Optiver

Insights

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Market Structure

# Modest term, big impact: Corporate actions and the options market

*Corporate actions can have major impacts on options prices, yet there's considerable uncertainty about these events among traders. Whether it's a dividend, a stock split or a merger, the communication of corporate actions should be clear, harmonised and proportional. In a series of papers, we explore these recommendations.*

The term 'corporate actions' is a modest description for a group of events that can have dramatic impacts on financial markets. Whether it's a dividend, a stock split or a merger, these events can fundamentally alter the economic value of a company's securities to the tune of tens or even hundreds of millions of dollars. But for a variety of reasons, even the best-informed options traders often remain in the dark about how corporate actions will affect the options contracts they trade.

In a series of papers, we'll explore some of these reasons. We'll also propose ways to improve this situation across various jurisdictions and scenarios, applying a set of principles we think should govern all corporate actions.

But first, let's make clear what a corporate action is. We're talking here about an event that brings about a material change to a company that in some way impacts the value of their shares. They can be capital adjustments (i.e. equity raisings such as rights issues) that may be dilutive, significant changes to strategy and operations (i.e. spinoffs, de-mergers, liquidations), corporate matters (special dividends, stock splits) or M&A (acquisitions, divestments, etc).

While significant attention is typically devoted to a company's shares after a corporate action, comparatively little is paid to a company's options. That's even though a change in the value of the stock underlying an options contract can dramatically alter the contract's price, such as changing it from in- to out-of-the-money or vice versa.

Companies and their investor relations departments cannot be expected to think of options markets when making changes to their corporate structure. Instead, the responsibility falls largely on exchanges and clearing houses to translate the corporate actions for the options market. And it's here where trouble can arise, and where the improvements we outline in these papers can have the most dramatic impact.

## Clear, predictable and accessible

We fundamentally believe that the treatment of corporate actions should be clear, predictable and accessible.

In many markets, the guiding principle of corporate action adjustments is to preserve the economic value of the contract, whether it's an option or a future. In other words, the value of the contract should remain unchanged pre- and post-corporate action. In the case of an extraordinary dividend for instance, this is achieved by adjusting both the strike price and the multiplier of the contract. Others take a different approach and the adjustment is typically only to the strike price.

While these methods differ, what's important is that they're made explicit and adhered to, and that they're easily accessible to investors. Established guidelines and historical precedents among exchanges and clearing houses can help create a predictable environment for handling corporate actions.

## Harmonised and standardised

While different jurisdictions may favour different approaches to corporate actions, within a jurisdiction contracts listed on the same underlying should be treated the same way. That should hold true even if the contracts are listed on different exchanges.

Various efforts have been made to achieve this goal across the world. European exchanges for instance have come together in the European Corporate Actions Committee, while in the US the OCC as the central clearing house makes determinations which the exchanges follow. But subtle differences can emerge – for instance, around the questions of whether to round lot sizes or when to adjust/not adjust the lot size. Exchanges should look to fully harmonise corporate action treatments, as failure to do so might become an impediment for investors to trade.

One scenario where harmonisation can be particularly challenging is when the corporate action takes place in a jurisdiction outside of where the exchange or CCP is based. We're thinking here of ADRs, or American depository receipts. These are certificates issues by a US depository bank that represent shares in a foreign stock. A corporate action involving an ADR requires coordination among the company, the ADR issuer/custodian and the exchange/clearing house, making the process more complex and prone to diverging interpretations. (We explore this process in greater detail in the third paper in our series)

A lack of standardised language can create confusion over the terms and the impact of the corporate action – such as whether a dividend should be treated as ordinary, special or extraordinary. Add to that a range of reporting, media and processing entities from which investors source their corporate action information, and the uncertainty can leave participants in the dark about what will happen to their positions and prone to step out of the market.

## Proportional

Finally, options adjustment methods should match the nature, size and impact of the corporate action. In other words, they should be proportional. In the event of highly dilutive corporate actions for instance, the regular method of adjusting strike and lot sizes might not be appropriate. Using a fair value methodology or capping extreme values for the adjustment could prevent undesirable scenarios from unfolding.

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As we lay out above, the key to effective management of corporate actions involves: (1) clear and predictable methodologies coupled with a (2) harmonised and standardised approach (3) that is proportional. In the papers that follow, we'll address some of the issues that prevent this from happening and propose improvements that we believe will increase stability and predictability for options investors.

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