strike price down to reflect the new stock price (excluding the dividend), sometimes called the "strike method." Or it can keep the strike price unadjusted and add the amount of the dividend as a cash component to the option deliverable (here: new-stock-price plus cash-amount-of-dividend), sometimes referred to as the "basket method." Under the basket method, should an investor exercise or be assigned on an option they will receive the new stock price plus the dividend amount. The OCC can also choose to make no adjustment depending on their interpretation of the dividend.

While these guidelines and provisions are transparent and publicly available, their application can be inconsistent from one event to another. Whether an adjustment is made depends on a variety of factors including the OCC's interpretation of the issuing company's dividend policies, the history of the issuing firm's dividends, the OCC's adjustment histories and the language used in the issuing firm's investor relations communications. As this process depends on a variety of communications and interpretations, the OCC's final adjustment decision can significantly diverge from the market's expected outcome.

The OCC communicates the decision to the general public via an OCC Information Memo. Since an option's value can be dependent on the OCC's classification and treatment, option liquidity providers and investors rely on these memos for their pricing and investment decisions, including whether to exercise their options contracts.

Working in a broken system

When a cash dividend is announced, the OCC will determine whether or not an adjustment needs to be made. To do so, the OCC relies on available language and information to determine if an adjustment is necessary. In most cases involving an ordinary dividend ("ordinary" meaning it is in line with the firm's policy and history of paying dividends), the OCC will not make any adjustment to the options using either the strike or basket methods. However there are times, when a firm declares an ordinary dividend that the OCC may adjust the options. This lack of standardized treatment is problematic.

Per its by-laws, the OCC has the ability to make interpretations on a case by case basis AND allow for exceptions in applying its guidelines to those interpretations.

Similarly, disclaimers provided on the OCC memo indicate that the memo serves as an "unofficial summary of the terms of corporate events that affect listed options and are prepared for the convenience of market participants" and that the OCC "accepts no responsibility for the accuracy or completeness of the summary, particularly for information which may be relevant to investment decisions." Further, the OCC states that "option or futures investors should independently ascertain and evaluate all information concerning this corporate event(s)."

The inclusion of these provisions in the OCC by-laws and memos suggests that there is room for improvements to the framework in which the OCC is forced to operate. Having to interpret, decipher and make decisions based on non-standardized language and processes creates unnecessary uncertainty and risk to investors.

In these situations, market participants face uncertainty about whether the OCC will follow its general guidelines or apply an exemption. Without a clear understanding of how the OCC will interpret the dividend, liquidity in the options chain may deteriorate. Providing a clear path forward for market participants to understand how an option will be treated allows investors to price these instruments with greater confidence and contributes to a more robust market.

Recent case study

Petroleo Brasileiro, more commonly known as Petrobras (“PETR”), is a Brazilian petroleum company that lists, via JP Morgan (JPM) as the custodian, its American Depositary Receipts (“ADRs”) as “PBR & PBRA” on the NYSE. Options on these ADRs are listed on all 17 options exchanges in the US. PETR has a policy that allows it to distribute additional dividends if its financial situation allows. PETR’s Shareholder Remuneration Policy states that extraordinary dividends are considered regular dividends. Professionals who invest in both the underlying stock or ADR and related option chains will be familiar with a firm’s dividend policy. Nevertheless, most of them would have been surprised by the sequence of events that followed.

On April 25, PETR made an initial dividend announcement stating that two dividend payments were to be made; one refers to its Shareholder Remuneration Policy (a regular dividend) and one refers to extraordinary dividends. On April 29, JPM, as the ADR Custodian, published an announcement indicating that the dividend outside the scope of the Shareholder Remuneration Policy was indeed an extraordinary dividend. Similarly, on April 29, Bloomberg reported that these payments would also be split as regular and extraordinary. After the market close on April 29, the OCC issued its Information Memo for these actions, indicating that part of the dividend would be considered “extraordinary” and thus they would adjust all PBR & PBRA options (and preserve the contract’s economic value) using the basket method.

It is important to highlight that over the past three years, PETR referred to dividends as extraordinary and paid additional dividends on top of their regular policy. When this occurred, the OCC did not make any adjustments. As a result, options market participants’ expectations leading into the dividends were that the OCC would follow this three-year precedent and not make an adjustment.

However, as the OCC released the Information Memo to the market, expectations regarding how the OCC would treat the options shifted largely in favor of an adjustment despite a stated policy by PETR and precedent by the OCC to the contrary.

