

Response to the ESMA Call for Evidence on shortening the settlement cycle

Annexes

DECEMBER 2023



Content

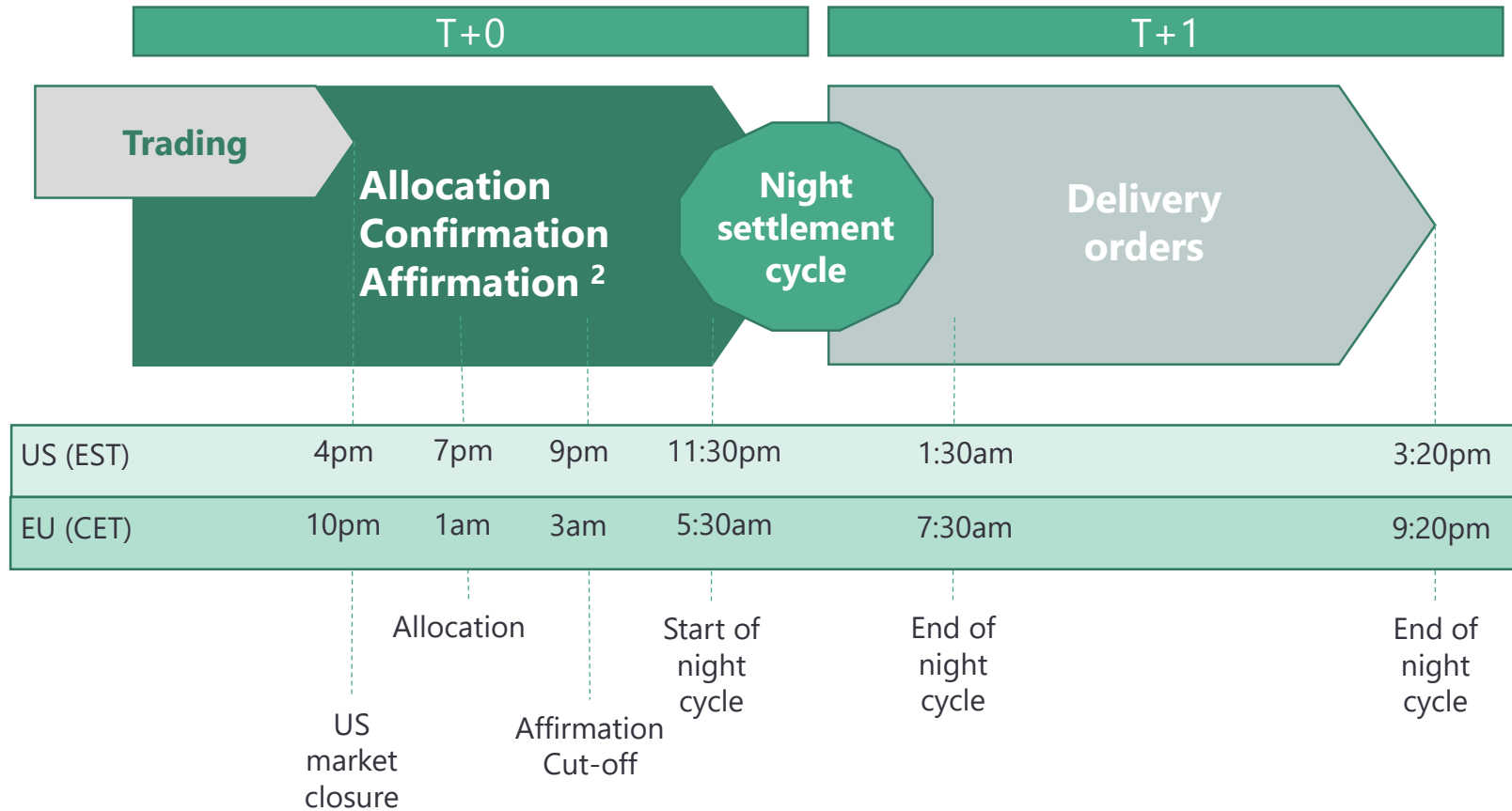
- I. Impact of the reduction of the securities settlement cycle in the operations of market players (Q1-Q4)**
- II. Costs and benefits of a shorter securities settlement cycle (Q5-Q14)**
- III. How and when to move to a shorter securities settlement cycle (Q15-Q20)**
- IV. International developments on settlement cycles and their impact on the Union's capital markets (Q21-Q27)**

