



# QUANTIFYING THE RISKS IN CORPORATE ACTIONS

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A WHITE PAPER FROM B.I.S.S. RESEARCH

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## INTRODUCTION

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Nearly everyone in the world's capital markets knows that there are significant risks associated in corporate actions processing. Indeed all suppliers with a product in the corporate actions space will say in their marketing and sales documents, that their product reduces risks. What is lacking is what risks are being reduced, from what and by how much!

This white paper commissioned by Vermeg, one of the leading international software solution providers, supplying some of the worlds' leading financial organisations with state of the art corporate actions systems, attempts to define the universe of risks in corporate actions and begin to quantify individual operational risks and arrive at an overall risk assessment.

### CORPORATE ACTION DEFINITION

For the purposes of this white paper the definition of a corporate action is a legal activity that changes the corporate structure by elective events, needed to be actioned by the beneficial owner of the asset, this also includes dividends and other activities, which alter the financial condition of the company.



RISK

# **CORPORATE ACTIONS PLAYERS**

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## **ISSUERS**

A Public Limited Company (PLC), which issues shares in the company and is listed on a Stock Exchange, enabling the general public and professional investors to trade/invest in the company. They create the corporate event with their Investment Bank corporate advisors to raise and distribute funds to eligible investors.

## **CORPORATE ADVISORS**

Normally part of an Investment Bank, but can be independent or part of a Broking business. Lawyers and accounting firms also take part in an advisory capacity during the initial phases of corporate actions event creation.

## **PRIMARY CORPORATE DATA ISSUERS**

These are often part of the media, but can be a Stock Exchange or other businesses with data distribution capabilities. They issue corporate data to the market and begin the market data chain.

## **DATA VENDORS**

Receivers of the initial Corporate Data, which they cleanse before standardising in either bespoke or ISO15022 format before electronically issuing to their market customers.

## **GLOBAL CUSTODIANS**

These are the power players in the market, who supply their customers with secure asset protection and service them by managing the corporate action process. They are huge data banks with the technical capability to manage static client data and receive enormous volumes of market data.

## **SUB CUSTODIANS**

Sub Custodians can be part of a Broker Dealer operation or act in a primary role in domestic markets with technology links to Global Custodians, acting in an intermediary capacity, often through a nominee, taking data from Global Custodians and other providers and are responsible for management of the corporate event.

## **BROKER DEALERS**

Acting in both a primary and agency capacity they provide a dual role with investing clients but also using their own funds to trade on their own behalf. They manage corporate events on behalf of the client and their own book

## **WEALTH MANAGERS**

Wealth Managers are Brokers that act singularly on behalf of their clients, who are normally high private net worth investors and act to protect their client's corporate action interests.

## **ASSET MANAGERS**

Normally act on behalf of professional investors. They protect the asset by taking the correct investment decision for the corporate event and pass their elective decision onto their brokers/agents/custodians.

## **FUND MANAGERS**

Normally acting on behalf of their own company's fund, like a pension firm or acting as agent for multi company funds. They ensure that the funds that they are involved in managing, take the correct elective decision in a corporate event and that the proceeds are distributed.

## **HEDGE FUNDS**

Traders trading high risk strategies in low investment, in short positions, creating high risk exposure to market volatility, but with potential a high return. They also ensure that corporate events are correctly elected and proceeds are distributed correctly.

## **DERIVATIVES TRADERS**

Trading in derivative instruments they often exercise the option and future creating an exposure to the underlying asset. They ensure that corporate events are correctly managed and the underlying asset is priced.

## **LEGAL**

Lawyers advise families or companies about corporate events.

## **ACCOUNTING**

Often managing family assets needing valuation services and market advice, who can help ensure that corporate events are correctly managed.

## **PRIVATE INVESTORS**

Individuals that are exposed to the market either by own named investments or as part of a group. They need to make sure they understand what action they need to take and importantly inform their agent of what action to take on their behalf.



## SUMMARY OF THE DATA CHAIN

With this long corporate data chain it's not surprising that things often go wrong. With non standard corporate data at the Issuer end, the market purchases corporate data many times over to ensure correctness and completeness. They then cleanse the mass data purchase to arrive at a single data record (often called 'The Golden Copy'), despite the fact that the data vendor has already cleansed the record before distribution. The costs of this convoluted operation are passed down the data chain.

The introduction of ISO15022 has reduced data distribution costs but as SWIFT the private banking network, has not penetrated the data chain, the retail investor's agents do not gain any benefits. There is also very limited global connectivity to SWIFT, notably in the US. This is something written about further on in this white paper.



## **CORPORATE ACTIONS**

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Corporate Actions vary per market internationally, with different local market rules often complicating settlement for international investors and their agents. Globalisation of the capital markets and the wide use of the web have fuelled transaction volumes. In Europe this has been increased massively by the introduction of many new trading venues (MTFs & Dark and Lit pools), which have caused a reduction in the size of trade executions. The trend for smaller executions is unlikely to change, without a shift in the current market structure by new regulations.

