Optiver

Insights

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Market Structure

Corporate actions and APAC equity options markets

Corporate actions can have a significant impact on single stock options, and investors value clear guidance on how contracts will be treated. We offer some ways exchanges can increase consistency and transparency in this area. This is the third in our series of articles exploring SSO trading across the APAC region. To read the first instalment, click here.

Corporate actions like rights issues and mergers can have sudden and dramatic impacts on a company's share price. Cash equities markets have developed widely-followed and predictable ways to adjust stock prices in these instances. But it's a different story for futures and options markets, particularly those in APAC.

Whether it's a merger, stock split or rights issue, the impact of corporate actions on options can be even more dramatic than on the underlying equities. But APAC exchanges have shown little consistency and transparency in how they treat single stock options (SSOs) in these scenarios. Without greater certainty about how their contracts will be treated, investors may be reluctant to enter into them in the first place.

This is a barrier to the growth of SSOs in APAC, but one that can be resolved with greater transparency and harmonization.

The issue

Conceptually, the problem is quite simple.

Corporate actions are events announced by companies that will impact the value of their shares, either due to capital adjustments that may be dilutive (i.e. equity raisings such as rights issues), significant changes to strategy and operations (i.e. spin offs, de-mergers, liquidations), corporate matters (special dividends, stock splits) or M&A (acquisitions, divestments, etc).

A derivative contract has two components – an agreed expiry date when the contract concludes and a size and settlement price agreed to by the writer and buyer of the contract.

A change in the underlying value of a stock after a contract has been struck between the writer and buyer means that one party will be adversely financially affected by the action, sometimes quite significantly.

Fair, transparent and comprehensive

While there is no recognised best practice in corporate action methodology, an exchange's ability to attract institutional liquidity and investors – particularly retail investors – to SSOs depends on how fair, transparent and comprehensive its methodology is. Most options exchanges deal with these situations by implementing corporate action adjustments, using their respective methodologies to maintain the value of open options positions as if the event had not occurred.

Still there could be improvements, particularly among options markets in APAC. For instance, exchanges could pursue greater coordination and harmonization in the following ways:

- Clarifying what corporate actions adjustments are triggered for each type of corporate action. There is divergence internationally on this point which could be cleared up.
- Adopting basket methodologies or fair value settlement for corporate actions beyond a certain size to avoid distortions (e.g. unknown prices on a large spinoff, etc.), and Ratio-method adjustments for deterministic corporate actions or ones with negligible adjustments.
- Using the same adjustment mechanism for options and futures.
- Making adjustment announcement timings and publishing the change to the exercise price or contract size immediately after the close of trading the day before the adjustment takes place.

Exchanges should continue to review their methodologies and scrutinise how other international markets apply corporate action adjustments, focusing particularly on those that have been successful in encouraging SSO liquidity. They could also consider seeking regular feedback from market stakeholders and investors to continue to inspire confidence and attract liquidity. By taking these steps, exchanges can go some way toward removing the barriers to more widespread adoption of SSOs throughout APAC.

About Optiver

Optiver is a global market maker with offices in Amsterdam, London, New York, Chicago, Austin, Sydney, Shanghai, Hong Kong, Singapore, Mumbai and Taipei. Founded 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 by competitive pricing, execution and thorough 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.