Executive summary

1. The financial industry already experienced a shortening of the settlement cycle in 2014 when moving from T+3 to T+2, hence there is knowledge on how to deal with this type of initiative.
2. As regards the move to T+1 that the industry has now to face, the environment is more difficult. Indeed, some new constraints have to be considered:
 - a. fragmented market infrastructure in the EU (14 currencies, 17 CCPs, 31 CSDs)
 - b. specific regulatory requirements as regards
 - i. risk management
 - ii. value for money with justification of costs charged to investors
3. The rationale of the move to T+1 is mainly based on capital requirements reduction benefiting to the credit institutions selling financial product.
4. The move to T+1 has unfortunately no direct benefit for asset managers, who are net buyers of financial instruments.
5. The move to T+1 creates a liquidity mismatch between the settlement date of the fund (typically T+3) and the date of investment in US underlying (T+1). This mismatch generates a cost of trading rise (new cut-offs) as well as a cost of funding rise. The funds' custodians will be in a position to propose more services to cover this mismatch.
6. Against this background, the longer the transition period between the US T+1 and the EU T+1 go-live (ca. 4 years), the more detrimental it will be for asset managers.
7. It is likely that certain asset managers will be able to isolate the specific T+1 cost and will pass them on to the end investors.

I. Q1-1

US T+1 workflow at DTC ¹



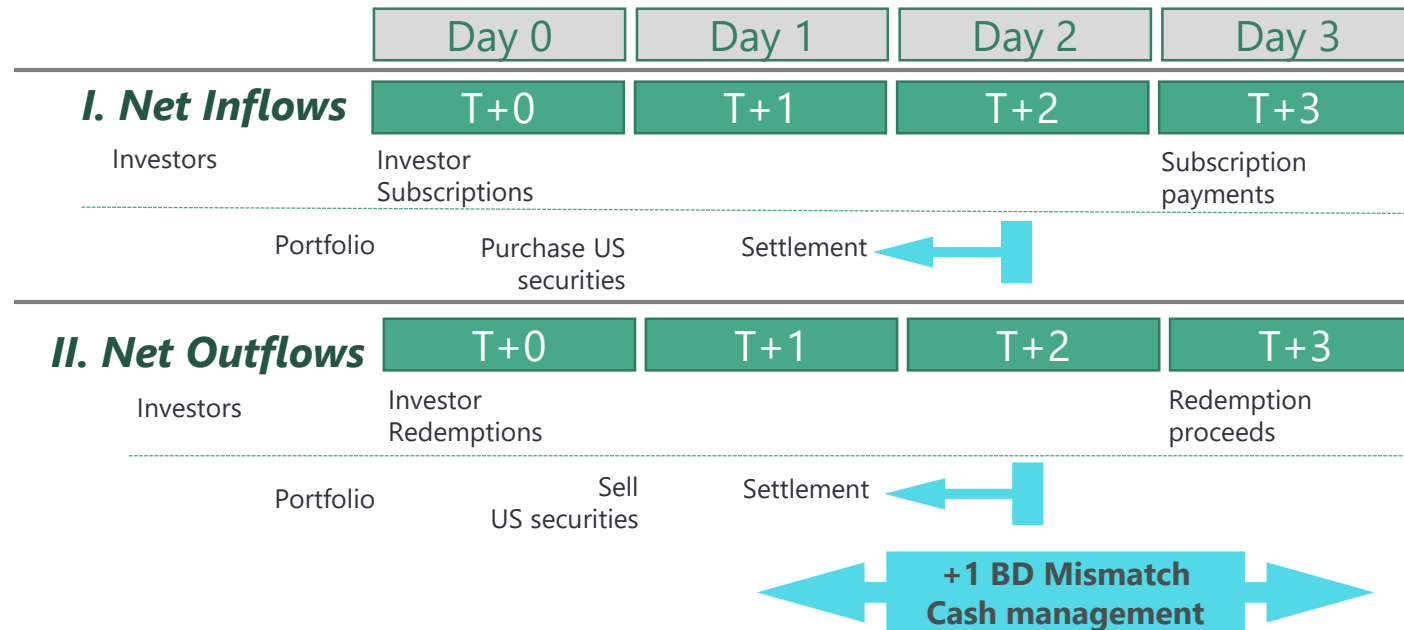
¹ Source: Accelerated Settlement (T+1), DTCC, June 2023.

