Enhancing Efficiency in Corporate Actions for OTC Derivatives

INTRODUCTION

Every time a portfolio manager says, "*What do you mean I can't do that?*" a new derivative type is born.

I'm half kidding, there are undoubtedly robust regulations to attempt to limit irresponsible decisions from having an outsized impact on the market, but when red tape or cost gets in the way of something sensible, OTC volumes increase. As portfolio managers leverage more OTCs, the need to manage additional life cycle processes grows in tandem. Corporate actions are particularly a headache for OTC derivatives with equity underliers.

While less common than other equity OTC processes like resets, corporate actions are frequently a challenge because the timing of information can leave the front office with delayed information, there may be a lack of standards on best practices or the data structure across all investment management systems does not lend itself well to altering existing contracts.

REGULATORY DRIVERS OF OTC VOLUME

As assets under management grow for index-based strategies, portfolio managers must maintain exposure to index constituents while meeting internal and regulatory obligations. For example, an asset manager must maintain a position equivalent to 21% of a given utility company to match the exposure on a variety of their index funds. Under the Federal Energy Regulatory Commission, the asset manager's aggregate position cannot exceed 20% of the outstanding voting securities for a public utility[1]. Many firms have a lower internal threshold to ensure compliance, such as 18% of voting securities as opposed to the regulatory 20%. This presents an opportunity for the asset manager to leverage synthetic exposure beyond the compliance or regulatory threshold through a total return swap or similar product. The swap grants the portfolio exposure but limits voting rights, maintaining internal and regulatory compliance.

Once the equity OTC is in place, operations must account for any corporate action. Many corporate actions, such as spin-offs, can be dependent upon an opening or closing market price to set the new initial price on the swap. The price timing can be challenging in most operational frameworks, which may not have the processes in place to process tomorrow's trades after market close or may leave the front office with incomplete information if processed after start of day.

OPERATIONAL IMPLICATIONS

Some OTC equity products follow relatively straightforward processing for OTC products with equity underliers. It's easier to align to a methodology when the instrument mimics direct exposure. For example, it's easy to imagine adjusting the details of a total return swap to mimic the underlier as it goes through a stock split or creating a new position if the underlier has a spin-off. Individual ISDA contracts may include customized provisions to specify alternative behavior. However, since the instrument is intended to mirror exposure, agreeing on guiding principles like mirroring the behavior of the underlier is less complicated.

It becomes significantly more difficult when the OTC instrument represents the right to ownership, such as an OTC option, rather than synthetically mimicking ownership. Although exchange-traded options typically provide greater liquidity, investment managers may choose to utilize OTC equity options in various scenarios.

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OPERATIONAL IMPLICATIONS (continued)

They might do so when the security is thinly traded, the trader prefers nonstandard expiration dates, or an option with bespoke features like barriers is necessary for the investment strategy. Central bodies like the Options Clearing Corporation (OCC) provide corporate action data, but data from the OCC is not always enabled directly to the asset manager, or the options may be held at broker, in which case the asset manager may not see the details until after the event. Additionally, OTC options with features like barriers or digital components will have additional considerations that need to be considered beyond adjustments to the strike.

SOLUTIONS AND BEST PRACTICES

Once the behavior is agreed upon, automating that behavior becomes an entirely separate challenge. Depending on the nature of the asset manager's systems and process ownership, there will likely be challenges associated with the timing of the trade to ensure the front office has a consistent view of its exposure. There can be further challenges with how data is passed across systems since many systems do not leverage separate security masters or data structures for OTCs. When this is the case, there can be limited functionality to transact on a deal beyond terminations, which makes altering the shape to match the equity underlier a unique challenge. While minimizing latency across the platform can address some of these challenges, significant development is often the only way to address differences in data structure.

Ultimately, overcoming these hurdles streamlines the automation process and enhances operational efficiency and accuracy, leading to more effective and transparent asset management practices. While some of the challenges mentioned above would most benefit from industry consensus, processing challenges, and automation should not inhibit asset management operations.

HOW MERADIA CAN HELP

Meradia has the skills and expertise to help ensure your front office has the most up-to-date information and does face delays in trading or analysis due to corporate actions on OTCs. Whether it's a matter of data structure or timing, Meradia has the experience to help streamline your operations and determine the most sensible way for your firm's front or middle office to process and automate corporate actions on OTCs.

Sources:

[1]Federal Energy Regulatory Commission. (April 25, 2024.). Blanket authorizations explainer. Retrieved May 29, 2024, from https://www.ferc.gov/OPP/blanket-authorizations-explainer

Jake Daly-Leonard is an investment management technology and operations expert who provides Meradia's clients with strategic guidance on the adoption and utilization of the industry's leading derivative valuation and collateral management solutions. A proven project manager, Jake has deep experience serving as a liaison between institutional asset managers and front-to-back office platforms as well as designing and implementing new features for OTC derivatives within other front-to-back office platforms. Similarly, he has also managed and executed transformational initiatives in the ABOR space. His background in the financial services industry, coupled with his knowledge of the technology landscape, provides unique value for firms looking to optimize operations through new and existing systems.

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