More complex investing strategies and portfolios that are becoming more industry sector focussed internationally, have also added to the overall transaction explosion. The combination of complexity and volume growth makes the corporate actions settlement operation extremely difficult and risky.

### **THE CORPORATE ACTIONS DEPARTMENT**

The corporate actions department is a key area within all back office operations where great losses can be incurred by the investor or firm, if it is not run efficiently. Many firms will run a suspense account of unresolved queries, which are often written off as losses in due course. The use of this suspense account has hidden the true picture of inefficiency and is one of the main reasons why the problems in corporate actions processing have remained unresolved for so long.

Budgets to develop or enhance corporate actions systems are also difficult to obtain, if the real picture of inefficiency and loss are clouded in write offs or negotiated, accepted losses between counterparties.

Corporate Actions can be complex and in an increasing global market entail varied domestic rules and practices, foreign to the investor and their agent and likely to create a system break. Any break from the norm can cause an immediate problem in settlement efficiency.

Without the authority of the end investor, their agent will need to contact them and explain the effective event and the pros and cons regarding what actions to take. This investor communication is often time sensitive and painful to undertake if volumes are high and time is short. If the investor assets are in a Nominee this process is alleviated.

But, with portfolios becoming more international, the responsibility of the corporate actions clerk is growing and the possibility of errors and breakdowns increasing. With back office systems limited to a standard corporate action process, it is left to the corporate actions clerk to recognise and solve problems, hopefully before they cause any losses or reputational risk.

Consequently the majority of financial services firms, staff their departments with people who have wide industry knowledge and can take or are able to make decisions and are given responsibility accordingly. However, for many firms this depth of knowledge is only at a senior management level, although in a large organisation may go down to supervisory level. But, below this rank many firms surround their managers with less knowledgeable staff, with no decision making responsibility or capability. The consequence of this industry trend is to centre industry knowledge in a very narrow band.

Cross training takes time and does not happen over night. Often this causes the best young prospect in the corporate actions department to leave to find new opportunities to achieve personal ambition. There is also a culture of personal job protectionism with experienced but ageing corporate actions managers looking at protecting their position and their pension, who are not prepared to invest their time in training new staff or introducing new systems.

## **CORPORATE ACTIONS DEPARTMENT RISKS**

- ⊖ Replacement risk
- ⊖ Operational risk
- ⊖ Reputational risk
- ⊖ Revenue risk

## CORPORATE ACTIONS SYSTEMS

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The vast majority of financial services firms have corporate actions functionality of some kind built into their legacy system. If they have been astute they will have continually invested in new developments and enhancements. However, in reality the lack of technological expertise and the job protectionism culture has prevented continuous system enhancements. The picture is also different in wholesale and retains market firms.

In the wholesale markets, the Custodians, Investment Banks and Broker Dealers tend to have invested more in corporate actions systems functionality. This is mainly due to the likelihood that they will bear the brunt of any losses created from corporate actions process breakdown. Even if their client is at fault it is most likely that the wholesale firm will protect the business relationship and accept the loss. Often the agents of the investor will negotiate a split of any loss to protect both their clients.

This is another instance which covers up the true picture of the industries corporate actions processing capability. As a result, the case for mass investment in corporate actions systems is underplayed, against the covered risks and losses. However, it has been evidenced in the market over the years, that if a major loss or situation becomes visible to the board, there becomes a motivation to undertake a corporate actions project.

But short memories abound in financial markets and any major problem today can soon be usurped by a bigger problem tomorrow.

It is also very difficult to gain systems development budget from the board if the board does not understand corporate actions operations nor the technology needed to support them. In many firms this creates a case of 'the blind leading the blind', which is normally resolved by the introduction of consultants.

The consequence of this lack of detailed knowledge at board level has been a massive industry under investment in modern technology to support corporate actions processing. Hence, globalisation, transaction complexity, growth and reduction in the capability of corporate actions staff have created the problems, we find today.

In the last ten years software vendors have stepped up to the plate to provide technology solutions to many of the corporate actions operational problems. Although in the early days this tended to be centred on SWIFT messaging and the need of the wholesale market. But corporate action systems have evolved fast and are now of real benefit to the retail market. With this newly developed technology some vendors have already been through several major updates and enhancements making them the most up to date systems in the market.

In the retail market, Investing institutions and Wealth Managers have relied on the capability of their agents, like Custodians, to provide efficient corporate actions processing. Their legacy systems functionality is geared more to monitoring and communicating corporate data via bespoke custody systems.

Most retail financial services firms are not SWIFT members, which is an obvious cause of breakdown, especially in high volume or time sensitive conditions. The retail firms have put an over reliance on the wholesale market and almost devolved responsibility.

New regulations concerning investor protection emanating from MiFID 2 could expose retail firms to greater demands to support their clients and their assets by becoming more proactive in processing and have more systems support. This could manifest in improved corporate data communication and greater control in elective events and settlement.

But, it is unlikely that even with a strong regulatory push, retail market firms will look at SWIFT connectivity or take part in ISO20022 message communication. However, the chances would be greatly increased if retail firms could access the SWIFT network through their existing network supplier.