² The Allocation process occurs when an Investment Manager sends instructions to its Broker on how to allocate a block trade to underlying client funds. Once the Allocation has been completed, the Confirmation and Affirmation process occurs, providing a detailed record of a transaction. Source: *Automated Institutional Trade Processing Required to Achieve T+1*, DTCC, 21 March 2022.

I. Q1-2

Liquidity mismatch in the subscription/redemption processes Investment/Divestment vs. Investor settlement

Illustration of the subscriptions and redemptions operations into a mutual funds with an underlying composed of US securities, considering the **typical** T+3 settlement cycle of the mutual funds & platform/distributor.



1. METHODOLOGY

Consider the distinction between

- i. **secondary market transactions** and
- ii. **primary market transactions**

which allows to better consider the situation of the asset management industry essentially involved in primary markets.

Indeed,

- i. while the move **of secondary market transactions** to T+1 will be mainly solved through market infrastructures adjustments outside the asset manager's sphere,
- ii. **primary market transactions** will imply organisational changes in the business model of asset managers and their relationships with their business partners.

2. T+2 AS LEGAL REFERENCE FOR THE TRANSITION PERIOD

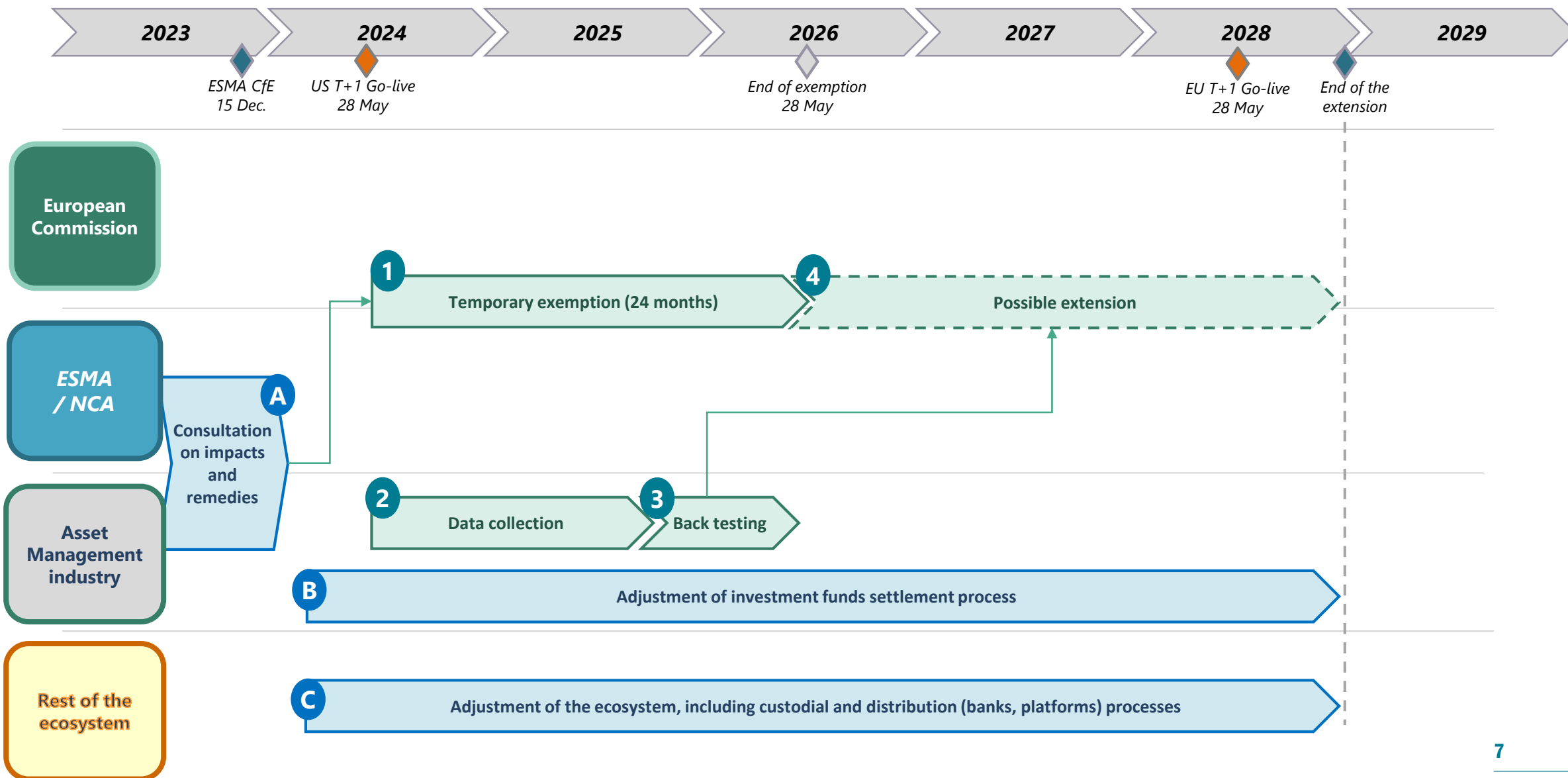
During the transition period (ie. US T+1/EU T+2) keep T+2 as the legal reference, in line with CSDR, while certain segments of the markets will move to T+1 on a voluntary basis, for competitiveness reasons.

