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# **Dividends with options - Proposed processing change**

Consultation paper • August 2016

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## CHAPTER 1: INTRODUCTION

This consultation paper outlines a pan European, market driven proposal to standardise processing of dividends that offer shareholders an alternative(s)<sup>1</sup> to the default cash payment.

There are currently a number of ways of processing this type of event, the common theme surrounding employment of some form of 'standing instruction' or 'mandate' to inform the Issuer of the investor's requirements.

This consultation paper proposes that one standardised operational practice should be introduced offering a clear and consistent method of tackling the event. It should be noted that this methodology is fully compliant with the European Corporate Action Standards. Accordingly this change both addresses the current STP shortfall as well as providing a strong driver towards moving the UK & Irish market closer to full compliance with European Standards.

This consultation paper is relevant to all CREST members. It will also be of significant interest to Issuers and their Agents.

It should be noted that the proposal relates to **clients that hold their securities in the CREST system only**. Certificated holders will continue to use the existing mandating process. Furthermore DRIPs do not form part of this project unless a currency option is also offered as part of the terms of the event.

Euroclear UK & Ireland Limited ("**EUI**") very much welcomes your feedback regarding this consultation and looks forward to receiving your responses.

**This consultation will close on 7 October 2016.**

**Responses should be sent by email to [consultationfeedback@euroclear.com](mailto:consultationfeedback@euroclear.com) quoting "Dividends with options".**

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<sup>1</sup> Alternatives include a choice of currencies and scrip dividends. DRIPs are not currently in scope unless there is also a currency option available.

## **CHAPTER 2: BACKGROUND**

It is common in the UK & Irish markets for Issuers to offer their shareholders the option to take an alternative to the default cash dividend payment. Typically, those clients that wish to opt for an alternative will do so by setting up a 'mandate' (sometimes known as an 'evergreen' or 'Standing instruction') between itself and the issuer. For EUI holders this mandate is created electronically.

Once the instruction has been validated and accepted by the Issuer, all subsequent dividends will be processed in accordance with this mandate<sup>2</sup>.

For non-CREST holders (i.e. for certificated holdings) this standing instruction is effected by submission of a written authority to the Registrar.

If the holder wishes to change this instruction, whether in paper form or via the CREST system, the original mandate must be revoked and a fresh election sent.

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<sup>2</sup> NB although not common practice, it is possible that 'one off' elections can be made i.e. the election only applies to the current event.

**CHAPTER 3: THE DRIVERS FOR CHANGE**

There are a number of reasons for changing this process as proposed including:

1. Removal of inefficiencies with the current election process

Evergreen instructions are ideally suited to certificated and smaller retail market shareholders as, typically, these holders will not change their election choice very often if at all. It is important to note that we do not propose to make any change to the process for certificated holders.

Conversely, the institutional and custodial market will consider their options each time a dividend is paid and often change their election. Indeed, for this client profile, change to the standing instruction might be necessary merely because of a change in beneficial holders of a pooled account.

Because revocation of past instructions is required, the process to change a standing instruction is cumbersome. Additionally there are many other pitfalls for CREST holders to overcome, namely:

- The CREST system treats all equity dividends as corporate action type 'cash dividend (CHD). Thus it is necessary for system members to retrieve details of dividends carrying options from another source
- Existing mandates must be revoked before a new one can be applied
- There is no definitive automated method of checking what, if any, election is in place – manually affixed mandates are not visible to holders
- Deadlines for election – currently may be on or before record date. Where this is the case the election process is 'blind' i.e. the election is made without the benefit of knowing the registered position

2. Compliance with the European market standards for Corporate Actions (Corporate Actions Joint Working Group Standards 'CAJWG': see Chapter 6).

The UK & Ireland is over 90% compliant with the CAJWG standards, but this is one of the few changes that remain outstanding. This initiative eradicates paper processing for CSD holders and brings the UK & Ireland in line with the other European member states.

It should be noted that this processing stream was one of a small number that the UK & Irish markets opposed at the time of agreeing the standards. However, whilst there are implementation difficulties, there are a number of tangible benefits associated with the change too. Accordingly, in the spirit of European harmonisation, UK & Ireland conceded this Standard in favour of others that were more difficult for our markets to adopt.

### 3. Buyer Protection

The current system offers no automated method of appending buyer protection instructions to open positions. Indeed for CCP transactions there is no manual solution either as system members are not able to identify their counterparties.