Corporate action system vendors have been able to build their solutions on 'state of the art' new technology. They have a comprehensive knowledge of the corporate actions market and importantly modern technology used for the solution. As the software vendors are able to focus on the automation of processes they are also able to detect weaknesses in procedures and produce a rounded solution that combines automation wherever possible but that will support manual intervention when necessary.

These systems are far removed from many systems that have been developed in-house, where I.T. people lack all-round corporate actions processing knowledge and where corporate actions operational people lack I.T. knowledge. The result is the inability to produce an imaginative, efficient solution with modern technology. Consultants have been introduced to bridge the I.T. and operational gap with variable degrees of success, but at great expense.

#### **CORPORATE ACTIONS SYSTEMS RISKS**

- ⊗ Legacy systems functionality
- ⊗ Limitations on automation of key processes
- ⊗ Limited communication
- ⊗ Unable to support complex corporate actions
- ⊗ Systems replacement
- ⊗ Knowledge limitations



## CORPORATE ACTIONS PROCESSING

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### DATA ANNOUNCEMENT CAPTURE

Despite the huge investment by financial services firms and the industry as a whole, data announcement capture remains the greatest risk in achieving efficient corporate action processing. In today's global markets, where the web and internet communication is widely used, it is somewhat surprising that data and information about corporate events is still a problem. To understand why problems exist and remain unresolved it is necessary to appreciate the culture and operational differences between the retail and wholesale markets and the protectionism that exists between private networks, data suppliers and those providing corporate action services.

The data supply chain has evolved over many generations into its present structure. New technology and the creation of message standards like ISO15022 have created efficiency and cost reductions (*although much of the cost reduction has not been passed onto the investor, rather retained as increased profit by the supplier*) but this is predominantly a wholesale market scenario, managed by SWIFT and outside of the retail market.

Of course the retail market could all join SWIFT but the cost of this tends to deter retail firms. There is a possibility that ISO20022 could be attractive to the retail firm, if it is a low cost connection, but at this stage it is not certain what the commercial benefits will be or what operational benefits will ensue.

If the risks are significant in the worlds largest international markets, they are even greater in emerging markets where manual processes and lax regulations and procedures can create immediate data problems, which can remain unresolved until final settlement. The implementation of electronic standard messaging in emerging markets would go some way to reducing the risks of error and make these markets more attractive to invest in.

The cost of finding solutions in the industry to the risks of non standard and free format data are huge. Investment in technology and services to find the “Golden Copy” has created a business all of its own because of the downstream problems caused by initial data capture issues. Internationally, the data problems are compounded by manual intervention and non centralised controls of market data distribution.

To date, the industry costs of solutions to the problems of non standard data are disproportionately huge to the impact they have had. A more measured and intellectual approach is needed, with the Issuers and the market data chain all brought closer together electronically through standardised corporate announcements and data distribution.

Investment in ISO15022 and data cleansing functionality can be measured globally in many billions. Despite the huge effort by international market groups over decades, the solutions that have been introduced are overly complicated, expensive and irregular, leaving corporate data still non standard.

There is hope that the DTCC/XBRL initiative in the US will be the first success in standardising corporate data at source and will relieve the risks and reduce cost to the data chain and of course the investor.

As mentioned the future introduction of ISO20022 will tackle some of the industries data risks, but this is very early days and this initiative has to be managed globally and be expanded as a network neutral solution. Message standards and communication have to have both retail and wholesale market take up and this is unlikely to happen quickly if SWIFT retains a central managing role.

The creation of a new global body to manage connectivity and be competitive on pricing is required. SWIFT should concentrate on standards only and divorce itself from being the single commercial network supplier.



If this unlikely scenario was played out we should see risk and cost reductions for the retail markets, investors both professional and non professional and the wholesale markets. However, unless cost savings were passed on, throughout the data supply chain and onto the investor, the overall cost to investors and the man in the street through their pension funds, will remain exceptionally high.

## **DATA ANNOUNCEMENT CAPTURE RISKS**

- ⊖ Data errors
- ⊖ Cost risk
- ⊖ Revenue risk
- ⊖ Development risk
- ⊖ Competition risk

## **NOTIFICATIONS**

The ability to notify investors and traders of corporate actions, with sufficient time, for them to understand, decide and take the necessary action is a fundamental need to enable settlement of a corporate event. The notification chain can involve multi-entities and multi-accounts, with any number of interested parties also needing information associated with the corporate action. Obviously settlement agents come into this category. The notification chain can be a long one.

The key elements for efficient notifications are complete data and an efficient communication method and network. In the wholesale market SWIFT performs this role excellently.

For the investor the early notification of a corporate event allows time to consider what actions they wish to take and begin the elective or instruction process. The control process and procedures for notifications should also ensure that they form a logical queue and build an escalating demand to take action and of course make sure that a deadline is not missed.

Equally for traders, early notification is vitally important to allow them to correct any pricing of the underlying asset and any strategy they may have, which is affected by the corporate event. Derivative trades can also form part of the trading or investment strategy and the overall position needs amending as soon as possible.