3. MEASURES TO BE TAKEN

- a. Provide guidance on how to handle **point-in-time breaches of cash limits** (pursuant to Art. 52(1) UCITS Directive) due to settlement cycle misalignment, **as a specific impact of the unwanted T+1 move**. Grant a temporary carve out for these technical breaches.
- b. Provide guidance on how to handle **point-in-time breaches of borrowing limits**, and on how to interpret the temporary basis notion that makes a borrowing eligible (pursuant to Art. 83(2) UCITS Directive) due to settlement cycle misalignment, **as a specific impact of the unwanted T+1 move**. Grant a temporary carve out for these technical breaches.

I. Q1-4

Timeline for the temporary exemption of cash/borrowing breaches Illustrative proposal subject to calibration



I. Q1-5

Recommendations to EU policy makers

A Consultation	a. Description of the remedies proposed by the industry to address the identified impacts b. If operational remedies do not suffice, support will be asked to the policy makers
B Adjustment of Investent Funds processes	a. Bring forward the settlement date of the fund, where relevant, typically from T+3 to T+2 or even T+1 b. Update processes with custodians to ensure T+1 settlement c. Update processes with funds distributors (banks, platforms) to provide the cash from investors earlier than T+3
C Adjustment of the ecosystem	a. Custodians will update their offer and processes b. Funds distributors (banks/platforms) will update their offer and processes c. Other service providers to investment funds will update their offer and processes

1 Temporary exemption	a. In order to mitigate the impact of T+1, policy makers would grant a temporary exemption as regards breaches of the UCITSD cash/borrowing limits, specifically due to the T+1 impact. b. The corresponding legal instrument could be for instance: i. delegated act from the European Commission in relation to the corresponding articles of the UCITSD. ii. forbearance from ESMA asking the NCAs not to “prioritise their supervisory actions” as regards the potential breaches of UCITSD limits due to T+1. This forbearance could be drafted in the same way as the one of 2019 for EMIR SFCs ¹ .
2 Data collection	Crossing of the UCITSD limits need to be documented and justified (ie. crossing vs. investment in US market) by the asset manager. The purpose is to isolate the T+1 impact, in order to be able to restrict the forbearance to T+1 events.
3 Back testing	Based on the data collected, a trend will be assessed to observe the magnitude of the breaches (amount and frequency). We assume these breaches will be only point-in-time, and related to the fund’s exposure in US securities, and the size of transactions.
4 Possible extension	The back testing will allow to determine a possible extension until the EU officially moves to T+1, with all the EU ecosystem adjusted.