**Question 1. Do respondents agree that establishment of one streamlined approach to processing Dividends with options throughout Europe is the right solution going forwards?**

**Question 2. Do respondents agree that the above inefficiencies must be addressed?**

## CHAPTER 4: THE PROPOSAL

### 1. Summary of the proposed change

The scope of the proposal covers Scrip Dividends, Currency election options and DRIPs with currency election options. It is intended that DRIPs will form part of the second phase of this initiative.

#### 1.1. Setting up of the event

Issuers would need to consider what, if any, changes are required to the governance documentation that underpins this type of event. It would also be the strong intention to remove some of the processing idiosyncrasies that currently exist including:

- disallowing partial elections
- removing mandates if the holding falls to zero
- election date taking place on or ahead of record date, and
- no firm default option e.g. default currency depends upon the registered address of the holder

#### **Question 3. Do respondents agree that the terms and conditions of the event should be revisited to maximise straight through processing?**

Registrars would be required to complete a Security Application Form (SAF) to authorise use of the Electronic election entitlement facility in the system. The Narrative 'Electronic Election Entitlement' will be added to the security description to ensure clients can readily identify that the ISIN relates to an EEE facility.

For most dividends, it is feasible that the ISIN allocated to the EEE line could be re-used for any future dividends for the same company. It is noted however that where a dividend pays four times a year (or more) this is unlikely to be possible as there may be more than one line active at the same time.

#### **Question 4. Do respondents agree that the EEE ISIN should be re-used where possible for subsequent dividends or should a fresh ISIN always be used?**



Two corporate actions would be set up in the CREST system. The first governs generation of the EEE whilst the second details all available options and provides the opportunity for clients to make elections for their chosen option.

For clarity it is proposed that a new corporate action type be established 'Dividend with Options' (DWO).

**Question 5. Do respondents agree that a new Corporate Action type should be created for this purpose?**

1.2. Distribution and characteristics of the entitlement

At record date for the dividend, all CREST holders would receive a one for one distribution of EEEs to their CREST account reflecting the record date balance.

As mentioned earlier in the paper, the change of process from Standing Instructions to electronic elections is greatly welcomed by the Institutional holders. However some retail holders are concerned about the additional administrative burden of maintaining an EEE. Primarily this concern surrounds the requirement for reconciliation.

EEEs do not have any of the characteristics of, and do not fall under any of the categories of 'safe custody asset' or 'financial instrument' for the purposes of being a safe custody asset. In particular, EEEs are not transferable securities within the FCA Handbook meaning. The FCA CASS team has confirmed that the EEE, as currently outlined in this proposal, is not a security and thus does not require reconciliation under the CASS Rules.

The EEE is not settleable and would not be traded or priced.

It is noted that in some markets the entitlement is Listed and can be freely transferred. However in the UK & Ireland a change to Company Articles of Association as well as a major overhaul of key infrastructure would be required to permit change of title to the entitlement. Whilst a development may be considered at a later date it is proposed that this would not be part of the initial phase of this project.

1.3. The election process

If CREST holders wish to make an election in respect of this corporate action they would have to do so using this process. Receiving Agents would not accept elections outside of the system or using other CREST transaction types. There would always be a default option for this type of event. Where

clients wish to receive the default outturn no election would be required. Indeed Receiving Agents would not be expected to accept elections for the default option.

There would be an election period that commences on or very soon after distribution date of the EEEs. This period is expected to be standardised at 10 business days but could not be less than 5 business days.

Those CREST holders wishing to receive an outturn other than the default option would need to send a USE instruction (on or before the last acceptance date and time) for the number of entitlements required to the nominated Receiving Agent, indicating the required option.

Elections would be irrevocable and there would be no systemic withdrawal facility.

It is intended that, as part of this proposal, Issuers would no longer be permitted to refuse to accept partial elections i.e. elections for less than the total registered holding.

**Question 6. Do respondents agree that partial elections should always be permitted?**

1.4. Open transaction management

In line with all distribution events that are set up in the CREST system, overnight on record date for the dividend, Claim transactions in the EEE line would be raised in respect of any qualifying (open) transactions in the underlying security. As the EEE is a non settleable security, these transactions will never settle.

It would be possible for counterparties to input buyer protection/transformation instructions against the claim transactions. This would allow the buying/receiving party the opportunity to instruct their counterparty to elect for their required option.

In line with all reorganisation events conducted in the CREST system, open transactions in the EEE line would be transformed in accordance with the selected election option overnight on Record date for the event. Where no transformation instruction has been received, open transactions would be transformed into the default option.