## **NOTIFICATION RISKS**

- ⊖ Inaccurate data
- ⊖ Incomplete data
- ⊖ Late data

## **CLAIMS MANAGEMENT**

With industry settlement timescales reducing due to a number of changes including contractual settlement, centralised clearing, nominees and increased liquidity created by stock lending/borrowing, the number of market claims against unsettled transactions has been reducing. However, this positive trend should not dilute the importance of efficiently handling market/investor claims.

When the claims process is inefficient, it can significantly increase operational workload through complicating reconciliations and possible losses against the profit and loss account.

If outstanding claims are not cleared, the possibility opens for replacement risk of the asset. The cost of this is more than likely undertaken by the financial services firm to protect their client but occasionally can be worse if the risk and associated cost are taken by the investor. If the investor is involved it does nothing for reputational risk of the firm and the industry.

With volatility increasing in market prices the chances of loss increase and if the outstanding claim continues into the next corporate action, a compound effect is realised.

Even if the firm is lucky and comes out on the profit side of a lost claim they are bound to pass this back to the investor and if they are on the loss side they will be bound to recover the loss. This is a case of 'heads I win and tails you lose' for the investor!

## CLAIMS RISKS

- ⊖ Compound loss
- ⊖ Replacement cost
- ⊖ Reconciliation risk

## ELECTIONS

Electing for a corporate action should be the easiest of the actions to undertake but if the investment decision is delayed or not forthcoming, or if the trader misses the date, the cost of failure can be significant. Zero misses is a benchmark of efficiency that the corporate actions department has to aim for.

The decision making capability of the corporate actions department is often called on, when the firm is left high and dry by missing elective instructions by the investor or the dealer. Therefore the need arises for experienced and knowledgeable corporate actions market professionals to be able to accept on behalf of investors/traders based on market knowledge and a keen eye for a profit. This puts the corporate actions department closer to the front office capability than any other back office operation. Front office risks are therefore in play. Systems support to ensure dates and timescales are not missed are a necessity as there will be times when human failure is inevitable. Systems can help plug any risk gaps to provide client and asset protection, which is a primary regulatory focus.

## ELECTION RISKS

- ⊖ Replacement risk
- ⊖ Profit & Loss risk
- ⊖ Reputational risk

## PROXY VOTING

There is much made of Proxy Voting as one of the industries main operational corporate actions warts. However, in terms of risk the impact is relatively small. There is of course the potential to upset an investor if their vote cannot be registered, but unless this is in a hostile corporate environment such as a takeover/merger this is hardly going to be noticed.

For small retail investors' proxy voting is considered not much more than a day out at their company's expense. Although small investors can be a vocal majority at any meeting. So providing they are informed by the agent of any meeting they will be happy.

## PROXY VOTING RISKS

- ⊗ Reputational risk

## SETTLEMENT

Settlement of corporate actions is getting more complex and difficult due to the fragmentation of trading venues and clearing houses. Trading is now across multiple trading venues and in much smaller sizes than before as orders are broken down and executions spread across many venues. The asset itself can be held in any number of depositories and through many different clearing houses.

With more complex portfolios and trading strategies the reconciliation of the house position is more difficult to gauge and more susceptible to error. Equally investing accounts and portfolios can hold contrary positions depending on the investing strategy per client. Although it is true that fragmentation in clearing spreads risk, there is a price to pay for not pooling the risk. Costs have increased as systemic risks fall. The risks of complexity and fragmentation make the overall reconciliation difficult and final settlement uncertain. Final settlement is only achieved once the asset is in a fully reconciled position and the trading or investing account has irrefutable ownership of the post corporate action asset.

With globalisation and the likelihood that assets will be held in multiple locations the need for systems to track the corporate action and produce an auditable record becomes necessary.

Arbitrage and international investment along with derivative trading and hedge funds, make the corporate actions operation the most complex of financial activities. When this is industry wide the problems become systemic encompassing the market, both on the retail and wholesale side and the investors.

### **SETTLEMENT RISKS**

- ⊖ Revenue risk
- ⊖ Reputational risk
- ⊖ Replacement risk
- ⊖ Systemic risk

### **RECONCILIATIONS**

Without ongoing reconciliations of the underlying assets any corporate action is likely to create an exposed position for the investor and trader. Un-reconciled underlying positions and following corporate actions will compound over time. The majority of firms have an in-house policy for write offs, which are normally within the accounting statutes. However, these write off positions should be regulated more stringently and become a regularly audited item. Market fragmentation issues have a direct bearing on the efficiency of reconciliations, the more fragmented and complex the environment the more arduous the reconciliation.

### **RECONCILIATION RISKS**

- ⊖ Compound replacement risk
- ⊖ Operational risk
- ⊖ Systemic risk

## ACCOUNTING

Accounting for corporate actions can be difficult depending on the complexity of the corporate event. Assuming all the relevant client accounts are reconciled and up-to-date, the firm then has a whole universe of data to work with to reconcile the position. The problem is ensuring that the correct data is updated into the right accounts. Timing is also important, as in volatile and high volume markets errors can quickly become compounded.