On May 2, the day before the ex-date (the day the stock and ADR will trade without the dividend included in its price), expectations in the options market suddenly shifted the probability to no adjustment being made. On the same day, Bloomberg reported that the dividends for the stock and the ADR were now considered “regular.” PETR reissued a statement reminding investors: “According to Petrobras’ shareholders remuneration policy, extraordinary dividends are considered regular dividends, not special dividends.” JPM similarly adjusted their memo to state: “This dividend distribution has been revised from extraordinary to a regular dividend.” Following these revisions, the OCC found itself in a difficult position as it had already issued a statement reflecting an upcoming adjustment.

Leading up to May 2, the market was rightfully expecting no adjustment by the OCC based on their prior interpretations regarding PETR ADR options. But on May 2, markets widened and liquidity deteriorated as the uncertainty of what the OCC would do increased. Further, market participants were unsure whether the OCC was allowed to re-adjust its interpretation. Knowing that the OCC has the ability to evaluate each corporate action on a case-by-case basis and make exemptions contributed to the uncertainty.

From April 25 to May 2, as a result of confusion and uncertainty stemming from the various conflicting announcements, markets progressively widened and liquidity thinned as it became increasingly difficult to confidently price the ADR options. Retail investors, perhaps unaware of what was driving this change, would have found a very different and more challenging environment to execute their strategies compared with the previous week.

Lessons learned

There are lessons that all market participants can learn from this and similar events. First, it makes sense for a company to have policies in place to allow for additional payments to their investors should their financing allow, but it is problematic that a firm is permitted to use language that can easily confuse investors and the businesses that support them. To refer to a dividend as extraordinary but consider it as part of a normal stated dividend policy, and thus 'regular,' has unintended downstream effects on market participants, including retail investors, that most Investor Relations teams could not predict.

Each link in the chain bears some responsibility. The Investor Relations team likely does not, but should have to, consider what impact their language choice will have on the options listed on their company's shares. The listing exchanges, whose parent groups also own options exchanges, should take care not to disrupt liquidity in any of the instruments they list. As a result, the language used by all entities involved in communicating and managing the corporate action should be uniform and standardized per listing exchange rule. Ideally, each entity should understand how their actions impact others down the chain and their interconnectedness.

Recommendations

Accordingly, we recommend the following measures.

Listing exchanges should mandate and require that issuing firms use standardized, uniform language in the corporate actions announcements and communications.

This industry should similarly agree to follow these standards and apply this language across all entities including but not limited to listing exchanges, issuing firms, custodians, media and the OCC.

The OCC should have clearly defined rules including a decision tree with relevant decision inputs that allows any investor to consume the standardized language from the issuer and be able to clearly understand whether and how an option will be adjusted in the event of a corporate action.

No party should have the ability to make exemptions and the path forward should be easily understood by all investors. So long as the ability to make exemptions and evaluate these events on a case-by-case basis still exists there will be unnecessary uncertainty and risks to investors. A more stringent and transparent framework needs to be defined and applied.



All information, including Listing Exchange standards, Investor Relations and OCC communications, should be made publicly available in an accurate, transparent and timely manner. Information should be provided in both human and machine-readable formatting.

Conclusion

As capital markets and their investor base grow, the industry must consider improvements that benefit the entire ecosystem, including options markets. While risk is inherent in all investments, unnecessary risk from solvable problems should be avoided. The lack of standardization and uniform processes increases the risk for investors and reduces market liquidity. A standardized process for managing, processing and communicating corporate actions across the market is essential. Alignment among all entities and participants, from listing exchanges to clearing houses, on how corporate actions are communicated and managed would benefit the overall market and all market participants. Standardizing the language, process, and treatment of information relating to corporate actions will enhance market efficiency, clarity and overall health.

About Optiver

Optiver is a global market maker founded in Amsterdam, with offices in London, Chicago, Austin, New York, Sydney, Shanghai, Hong Kong, Singapore, Taipei and Mumbai. Established in 1986, today we are a leading liquidity provider, with close to 2,000 employees in offices around the world, united in our commitment to improve the market through competitive pricing, execution and risk management. By providing liquidity on multiple exchanges across the world in various financial instruments we participate in the safeguarding of healthy and efficient markets. We provide liquidity to financial markets using our own capital, at our own risk, trading a wide range of products: listed derivatives, cash equities, ETFs, bonds and foreign currencies.