Options Newsletter for Investment Advisors

TMX Montréal Exchange

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Adjustments to the Terms of Options Contracts

It is common for companies to proceed with corporate actions, which can have a material impact on the value of their shares. These actions also impact the value of options contracts on MX's options market.

Stock splits are the most frequent corporate action. For example, Potash Corporation of Saskatchewan Inc. (symbol: POT) announced on January 26, 2011 a three-for-one stock split of all its outstanding common shares[1]. As a result of the three-for-one stock split, common shareholders of record on the close of business on February 16, 2011 received two additional POT shares for each share held. Following this distribution, the stock price was divided by three. Thus, shares that were trading over $180 before the split were trading at $60 the following day. The value of options contracts has been impacted by the corporate action as well. Call options with a strike price of $180 do not offer the same upside potential after the split, whereas the value of put options with a strike price of $180 has suddenly increased substantially. These inequities must be corrected to protect investors with open positions taken before a corporate action.

In Canada, the Canadian Derivatives Clearing Corporation (CDCC) is responsible for monitoring and identifying corporate actions and their impact on the options contracts of a company. In fact, CDCC interprets the information received from the company and communicates it to the Adjustment Committee as soon as possible. A meeting is then scheduled by CDCC to review the information. The Committee shall then determine whether to adjust the terms of the options contracts to reflect particular events on an underlying interest, and the nature and extent of any such adjustments based on its judgment as to what is appropriate to protect investors and public interest.

In the POT example above, the proper adjustment that CDCC was required to make to the terms of the options contracts was to divide the strike price of the options contracts by three and to issue two additional options contracts for each contract held by an investor. So, investors that held one option contract (call or put) with a strike price of $180 before the split would hold the next day three options contracts with a strike price of $60. Therefore, the value of the options contracts is maintained. Holders of call options who had the right to buy 100 POT shares at $180 before the split (for a total value of $18,000) could the following day buy 300 POT shares (3 multiplied by 100) at $60 for the same value of $18,000.

[1] http://www.m-x.ca/f_circulaires_en/030-11_en.pdf

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All forms of corporate actions are covered in Article A-902 of the Rules of CDCC on the adjustments to the terms of options contracts and they include[2]:

- the announcement of a dividend (cash or stock),
- a stock distribution, a stock or trust unit split,
- a reverse stock or trust unit split,
- a rights offering,
- a distribution, reorganization, recapitalization, reclassification or similar event, or
- the merger, consolidation, dissolution or liquidation of the issuer of any underlying interest.

The adjustments to the terms of options contracts that CDCC can make are the following:

- the number of contracts,
- the unit of trading,
- the strike price and/or the underlying interest.

Normally, no adjustments are made to reflect the payment of an ordinary cash or stock dividend. Besides, an adjustment will take place only for special dividends greater or equal to $0.15 per share.

The most recent example illustrating such an announcement is Centerra Gold Inc. (symbol: CG) which declared a special cash dividend of $0.30 per common share payable on May 18, 2011 to shareholders of record on May 12, 2011[3]. Following the announcement, CDCC accounted for the special dividend by adjusting the strike prices of CG options contracts by an amount equal to the special dividend of C$0.30 on the ex-dividend date of May 10, 2011.

Strike Price Adjustments

Centerra Gold Inc.		
Symbol	Current Strike Prices	New Strike Prices
CG	$9.00	$8.70
CG	$10.00	$9.70
CG	$11.00	$10.70
CG	$12.00	$11.70
CG	$13.00	$12.70
CG	$14.00	$13.70
CG	$15.00	$14.70
CG	$16.00	$15.70
CG	$17.00	$16.70
CG	$18.00	$17.70
CG	$19.00	$18.70
CG	$20.00	$19.70
CG	$21.00	$20.70
CG	$22.00	$21.70
CG	$23.00	$22.70
CG	$24.00	$23.70
CG	$25.00	$24.70

Following the adjustment, the holder of a call option with a strike price of $19 now has the right to buy CG shares at $18.70. The same adjustment applies as well to the holder of a put option who now has the right to sell CG shares at $18.70 instead of $19.

[2] http://www.cdcc.ca/f_rules_en/A-09.pdf
[3] http://www.m-x.ca/f_circulaires_en/077-11_en.pdf

The reasons behind this contract adjustment can be explained using the following example. Let's assume that CG shares are priced at $19 and that CG does not pay a dividend at the time an investor buys call options with a strike price of $19. As an extreme example, let's further assume that CG declares a special dividend of $10 per share instead of $0.30. We can expect that, following the payment of the special dividend, the value of CG shares to be only $9 per share. The holder of call options with a strike price of $19 would then be at a disadvantage compared to the holder of equivalent put options who would see the value of his options suddenly increase. By adjusting the strike prices to reflect the value of the special dividend, both the holder of the calls and the holder of the puts would see the value of their options preserved and maintained to the level that existed before the payment of the special dividend.

The same logic of preserving the value of options contracts for all holders applies in the following example as well. Fronteer Gold Inc. (symbol: FRG1) announced on March 30, 2011[4] that a majority of its shareholders approved a plan of arrangement under which Newmont Mining Corporation acquired all the issued and outstanding common shares of Fronteer Gold. Under the terms of the plan, FRG1 shareholders received $14.00 in cash and 0.25 common share of the new company named Pilot Gold (which trades under the ticker PLG) for each FRG1 share held. In this particular case, the underlying value of the options contracts ceased to exist and holders of options contracts were no longer be able to neither buy nor sell shares of FRG1 when they exercise their contracts. Thus, a contract adjustment is necessary to preserve the value of options contracts. Since FRG1 shareholders received $14.00 in cash and 0.25 PLG common share, it makes perfect sense to change the underlying value of the options contracts as follows: $1,400 in cash and 25 PLG common shares. Hence, the value of the contracts is preserved since the holder of one call option who initially had the right to buy 100 FRG1 shares now receives $1,400.00 and 25 PLG common shares; whereas the holder of one put option now pays $1,400 and delivers 25 PLG common shares for each contract that is exercised.

These are only a sample among the types of contract adjustments made by CDCC each year. Only for the year 2010, more than 29 contract adjustments were either announced or made by CDCC. For the period of January to April 2011, more than 19 adjustments[5] have been either announced or made.

Adjustments to the terms of options contracts are essential for the smooth functioning of the options market. It is very important for the value of the options contracts not be adversely and wrongfully affected by any corporate action. Contract adjustments made by the CDCC have for objective to keep the value of the options contracts to the level they were at the time of the corporate action to protect investors and public interest.

[4] http://www.m-x.ca/f_circulaires_en/066-11_en.pdf
[5] Please refer to the section « Circulars » on the site of the Montréal Exchange at http://www.m-x.ca/publi_circulaires_fr.php

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