For investing clients, proceeds of a corporate action are likely to be reinvested and delays could cause losses or at the very least, risk of losses. For trading firms delays can increase risks to their profit & loss and affect the position on their trading book.

### ACCOUNTING RISKS

- ⊖ Profit & Loss risk
- ⊖ Client losses (possibly covered by the firm)
- ⊖ Reputational risk
- ⊖ Operational risk
- ⊖ Reconciliation risk

## TAX

Tax is the ugly sister of corporate actions, especially in the international markets, where bureaucratic procedures can produce tedious, manual form filling.

Tax reclaims are an arduous and time consuming exercise, which have little financial reward for retail financial services organisations, baring protection of their client's interests and fulfilling service level agreements (SLAs) and regulatory requirements.

Double taxation agreements and recovering tax in the international markets is a time consuming operation. Often it is an ongoing operation rather than a diligent process. This can mean that the firm is not recovering as much as they can for their trading book or at the very least it is heavily delayed, causing missing revenue or in some cases firms may have to fund their tax accounts.

For the investor it can also mean that tax funds are not in their accounts causing funding issues. In all cases, the non recovery of tax or delay has a detrimental impact on fund availability.

It's possible that regulators will take more interest in firm's tax management capabilities in the future, especially from the investor's point of view.

For the trading firm, at least the tax recovery operation has a financial incentive to be efficient, whilst its tax payments only keep the tax man happy. This can leave a negative impact on the tax accounts if payments are always more efficient than recovery. Potential fines from the tax authorities cannot be discounted as a cost and a risk to revenue.

It is in the interests of all parties that tax management is as efficient as possible negating risks whilst improving performance.

## **TAX RISKS**

- ⊖ Reputational risk
- ⊖ Revenue loss
- ⊖ Profit & loss risk

## **REGULATORY**

The regulators have been surprisingly quiet, with actions against firms very limited especially with any that are not out in the public domain. However, MiFID 2 is heading towards the market in 2011, with a likely concentration on client protection. The regulators are going to become far more interested in how firms are maintaining their SLA s and contractual obligations to their clients.

Asset protection can only be attained if the asset servicing systems and procedures are totally efficient. Weaknesses in systems or procedures and even knowledge of people offering these services, will get found out. It is up to the board of financial services firms to ensure that it has the best systems and an efficient operational environment is created, to achieve the services and contractual obligations agreed with their clients. Failure to fulfil legal obligations to its clients will incur the scrutiny of the regulators and subsequent penalties.

## REGULATORY RISKS

- ⊗ Fines and other sanctions
- ⊗ Reputational risk
- ⊗ Loss of business
- ⊗ Loss of clients

