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ESMA Issues Call for Evidence on Shortening the Settlement Cycle

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TO: ICI Global Members
Europe Regulatory and Policy Committee
Global Operations Advisory Committee
Operations Committee SUBJECTS: Closed-End Funds
Exchange-Traded Funds (ETFs)
International/Global
MiFID, EMIR, AIFMD, UCITS V
Money Market Funds
Operations
Settlement RE: ESMA Issues Call for Evidence on Shortening the Settlement Cycle

On October 5, the European Securities and Markets Authority (ESMA) published a call for evidence on shortening the settlement cycle (Call for Evidence).[1] ESMA is seeking stakeholder views and quantitative evidence to better understand issues and costs and benefits associated with shortening the settlement cycle. ESMA is also requesting feedback from central banks and the TARGET2-Securities (T2S) operator regarding the impact of shortening the settlement cycle on the operation of T2S, the European securities settlement engine.

Background

On February 15, 2023, the Securities and Exchange Commission (SEC) adopted rule changes to shorten the standard settlement cycle for most broker-dealer transactions in securities from two business days after the trade date (T+2) to one business day after the trade date (T+1).[2] The SEC will require compliance with the change by May 28, 2024. Following the SEC's announcement of its rule changes, Canada and Mexico also determined to accelerate trade settlement from T+2 to T+1 in late May 2024.[3] These countries join India, which fully implemented T+1 settlement in early 2023.[4]

In the European Union (EU), the Central Securities Depositories Regulation (CSDR)[5] includes a T+2 requirement for all transferable securities transactions that are executed on trading venues.[6] Following the move to T+1 in North America, there will be a lack of harmonization of settlement timelines between Europe and North America.

ESMA's Call for Evidence

ESMA recognizes the duration of the settlement cycle is important to the EU and notes several potential benefits may be associated with shortening the settlement cycle. At the same time, ESMA acknowledges that shortening the settlement cycle requires market participants to increase operational efficiency. This may require increasing automation and phasing out manual interventions and restructuring funding practices, particularly for FX transactions.

ESMA also notes there is more operational complexity in the EU than in other jurisdictions, which may in turn complicate shortening the settlement cycle in the EU. There is, however, no legal or regulatory impediment currently in the EU to shortening the settlement cycle.

Through the Call for Evidence, ESMA is seeking to better understand the issues, costs, and benefits associated with shortening the settlement cycle to both T+1 and T+0.

ESMA's Call for Evidence is divided into four sections:

1. Impact on operations;
2. Costs and benefits;
3. Timing; and
4. Impact of international developments

ESMA asks questions and seeks quantitative feedback regarding each of these four issues.

Impact on operations

ESMA wants to consider the impact of moving to both T+1 and T+0 across a broad set of instruments and asset classes. It is trying to understand whether there are incompressible post-trade processes and what constraints exist on compressing post-trade processes. It asks whether the impacts are broad or specific to particular products, asset classes, or transactions.

ESMA notes that initial feedback suggests that market participants' readiness to reduce their post-trade processes is uneven. While Central Securities Depositories and Central Counterparties could do so, ESMA reports that asset management representatives have raised concerns about costs, especially for Exchange Traded Funds (ETFs).

In addition, ESMA is looking at impacts on hedging practices and transactions with an FX component and the functioning of trading and retail access to financial markets.

Costs and Benefits

ESMA requests information about the costs associated with shortening the settlement cycle that would be associated with post-trade processes (such as allocation, confirmation, and clearing), systems for fails reporting and management of cash penalties, and phasing out manual process and investing in automation. Additionally, there are questions about how much of these costs would be passed on to clients/end-investors. ESMA also wants to understand whether an increase in settlement fails would be temporary or permanent, and whether there are structural reasons that would cause any permanent increase.

ESMA recognizes that moving to T+0 would require greater automation and digitalization but seeks more detail about these costs as distinguished from those associated with moving to T+1.

ESMA also seeks information on the potential benefits associated with shortening the settlement cycle. These include increasing efficiency, reducing counterparty credit risk and related collateral needs, and, potentially, increasing the competitiveness and attractiveness of the EU financial markets.

Timing

Shortening the settlement cycle requires a number of steps including updates to the legal framework, trade processing, asset servicing, documentation, securities lending, prime brokerage, funding and liquidity arrangements, testing, and effective migration. ESMA requests information about the time necessary to make the requisite changes for each of these steps.

ESMA wants to consider how timing might vary if there is a voluntary shift in settlement cycle timing rather than a mandatory regulatory change.

In addition, ESMA wants to analyze whether there should be differences in the timing for different instruments or transaction types. ESMA is also considering whether there are additional transactions, not currently covered by CSDR, that should be brought within the scope.

Impact of International Developments

ESMA is concerned about the impact of international developments regarding settlement timelines on EU market participants, including potentially varied impacts on small and large institutions. With North American markets moving to T+1 in May 2024, EU participants will be required to undertake all settlement-related processes in US financial instruments at night. ESMA also expresses concern about complications for portfolio management as there is the potential for liquidity mismatches between EU instruments and related instruments in jurisdictions with T+1 settlement. Arbitrage opportunities and the potential for increased settlement fails from misalignment are also concerns.

Next Steps

Responses to the Call for Evidence are due on December 15, 2023. ESMA will consider the feedback in the first quarter of 2024 and submit a report to the European Commission (EC) by the end of 2024. However, ESMA may report to the EC on the impacts of international developments on EU market participants more quickly.

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Notes

[1] ESMA, Call for evidence On shortening the settlement cycle (October 5, 2023).

[2] SEC, Shortening the Securities Transaction Settlement Cycle (Feb. 15, 2023) 88 FR 13872.

[3] Canadian Capital Markets Association (CCMA), CCMA Announces Canadian T+1 Start Date, Monday, May 27, 2024 (March 14, 2023); Contraparte Central de Valores (CCV) Announcement to Market Participants (July 11, 2023).

[4] Following an announcement by the Securities and Exchange Board of India (SEBI) that exchanges would be permitted to implement T+1 settlement, the Bombay Stock Exchange (BSE) and National Stock Exchange of India (NSE) announced a phased implementation that moved all stocks to T+1 by January 27, 2023. See SEBI, Circular: Introduction of t-1 rolling settlement on an optional basis (Sept. 7, 2021); BSE, Roadmap for introduction of T+1 rolling settlement cycle in equity market (Nov. 8, 2021); NSE, Roadmap for introduction of T+1 rolling settlement cycle in equity market (Nov. 8, 2021).

[5] Regulation (EU) No 909/014 of the European Parliament and of the Council of 23 July 2014 on improving securities settlement in the European Union and on central securities depositories.

[6] See Article 5 of CSDR.

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