Breaking the corporate actions stalemate

As various studies have shown, financial services firms now have the appetite to improve their corporate actions processing efficiency. The key to success going forward lies in establishing and following industry best practices

By James Femia

Corporate actions are the finance world's version of a chess match. Both activities involve an almost infinite number of intricate moves, forcing players to think strategically about the outcome. And just when you think you've mastered your position, a new wrinkle enters into play and the threat of loss is real.

To win at chess or at corporate actions processing, attention to detail with a view toward the big picture is essential. So are planning and foresight. The dilemma for corporate actions managers is that as volume and complexity intensify, the number of positions that need to be analysed increases exponentially – as does the potential for error. No matter how many people or how much money firms throw at the problem, it doesn't get much easier, or safer.

In short, corporate actions processing is a business ready for a serious overhaul, and that's why financial institutions need to be charting a course of action to advance their positions.

The corporate actions conundrum

The very complexity of corporate actions today has hamstrung the industry's movement to an automated STP environment. In fact, some financial institutions suffer from a kind of organisational inertia that prevents them from taking a bold move forward. As in chess, stagnant positions often demand to be broken by aggressive moves.

To be sure, firms face a number of challenges as they seek to automate what is arguably the industry's most paper-bound process. Yet it is the financial institutions which make sure use of the "clock" by automating that have the soundest end game.

To date, although automating corporate actions is commanding considerable attention in the securities industry, progress has been patchy. Consequently, even as financial institutions continue to focus on STP for clearing and settling trades, tackling corporate actions is looming ever larger.

It looms so large, in fact, that it has now emerged at the top of the industry's agenda. The problems associated with corporate actions were raised in the Group of 30's January 2003 *Global Clearing and Settlement: A Plan of Action*. Among its 20 recommendations for improvements, the G30 lists the automation and standardisation of asset servicing processes, including corporate actions and tax relief arrangements.

The study states: "Corporate actions, across the market, are the major source of financial losses attributable to operational failure."

Broadly speaking, a corporate action occurs whenever a financial change or new opportunity impacts a security. Common instances include share reorganisations, elective dividends, takeover events, warrant exercises, conversions and spin-offs.

Every day, financial institutions around the globe are flooded with millions of faxes, phone calls, emails and letters carrying news of various corporate action events. The information comes from a diverse range of sources, including custodians, broker/dealers, depositories and exchanges, as well as news journals, wire services and data vendors. The information may be ambiguous, contradictory, outdated and sometimes just plain wrong.

Each corporate action has a multiplier effect. A single event may involve hundreds of financial institutions and result in tens of thousands of communications sent, and/or cash or share payments allocated.

For voluntary events, such as a rights issue, the investor is given a number of options to choose from within a set timeframe. If the investor is not given timely, accurate notification, or if the decision is not relayed by the due date, the financial institution processing the event may have to pay a substantial sum to cover the loss.

It all comes down to risk and cost

As is the case in most industries, risk and cost drive change in financial services.

According to some estimates, large custodians can budget as much as several million dollars per year to cover corporate actions losses. Any institution that has suffered a significant loss from a missed or wrongly processed corporate action event understands the pain a single mistake can cause.

To help protect against these losses, financial institutions worldwide invest considerable sums to train their corporate actions staff, install tight management controls and acquire additional sources of information. This makes corporate actions processing one of the most costly operations areas in the global securities marketplace.

It also makes managing resources very difficult. Scaling operations up or down to deal with volume peaks (eg year-end notifications, dividend season) and troughs is easier said than done.

Meanwhile, overall volumes continue to climb. Just this past October, the markets saw the biggest wave of takeover announcements since the end of the bull market. Four deals were announced in a single day, valued at more than $70 billion, involving companies in the banking, health insurance and tobacco industries.

These deals have raised hopes that an improving economic picture will spur the mergers and acquisitions business, and a surge in corporate deal making means more corporate action events to process.

At DTCC's depository subsidiary, we continue to process high volumes of reorganisations, redemptions, dividend and interest payments. In the first nine months of 2003, we processed $1.7 trillion of transactions – 24 per cent higher than the same period last year.

Time to make a move

Two surveys carried out this year indicate that financial institutions are now ready to take on corporate actions. Celent Communications estimated that the securities industry would spend $830m on corporate actions solutions between now and 2007. In a survey conducted by Swift, Smartstream and CityIQ earlier this year, 75 per cent of respondents anticipate "substantial" automation of their corporate actions processing, with operational costs cited as the main driver by 59 per cent and the ISO 15022 messaging standard cited by 46 per cent.

Estimates vary as to the savings that can be delivered by corporate actions automation, but industry estimates show that financial institutions, which have automated part of their corporate actions processing areas, have been able to increase the productivity of existing staff by 30 to 50 per cent. These types of gains enable the back office to handle growing volumes, increase operational efficiency and reduce expenses.

Just as the proper placement of pieces on the chess board almost inevitably creates opportunities to advance, a more efficient operation almost inevitably leads to economic gains that extend beyond the back office. For example, providing timely and accurate corporate action announcement information to the front office gives traders the knowledge they need to make sound decisions to buy or sell securities.

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However, it's the lack of standardisation and uniformity in how events are announced that creates the difficulty. Issuers, offerers and agents announce events in different ways, using various means for describing the terms applicable to an event. The multiplicity of securities identifiers – for example ISIN, Cusip and Sedol – require firms to cross-reference identifiers in order to determine precisely which security is involved in an event.

Engaging the industry

Two industry groups have launched corporate actions initiatives aimed at this problem. Both the International Securities Services Association (ISSA) and the Securities Industry Association (SIA) are promoting initiatives to provide clear, consistent and uniform corporate action information in prospectuses and proxies.

The ultimate goal of these efforts is twofold: to "reduce the distance" between the initial source (the issuer or offerer originating the corporate action) and the investor, and to allow for the electronic distribution of the information.

Globally, an ISSA committee is working on an effort to obtain agreement on a standard set of data elements that should be included in the initial corporate action announcement in all securities markets. DTCC supports this ISSA initiative in conjunction with other securities depositories around the world.

In the US, DTCC is working with the SIA's Corporate Action Division on the adoption of a standard template of corporate action data elements and is supporting efforts to urge the Securities and Exchange Commission to mandate new requirements.

Fostering solutions

Any corporate actions initiative should be based on industry best practices. They provide the structure and substance to help streamline processing in the global marketplace. Best practices begin at the very start of a corporate action with the announcement itself. Without clean data at the beginning of the corporate action process, the whole cycle falls into disarray.

Also fundamental to improving corporate actions processing is automating the communication of event notifications and election instructions and eliminating error prone messaging by fax, phone call and email.

National and global securities market practice groups, in which DTCC actively participates, have been working to develop best practice guides for the use of ISO 15022 corporate action message standards.

There are many more industry initiatives under way, including those by the Canadian Capital Markets Association (CCMA), the International Securities Association for Institutional Trade Communication – International Operations Association (ISITC-IOA) and central securities depository associations in Europe and the Americas.

No one single approach will result in a complete corporate actions solution. It's going to take a confluence of efforts by industry groups working within national markets and across borders, and individual industry participants, to ensure progress.

Financial institutions that want to avoid corporate actions checkmate need to look at the big picture, anticipate the risks that lie ahead and initiate change.

And now it's your move.

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