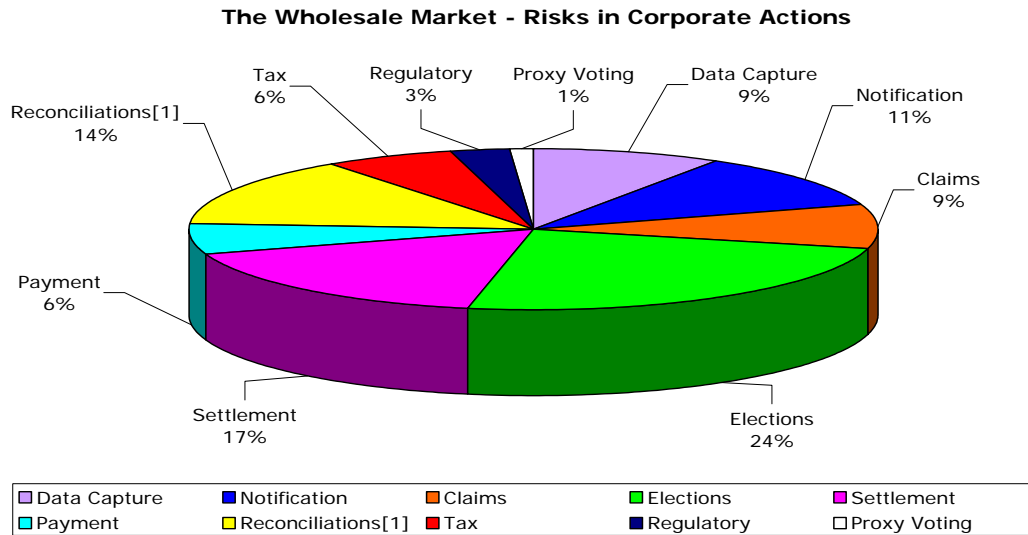




# RISK DEGREES IN THE CORPORATE ACTIONS PROCESS

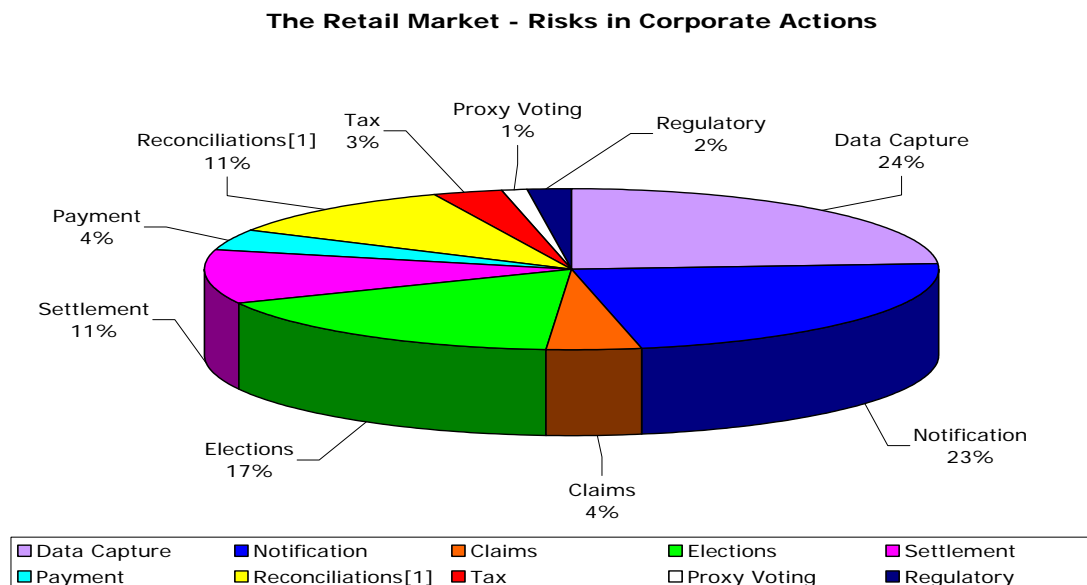
## WHOLESALE MARKET SURVEY RESULTS DIAGRAM

[Results based on survey of a number of financial services firms covering Custodians, Investment Banking and Broker Dealers over the period of two years covering UK and EU markets.]



## RETAIL MARKET SURVEY RESULTS DIAGRAM

[Results based on survey of a number of Asset Managers, Fund Managers, and Wealth Managers over a period of two years covering UK and EU markets.]



[1] This is both reconciliation of the underlying asset and the corporate event itself

## SUMMARY OF DEGREES OF RISK FINDINGS

There is a disparity between the wholesale market risks and those in the retail market. This is most noticeable in data capture and notifications where SWIFT and standard messaging has had a positive risk reduction impact.

The retail market is heavily reliant on efficient and accurate data and notification information and takes a more passive role. The lack of messaging technology and SWIFT connectivity is also an obvious cause of greater risk than in the wholesale markets.

Elections are a high risk for both wholesale and retail markets and indicate a shared risk level and a reliance on manual or non standard processes. This appears to be across the EU although the UK has a slightly reduced risk possibly due to the relationship of Crest/Euroclear to the retail market and standard operations and communication they share.

It is clear from the survey findings that corporate actions risks are impacting both markets, with many of these risks passed on between the wholesale and retail market players. Risks are only reduced when benefits of messaging standards are passed on or when there is centralisation of processes or communications.

It is also clear that any standardisation of corporate data at the beginning of the corporate action process, when the Issuer releases the data will have the most dynamic risk reduction impact for both wholesale and retail market firms and presumably the end investor.

Even if this positive move were to take place, both the wholesale and retail securities markets would still require changes in operations and processing, as the risks in operational processes increase greatly when EU markets provide disparate operational processes.

It would be easy to say that risks in corporate actions would be reduced for both the Retail and Wholesale markets if there was a single central processing entity. However, politics and fragmentation of EU markets prevents this obvious solution from becoming a reality.

Thus to reduce operational processing risks across the EU, the introduction of standardised rules and practices for corporate actions would be a big step in the right direction.



## MARKET INFRASTRUCTURE

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### SWIFT

SWIFT has been instrumental in the wholesale markets, bringing operational efficiency based on ISO message standards. However, it is powerless to tackle the retail market across the globe, where the vast majority of corporate actions problems start. For example in the USA, the buy side firms, universally, do not use SWIFT and it's the same picture in South America. It is only a slightly better story in Asia and in the emerging markets, virtually not at all. For this reason its limitations must be recognised by the industry, as a solution in solving all the problems in corporate actions processing.

Thus as the majority of the worlds markets and especially the retail firms are not SWIFT connected any introduction of new message standards via SWIFT initiatives, will only go part way in bringing automation and cost reductions to the international securities markets. This is equally true for risk reductions. Getting all international firms to connect to SWIFT will be impossible in the long term. In fact with standardised electronic messaging able to pass over any network technically it is not necessary anyway.

Like voice networks decades ago inter-network connectivity should be an important part of the industry solution. But this would require the SWIFT organisation to be changed. So should SWIFT be split up into a standards body and a commercial network supplier?

### DTCC AND XBRL

In the USA the drive to bring the Issuer and the market closer together has gained momentum with the DTCC/SWIFT/XBRL project. This is an excellent demonstration of complimentary market structure organisations coming together to utilise existing technology to solve a legacy industry problem.

ISO20022 and XBRL being used by the DTCC project in the USA will be a tremendous leap forward for the global corporate actions market, as it tackles corporate data problems at source (the Issuer) and should percolate down the data chain. It has, at least, an openness and simplicity of connection, which should be cheap and inclusive of retail markets and the wholesale market. But this will be just the start of a long road, in resolving communication and data issues and connecting retail investors with the wholesale market, bringing down risks within the market as a whole.

