**Market Consultation**

To: Market Participants
From: Indices Department
Date: 15 December 2016
Subject: **Market Consultation: Treatment of Scrip Dividends in the FTSE/JSE Index Series**

## 1. Introduction

A scrip dividend (SC) is a type of dividend where shareholders may elect to receive either scrip or cash, with a default option for those shareholders that do not make an election. For shareholders that select the scrip option, the new scrip is generally issued in a ratio to the scrip already held. Real Estate Investment Trusts (REIT) have a similar event called an electable REIT distribution (RE). The treatment of SCs and REs in the FTSE/JSE Africa Index Series is currently different from the standard FTSE Russell treatment applied in the FTSE Global Equity Index Series and others. FTSE/JSE is seeking to align the treatment of SCs and REs in the Index Series to the current FTSE Russell treatment.

## 2. Background

According to the JSE definition, there must always be an election between cash and scrip for an SC or RE to apply; if not, the event will be deemed to be a Capitalisation Issue (scrip) or a Cash Dividend. The current index treatment of scrip dividends follows the default option to shareholders, which is announced by the company in the event announcement. Should cash be the default option, the scrip dividend would be applied as an ordinary cash dividend and the only impact would be to the Total Return index value. However, should the default option be scrip, the event would be applied as a Capitalisation Issue in the Index Series. With this treatment the shares in issue number in the index is increased and the price of the constituent is reduced with an overall market cap neutral effect. This treatment allows index investors to receive the bonus shares and to hold them in the index without any trade required.

The standard FTSE Russell index treatment is to apply all SCs or REs as cash dividends regardless of whether there is a scrip option or even a scrip default. Should the company issue additional shares as a result, these will be reviewed in line with the index rules, and typically updated in the constituent weighting at the subsequent quarterly index review.

## 3. Impact of Scrip Dividend Treatment in the Index Series

Since the FTSE/JSE Index Treatment depends on the default option, the exact treatment is not always apparent to index investors. For this reason, FTSE/JSE currently publishes an Informative Notice for Large & Mid Cap constituents informing index investors in advance of the treatment that will be followed in the index.

At an issuer level, it is useful to consider the two election components separately before looking at the combined index treatment. If all shareholders elect to take the cash, then the company would pay out a distribution to their shareholders. This would typically result in a decrease in the value of the company, and a fall in the share price from when the instrument trades ex-dividend. From a capital index perspective this would be treated exactly as a cash dividend.

In the event that all shareholders elect to the take up the shares, the company would effectively issue new shares to all existing shareholders with no distribution or expenditure of cash. This gives each shareholder a greater number of shares but an unchanged percentage holding and therefore decreased value per share. The current FTSE/JSE index treatment assumes this 100% scrip take-up scenario and consequently adjusts the index weights to reflect the increased number of shares held. The index investor would simply elect the scrip option and hold those shares in the portfolio, with no consideration of the dividend pay-out. When the scrip is the default option, or a shareholder elects to take the scrip, it is not currently seen as a dividend in index terms, but rather as a pure scrip distribution, which aligns with the definition of a Capitalisation Issue.

## 4. Alternative Treatment of Scrip Dividends

The current index treatment is a concern for index derivative traders, who would typically price in a future scrip dividend as an ordinary cash dividend when valuing the derivative contract. The current index treatment therefore introduces complexity to the valuations process, since the valuation depends on the default treatment of the SC.

FTSE/JSE proposes that all SCs and REs are treated as cash dividends in all FTSE/JSE indices, regardless of the default election option attached to the corporate action. The index treatment would be to apply the dividend at the declared cash rate. Index investors could either elect to receive the cash, or alternatively receive the scrip and immediately sell it in the open market to obtain the cash dividend amount. This proposal is supported by the FTSE/JSE Index Advisory Committee and the JSE Financial Derivatives Advisory Committee.

Note that if most shareholders elect scrip, this would increase the total issued shares of the company. This would be applied in the index series at the subsequent quarterly index review, and could conceivably lead to a scenario where an index tracker elects scrip, immediately sells it to realise the dividend, only to repurchase it at the next index rebalance.

## 5. Responding to the consultation

FTSE/JSE would like to obtain the view of market participants on changing the way that SCs and REs are treated in the Index Series, and in particular on the proposal to treat all SCs and REs as Cash Dividends at the declared rate, regardless of the default option.

It is important to FTSE/JSE to be aware of the impact on clients in terms of trading, administration and taxation, as well as any unintended consequences. Therefore, FTSE/JSE requests comments regarding the possible impact of the change and any concerns regarding the change.

**Please provide us with your comments and suggestions by Friday, 10 February 2017 to the following email address: [indices@jse.co.za](mailto:indices@jse.co.za)**

All feedback received by 10 February 2017 will be carefully considered before making any final decisions, and presented to the FTSE/JSE Advisory Committee Meeting in March 2017.

This document is not confidential and should be distributed as widely as possible to all stakeholders.

Yours Sincerely,
**Indices Department**