¹ [ESMA70-151-2050](#), 31 January 2019.

I. Q1-6

Recommendations to EU policy makers

UIC TSD provisions

Book-entry form

Art. 57(1): UCITS are not required to comply with the limits laid down in this Chapter when exercising subscription rights attaching to transferable securities or money market instruments which form part of their assets.

Art. 57(1): While ensuring observance of the principle of risk spreading, Member States may allow recently authorised UCITS to derogate from Articles 52 to 55 for six months following the date of their authorisation.

Art. 57(2): If the limits referred to in paragraph 1 are exceeded for reasons...

...beyond the control of a UCITS...

...or as a result of the exercise of subscription rights,...

...that UCITS shall adopt as a **priority objective** for its sales transactions the remedying of that situation, taking due account of the **interests of its unit-holders**.

Our interpretation of the applicability in the T+1 context

This provision refers to the ancillary liquid assets limit of Art. 50(2)b.
This provision refers to the cash limit of Art. 52(1).
This provision does not cover the borrowing limit of Art. 83(2).

1. According to CSSF Circ. 02/77 FAQ¹: "As the settlement date mismatch is predictable/avoidable and thus **not beyond the control of the UCITS**, the breach is considered active."
2. According to CSSF FAQ² on the Law of 17 December 2010, the limit on ancillary asset shall **only be temporarily** breached because of **exceptionally unfavourable market conditions**.

A subscription right is a specific type of transaction, not encompassing the regular fund units subscription/redemption process.

¹ FAQ regarding CSSF FAQ on Circ. 02/77 FAQ. See next page.

² CSSF FAQ on the regarding law of 17 December 2010. See next page.

I. Q1-7

Recommendations to EU policy makers FAQ regarding CSSF Circ. 02/77



1. CSSF FAQ (Version 15 – December 2022) on the Law of 17 December 2010 transposing the UCITS Directive into LU law.

- i. See Q14 p19 on Art. 41(2)b of the law corresponding to **Art. 50(2)b UCITSD**. This Q14 deals with the short sentence included at the end of the article :“**UCITS may hold ancillary liquid assets**”.
- ii. **The response** (dated 3 Nov. 2021) says in particular:
 - in §1: The holding of such ancillary liquid assets is limited to 20%...
 - in §2: The above limit shall only be temporarily breached..., because of exceptionally unfavourable market conditions...

2. FAQ (Version diffusée – 7 July 2020) regarding CSSF Circular CSSF 02/77 on Protection of investors in case of NAV calculation error and correction of the consequences resulting from non-compliance with the investment rules applicable to undertakings for collective investment.