## **CLEARING & SETTLEMENT ORGANISATIONS**

Structure organisations currently involved in clearing and settlement in domestic markets actually underpin the problems by maintaining their systems and processes, rather than acting as a central force within their market for change.

The CSDs and ICSDs in the international markets adopt domestic international markets into their own offering, which only extends the problems, rather than producing solutions. The risks are more likely to be cemented and imbedded within any domestic market as a result.

Change for improvement is very unlikely, with risks now extended internationally. These organisations simply do not have the motivation for change. In most cases, they are all very protective of their revenue generating operations. Therefore, implementation of new rules, procedures, processes or systems are difficult, slow and unlikely.

## **SYSTEMS VENDORS**

It has been the development of corporate action systems functionality by the vendors, which has had the most beneficial impact on reducing risks within corporate actions operations. Their investment in the latest technology has had a dramatic impact on risk reduction within corporate actions, worldwide.

## SUMMARY

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Corporate actions include risks that are found in the front office, as well as back office operations. Replacement risk caused by operational errors, which cause financial services firms to purchase securities to cover and maintain the investor's original position, can be very expensive. Even trading firms with in-house positions can be adversely affected by replacement risk, even if the house position is a bull or bear. Any strategically designed traded position will need amending with dealing activity to retain the traded strategy.

Elective events where the investor is late or unable to provide a decision often calls for the corporate actions clerk to demonstrate a similar dealing and investment mentality with the capabilities and thoughts of a front office dealer. And it is often the front office dealer, who will seek and take advice from the corporate actions clerk, for a mutual decision on what election they should make.

With globalisation of the finance industry has come a proliferation of new derivative products and more complex corporate actions, across more diverse international markets, with an array of domestic rules, processes and procedures to be catered for. The risks of error in this ongoing, developing, global market are increasing. Market systems are as fragmented as the structures and workarounds, with manual processes to cover systems functionality deficiencies, further hindering the industry from building effective and efficient corporate actions operational capability.

This white paper has outlined the basic corporate actions, operational functions, with the associated risks outlined. The functional list itself should not surprise anyone. But the commonality of how these all have similar operational weaknesses, within all types of financial services firm, which are all systemically interlinked between markets, counterparties and investors, might be a revelation.

It would seem that in order to reduce industry wide corporate actions risk, a common and international centralised global body is required to give direction and also lead the way. This is unlikely to come from within SWIFT as they have a vested interest and are unable to produce a compelling commercial and technical proposition to attract the retail market. Although SWIFT should certainly be a part of the solution. Possibly a new 'not for profit' organisation with a global board encompassing all market parties and with regulatory powers, would give the industry, the direction and motivation to make the changes necessary.

Corporate actions risks are often referred to but have never been mathematically defined. Perhaps the range of risks found within corporate actions makes this to complicate to arrive at a single equation.

The many hybrid risks in corporate actions does need some sort of standard definition and industry wide recognition, which could then be formed into an equation that accurately represents the overall risk. If this can be achieved and accurately measured and assessed the result will create the motivation for financial services firms to make the necessary decisions to change current practices, processes, procedures and rules.

For too long corporate actions risk has been allowed to fly under the radar or be bundled into operational risk, because of its complexity. It is now time that the risks found in corporate actions for the individual firm, despite their type of business, are defined, universally accepted and can then be mathematically equated. This will create the impetus for the industry to introduce more radical solutions sooner than at present, negating the need for the many global groups or committees who although they should be applauded for their efforts have been unable to speed up the process.

Software vendors, such as Vermeg, have designed very good solutions for the corporate actions problems for both retail and wholesale markets. The implementation of these corporate actions systems across the whole industry would no doubt reduce risks massively, but this fanciful notion will not happen anytime soon, when action is needed now.

The corporate actions systems available to the financial services markets worldwide have been developed over the last ten years and have the benefit of being on modern and flexible development frameworks. For this reason speed of implementation is much faster than the in-house legacy systems that populate the market today.

Although the investment in these systems may be high at first look, a deeper investigation would show that there is a large reduction of corporate actions risk, with immediate effect and an ongoing operational cost saving, which produces a very early ROI.

For financial services firms looking to implement corporate actions solutions to reduce their risks and costs, with limited budgets to play with, a managed services offering or software as a service offering (SaaS) is a welcome new introduction in the market. There is a very positive risk impact by taking up these outsourced options and if this business becomes successful on a wide international scale, it will have a similar industry risk reduction, as any of the international messaging standard initiatives.

With client servicing a high priority for the regulators, it would also appear that regulatory risks will also be beneficial to any firm going down the SaaS or managed services route.

Corporate actions risk reduction is a complex subject. It involves cross-market as well as vertical product and inter-market dependencies.

There are business protection issues and organisations that control parts but not all of the industries corporate actions processes.

There is a lack of regulatory pressure to date on existing industry practices, systems and processes.



There is a lack of board understanding and a burgeoning lack of people with corporate actions process knowledge.