### 1.5. Distribution of the outturn

In accordance with the event timetable (which prior to publication of the corporate action would be agreed with the London Stock Exchange dividend timetable) the outturn would be paid on the published dividend payment date. It is expected that all proceeds will be distributed in the CREST system.

### **Question 7. Do respondents agree that the default distribution channel for proceeds should be the CREST system?**

### 1.6. Indicative implementation timeline

ICSA Receiving Agent Group to complete draft scope document	31 December 2014
ICSA Registrars Group agree Scope document	31 January 2015
Euroclear issue consultation document	18 August 2016
Consultation ends	7 October 2016
Development of systems/Market Practice and communications:	
Commence	21 October 2016
Complete	Q4 2017

## **CHAPTER 5: ADVANTAGES AND DISADVANTAGES OF THE PROPOSAL**

### **1. Advantages**

- There will be one streamlined method of processing dividends with options
- The terms and conditions underpinning these events should become more standardised
- Dividends carrying options will have a unique Corporate Action Type and details would be reflected in the CREST system
- There will no longer be a need to revoke existing elections prior to input of fresh instructions
- Buyer protection would become available for these events
- As the process would become fully STP, operational risk would be reduced
- Holders sometimes do not realise or may forget that a standing instruction is in place and therefore receive an outturn they would not expect or want – the new process will stop this happening

### **2. Disadvantages**

- System changes will almost inevitably be required
- Clients will need to be able to cater for more securities and corporate actions
- All claim transactions will need to be transformed irrespective of the selected election option
- Clients that always choose the same election option will need to input each time there is a new event rather than leaving a 'standing instruction' in place

**CHAPTER 6: THE CORPORATE ACTIONS JOINT WORKING GROUP STANDARDS****The Corporate Actions Joint Working Group Standards.**

At the behest of the European Commission, the Giovannini group was formed in 1996 and has focused its work on identifying perceived inefficiencies in EU financial markets and proposing practical solutions to improve market integration. This group has produced two reports (in 2001 and 2003) identifying a number of barriers hindering the integration of an EU clearing and settlement infrastructure. The second report, which supersedes the first, can be found at; [http://ec.europa.eu/economy\\_finance/publications/publication\\_summary1960\\_en.htm](http://ec.europa.eu/economy_finance/publications/publication_summary1960_en.htm)

The barriers that specifically affect this constituency are Barrier 1 (communication protocols) and Barrier 3 (corporate actions – including Company meetings).

To progress harmonisation and efficiency the European Central Securities Depositories Association (ECSDA) and the European Banking Federation (EBF) were tasked with removing barrier 3.

To this end, they produced a number of recommendations:

e.g. [http://www.ecsda.eu/site/uploads/tx\\_doclibrary/2005\\_06\\_30\\_ECSDA\\_Response\\_Mandatory\\_Distributions.pdf](http://www.ecsda.eu/site/uploads/tx_doclibrary/2005_06_30_ECSDA_Response_Mandatory_Distributions.pdf)).

It quickly became clear that the barriers could not be removed without full market support. ECSDA and EBF engaged with a number of other market participants and two working groups were established. The Joint Working Group for General Meetings "JWGGM" has responsibility for general meetings and is chaired by European Issuers. The Corporate Actions Joint Working Group "CAJWG", chaired by AFME, sought to address the Corporate Action barriers. These groups progressed, extended and agreed a number of 'Market Standards' (the Standards) with the aim of achieving compliance from all member states.

These Standards have been endorsed by representative bodies across the various constituencies and markets e.g. the British Bankers' Association (representing Banks & Custodians), AFME (the Association of Financial Markets in Europe, representing Custodians & Investment Banks) and ECSDA (the European Central Securities Depositories Association).

The standards are not legally binding but it is intended that each market works towards compliance with a view to completion by end of 2015. There is a veiled threat, should voluntary compliance not be achieved, that the standards might be enforced by European Legislation.

Consultation questions:

**Question 1. Do respondents agree that establishment of one streamlined approach to processing Dividends with options throughout Europe is the right solution going forwards?**

**Question 2. Do respondents agree that the above inefficiencies must be addressed?**

**Question 3. Do respondents agree that the terms and conditions of the event should be revisited to maximise straight through processing?**

**Question 4. Do respondents agree that the EEE ISIN should be re-used for subsequent dividends or should a fresh ISIN always be used?**

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