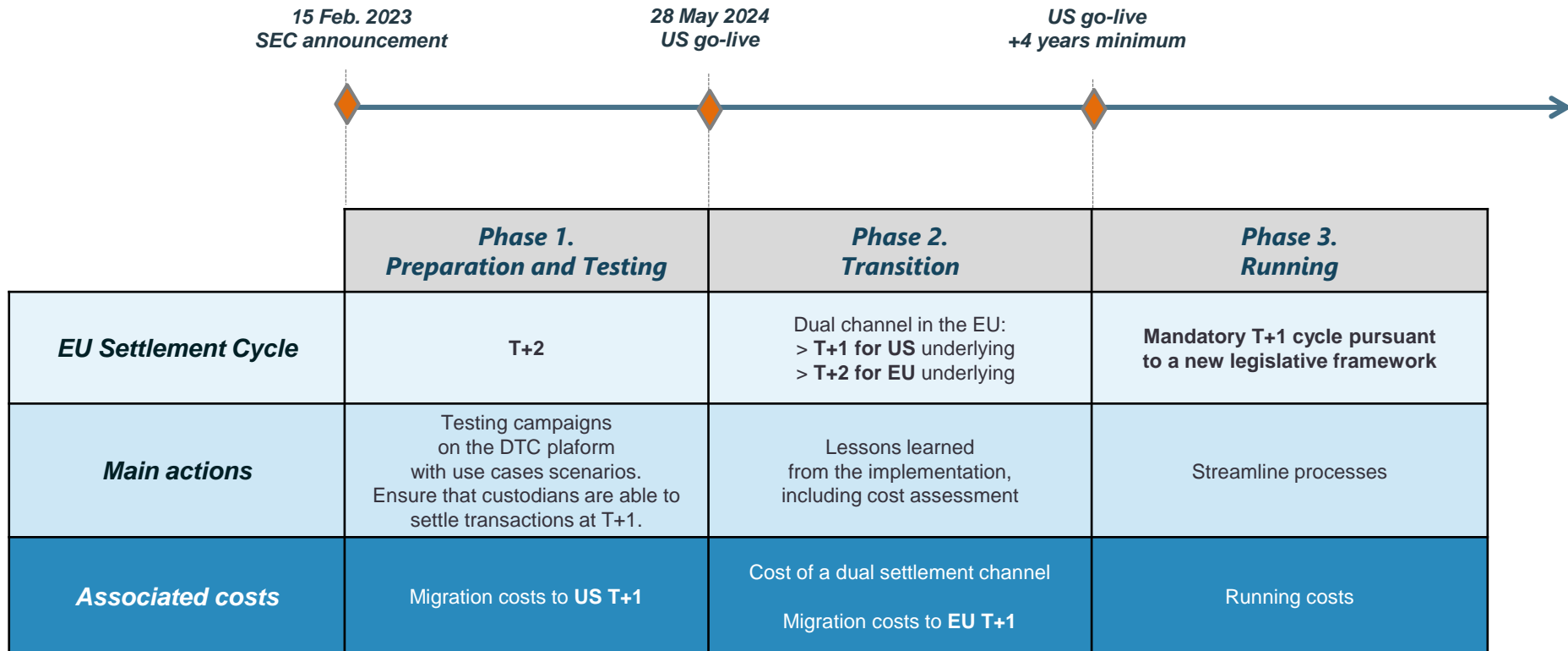
- i. See Q4 p5 on Art. 43(1) of the law corresponding to **Art. 52(1)b UCITSD**. This Q4 deals with the following sentence in the article :“**A UCITS may not invest more than 20% of its assets in deposits made with the same body**” (i.e. the fund’s depositary bank).
- ii. This Q4 touches upon settlement mismatches as will happen because of US T+1 (liquidity mismatch due to settlement leg at T+3 vs. investment leg at T+1), see the examples (a) and (b) p5.
- iii. **The response** (dated 7 July 2020) says :“As the settlement date mismatch is predictable/avoidable and thus not beyond the control of the UCITS, the breach is considered active.”

Timeline to consider 3 phases for the EU settlement cycle

We propose the milestones below. The EU T+1 milestone is positioned **realistically** ca. 4 years after the US go-live for the following reasons:

1. Remove **barriers out of the direct control of Asset Managers** (adjustment in the rest of the landscape)
 -custodians off course, as regards their capacity to settle at T+1
 -but also distributors (banks and platforms) who collect investors money

2. Preparative works for Asset Managers:
 -specific legislative process underpinning EU T+1 (2024/25/26)
 -post mortem of the US go live (2024/25)
 -appetite and ability to invest in this project, as an industry consensus
 -preparation for the EU T+1 go-live (2026/27/28)



III.Q17 – 20

Scope of CSDR

CSDR provisions

Book-entry form

Art. 3(2) Where a transaction in transferable securities takes place on a trading venue the relevant securities shall be recorded in book-entry form in a CSD on or before the intended settlement date, unless they have already been so recorded.

Intended settlement date

Art. 5(1). Any participant in a securities settlement system that settles in that system on its own account or on behalf of a third party transactions in **transferable securities, money-market instruments, units in collective investment undertakings and emission allowances** shall settle such transactions on the **intended settlement date**.