Systems within financial services firms are old and operate outdated or at best part support of the corporate actions process.

There is currently no quantitative risk equation to highlight in mathematical terms the risks that firms are living with on a day to day basis. However, this white paper should be viewed as a first step in indentifying the universe of risks that need now quantitative analysis to create the first corporate actions risk equation.



## ABOUT VERMEG

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*The following information has been provided by the vendor*

Vermeg is a leading provider of software solutions in global financial markets, with a focus on high quality processing for Securities and Investment Funds.

Vermeg's solutions are found imbedded in many leading financial institutions worldwide.

With a growing client list of over 50 clients in 15 countries including custodians, asset managers, central banks and brokers, Vermeg's reach is constantly expanding.

The Megara modular system is the most comprehensive securities processing platform in the market today, able to support many areas in global financial services including middle to back office solutions for businesses such as Custodians, Wealth Management and Broker Dealers.

Megara has a wide array of capabilities, offering a one stop shop for the customer, operational areas covered include Custody, Corporate Actions Processing, Collateral Management, Order Management, Treasury, Fund Management etc, modules are able to be selected and assembled to specific customer requirements creating Risk Mitigation.

MegaCor is the corporate actions component of the Megara suite. It automates corporate actions processing wherever possible and supports manual intervention when necessary, to create a management control between investors and the market.

MegaCor's functionality is modular and can be selected as required, in any combination, to fit into an existing system's architecture.

Whether it's the corporate actions notifications or claims processing or simply taxation, MegaCor will suit the needs of buy and sell side financial services firms.

MegaCor is an industry accredited corporate actions processing solution, having gained both the SWIFTReady corporate actions accreditation and the B.I.S.S Accreditation for corporate actions processing systems every year since 2003.

MegaCor delivers the following benefits:

- Automation of corporate actions processing
- Management control of the entire corporate actions process
- Exception processing
- Risk reduction by highlighting and prioritising actions in time for elections
- Focused client service solution
- Functionality for all sectors in the domestic and international securities markets
- Highly scalable solution, currently used in very high volume environment
- Flexible & Modular Design
- Top class, independently rated, systems support
- SWIFT Messaging

MegaCor's design and interface layer simplify its integration with all the back office downstream systems.

For more information visit [www.vermeg.com](http://www.vermeg.com)

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## ABOUT THE AUTHOR

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Gary Wright, MSI, C.E.O. B.I.S.S. Research has been active in the Securities industry since 1969 and during an impressive career in the City has held senior positions in some of the worlds top financial institutions. He has also been employed within a number of leading suppliers giving him a unique position to appreciate the problems of procurement from both sides. He is the creator of the unique B.I.S.S. Accreditation, which independently benchmarks international systems and services from the buyer's perspective.

An accomplished speaker and commentator on the many changes in the global financial services market place, he is regularly contacted by the media and financial services organisations for his forthright opinions and independent analysis.

His blogs, articles, white papers and reports are published world-wide both on the web, in the press and trade journals.

During his career he has been involved in many industry committees covering the many initiatives that have shaped today's securities markets; including setting the CISI Operations Management exam papers, lecturing at Reading University and at the ICMA Montreux event.

He has run a number of industry workshops, training sessions and roundtables and chaired and spoken at many conferences globally on topics related to Financial Services.

## ABOUT B.I.S.S. RESEARCH

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B.I.S.S. Research is an independent company providing analysis of financial market issues, technology and services of suppliers in the Global financial services industry.

B.I.S.S. Research analysts are all from a business to IT background with a long track record experience and procurement in the financial services market place, which enables them to produce unique and valuable assessments of technology and services and their value to the supplier and the market place. B.I.S.S. Research analysts are available for commission for report writing, articles and speaking engagements including web broadcasts.

B.I.S.S. Research undertakes commissioned research projects for financial institutions and vendors that range from the securities market to the payments industry. Its white papers and thought provoking articles are regularly featured in the media, as well as being published on the B.I.S.S. Research website.

B.I.S.S. Research has created a unique benchmarking process to prove the real capability of functionality and service capabilities to buyers in the financial services industry. The B.I.S.S. Accreditation has been operating since its creation by Gary Wright in 2003, which is to be launched on-line shortly.

The B.I.S.S. Accreditation Logo is rapidly growing as mark of confidence for the buyer of software and services, it proves that the vendor has received an independent valuation and thus helps secure the purchase.

The Benchmarking report is an independent source of detailed information and published globally on the B.I.S.S. Research website and marketed through the industry media and analyst channels.

The B.I.S.S Accreditation is suitable for suppliers of any financial system or service including; Front Office, Middle Office, Back Office, Corporate Actions, Compliance (including MiFID, SOX, Basel II), XBRL, Market & Reference Data, Risk Management, Treasury, Payment, Banking Services, Custody Services, Broking Services, Stock Exchanges, CSDs, Web Services and Integration.

B.I.S.S. Research is a privately owned company based in the UK, but marketed globally, where it has already large international customer base.

For further information visit [www.bissresearch.com](http://www.bissresearch.com)

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