Art. 5(2). As regards transactions in **transferable securities** referred to in paragraph 1 which are executed on trading venues, the **intended settlement** date shall be **no later than on the second business day** after the trading takes place. **That requirement shall not apply** to transactions which are negotiated privately but executed on a trading venue, to transactions which are executed bilaterally but reported to a trading venue or to the **first transaction where the transferable securities concerned are subject to initial recording in book-entry form pursuant to Article 3(2)**.

Measures to address settlement fails

Art. 7(2) For each securities settlement system it operates, a CSD shall establish procedures that facilitate settlement of transactions in **financial instruments referred to in Article 5(1) that are not settled** on the **intended settlement date**. These procedures shall provide for a penalty mechanism which will serve as an effective deterrent for participants that cause settlement fails.

In scope instruments

NOT in scope instruments

Transferable securities which are negotiable on the capital market, with the exception of instruments of payment.

Primary market transactions.

All products

-

Transferable securities which are negotiable on the capital market, with the exception of instruments of payment.

Primary market transactions.

Transferable securities which are negotiable on the capital market, with the exception of instruments of payment.

Primary market transactions.

III.Q21

EU Staying under T+2

Opportunity costs



1. EU-DOMICILED ASSET MANAGERS

Staying under T+2 would have the following opportunity cost:

- a. The longer the transition period between the US T+1 and the EU T+1 go-live (ca. 4 years), the more detrimental the liquidity mismatch will be for asset managers.
- b. So far from a competition point of view between regions, **no major inconvenience** is anticipated in not moving to T+1 if a given product (e.g. a fund) is only proposed for settlement at T+2, without similar product proposed at T+1.
- c. If a similar product is proposed at T+1 in the US/UK, certain EU players will adjust the settlement cycle of their product to T+1, for competition reasons, on a voluntary basis.

2. EU COMPETITIVENESS WITH REGIONS AT T+1

The jurisdictions that plan to move to a T+1 cycle are:

- India
- America (USA / Canada / Mexico)
- UK (most likely)

3. MISALIGNMENT BETWEEN REGIONS

A misalignment (in particular EU T+2 vs. America T+1 and Asia T+1) would have the following consequences:

- a. US-domiciled asset managers that trade international exposures will **have to wait longer (T+2) to receive the corresponding securities.**
- b. EU-domiciled asset managers that trade Asian exposures **will have to wait until T+2 to receive the corresponding securities.**
- c. As regards the specific case of the UK, if this jurisdiction were to move to T+1 after the US but ahead of the EU, it would will lead to **different settlement cycles** between locations **for similar ISINs.**

V.1. Statistics

% of US Securities in EU domiciled UCITS funds

HOW HAS THE ASSET ALLOCATION OF UCITS CHANGED IN THE LAST DECADE?

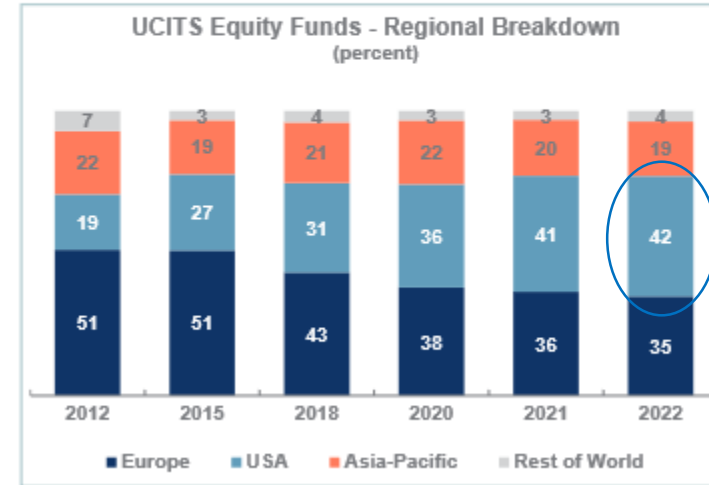
Source EFAMA Fact Book 2023, Key findings and figures, page 8. Available [here](#).

The share of European stocks in the asset allocation of UCITS equity funds has declined sharply since 2012.

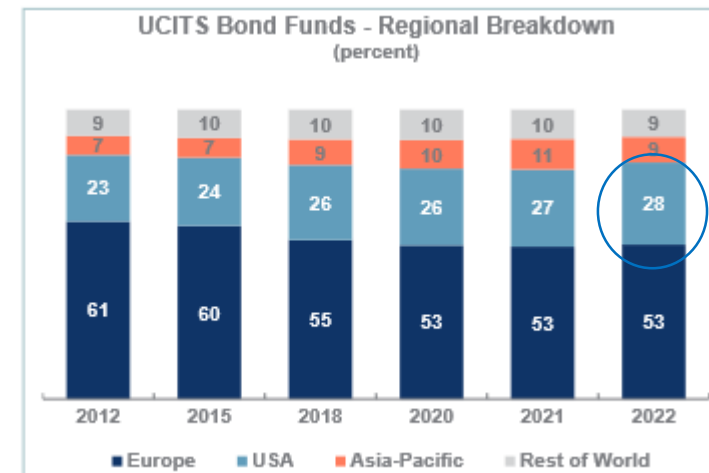
This trend has coincided with a **growing demand for US stocks**, which can be explained by several factors that have made US stocks an attractive investment option for both domestic and international investors, notably the strength of the US economy and the fact that the US is home to many successful companies, particularly in the technology sector. The share of Asian stocks dropped markedly in 2021 and 2022, mainly due to a fall in stock markets in China.

European-issued bonds accounted for slightly over half of total debt holdings of bond UCITS at end 2022.

Some 53% of the bonds held by UCITS bond funds at end 2022 were issued in Europe, compared to 61% in 2012. This decline, which halted in 2020, coincided with an increase in the share of bonds issued in the US and Asia-Pacific. This can be explained by the generally lower interest rates in Europe compared to the US and many Asian countries, making European bonds less attractive to investors seeking higher yields.



42% of US equities



28% of US equities

V.2. Statistics

Breakdown of Luxembourg UCI funds by reference currency

BREAKDOWN OF UCI FUND UNITS REGISTERED IN LUXEMBOURG BY REFERENCE CURRENCY

Source **CSSF**, Newsletter n°274 November 2023, page 13. Available [here](#).

Currency	Net assets (in bn EUR)	in %	Number of fund units	in %
AUD	2.980	0.058%	14	0.099%
CAD	2.207	0.043%	14	0.099%
CHF	50.740	0.991%	238	1.688%
CNH	7.059	0.138%	26	0.184%
CNY	4.043	0.079%	6	0.043%
CZK	1.366	0.027%	48	0.340%
DKK	1.464	0.029%	12	0.085%
EUR	2,734.993	53.440%	8,675	61.521%
GBP	152.959	2.989%	276	1.957%
HKD	2.614	0.051%	8	0.057%
HUF	0.236	0.005%	18	0.128%
JPY	57.729	1.128%	152	1.078%
NOK	4.390	0.086%	26	0.184%
NZD	0.196	0.004%	1	0.007%
PLN	0.143	0.003%	3	0.021%
RON	0.557	0.011%	2	0.014%
SEK	35.992	0.703%	118	0.837%
SGD	1.866	0.036%	7	0.050%
USD	2,056.316	40.179%	4,456	31.601%
ZAR	0.018	0.000%	1	0.007%
TOTAL	5,117.868	100.000%	14,101	100.000%

Glossary

Acronym	Description
AP	Authorised Participant
CSDR	Central Securities Depositories Regulation
CCY	Currency
DTCC	Depository Trust and Clearing Corporation
DVP	Delivery versus Payment (Securities against Cash)
EPM	Efficient Portfolio Management
EPTF	European Post Trade Forum
ESMA	European Securities and Markets Authority
ETF	Exchange Traded Fund
EU	European Union
FOP	Free of Payment (no cash exchanged)
FX	Foreign exchange
ICI	Investment Company Institute
MBI	Mandatory Buy-In (CSDR)
NAV	Net Asset Value
RTS	Regulatory Technical Standards
SIFMA	Securities Industry and Financial Markets Association
TD	Trade Date
SD	Settlement Date
UCITS	Undertaking for Collective Investment in Transferable Securities
VD	Value Date

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