EFAMA

European Fund and Asset Management Association

MEMO

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European Buy-side Reflections on US T+1: Preparedness and Impact

Executive Summary

The main objective of this paper is to identify the key challenges arising from the US move to T+1 settlement for European asset managers. Our initial findings point to a number of impacts in Europe:

- A transfer of risk away from market risk (particularly for broker/dealers) to other areas including settlement risk (FX settlement) and operational risks.

- A need to cover US trading hours, whether through night desks in Europe, or expanded US operations

- An automatic increase in the cost of trading for funds and ETFs to make up for the funding gap associated with T2 settlement for funds, and T1 settlement for US securities.

- A reduction in securities lending to mitigate against settlement fails when faced with shorter recall periods, and a resultant performance drag on funds.

- Regulatory uncertainty when it comes to UCITS cash breaches resulting from the settlement misalignment. Equally, regulatory uncertainty as concerns the SEC when it comes to the possibility to request extended settlement for EU funds.

- Holidays in non-US jurisdictions will make it very difficult to comply with T1 settlement, here too clear exemptions would be required.

What remains unclear is the net effect of adapting to T1 in Europe. Some costs (investments) are already underway including increasing coverage of US trading hours, managing cash funding and FX gaps through creative and costly solutions. What is unclear and difficult to quantify today is the extent to which misaligned settlement cycles could a) decrease interest in US securities over time or b) simply render EU products less competitive compared to their US peers.

In terms of a hypothetical EU move to T+1, the funding gaps caused by misaligned settlement cycles for funds and securities would be resolved, but the FX funding challenges, securities lending contraction and challenges in performing allocation and confirmation would remain. For the latter set of issues, the solution would lie more in changes to market structures and improvements in automation and technology, rather than a straight matching of US T1 though the direction of travel is arguably similar.

What does appear clear at this stage is that the US moving to T1 is a systemic shift that all capital markets across the globe must adapt to, and the resulting questions on what is reasonable, achievable and necessary in terms of settlement reform must be looked at.

The European Union differs from the US in two important ways making alignment with US T1 a much greater operational challenge. Firstly, the legal and regulatory framework relating to settlement efficiency differs from the US with EU market participants facing cash penalties for failed trades, while no similar mechanism exists in the US. A second major difference revolves around the sheer number of market infrastructures operating in Europe: (29 CSDs in Europe versus two in the United States, just one CCP in the United States versus 16 in Europe) multiple securities settlement systems, market and currency infrastructures (euro and non-euro zones) and non-aligned trading. Finally, European markets are much more fragmented when it comes to trading and liquidity can vary significantly across trading venues.

Background

US move to T+1

In February 2023, the US SEC adopted a rule change to shorten the settlement cycle for securities trades from 2 business days from the trade date (T+2), to one day after the trade date (T+1). The new rules come into force on 29 May 2024. Canada will also move to a shortened settlement cycle on the same weekend in May 2024. Mexico has recently announced that it will follow the US and Canada and implement a shortened settlement cycle according to the same timetable.

The move, which a few jurisdictions have already undertaken (India under a phased approach, China on certain securities), is widely seen as a way of modernising infrastructure and processes and ultimately taking the risk out of the settlement process. Under T1, the time between when the trade executes and when the securities and cash are exchanged is reduced by a full day, thereby also reducing the period of time during which a counterparty may have failed to fulfil an obligation.

A shortened settlement cycle promises to reduce settlement risk and promotes operational and capital efficiency. In reality, EFAMA observes more of a transfer of risk, rather than an elimination of risk. We would argue it transfers costs and risks from retail brokers and proprietary trading firms to the asset managers that represent the savers of Europe with new risks generated on FX settlement and operational risks.

A single market event is often referenced to explain the drive to migrate to a T+1 settlement cycle in the US. When trading stocks and settling on the NSCC, US clearing members are required to put up margin in case of a failed trade with the NSCC (a clearing house which provides insurance against risks of failed trades). These margins spiked so high during volatile trading of Gamestop (the trading frenzy itself driven by meme trading). that clearing brokers halted trading in Gamestop as they were not able to post the required capital margins. The logic goes that with a shortened settlement timeframe, NSCC's risk exposure and margin requirements will be reduced, thereby bringing about a much more efficient use of capital.

The transition to T+1 requires changes in behaviour, standardisation of processes, and modernisation of infrastructure (automation). This is true for the domestic US market players involved in the settlement chain.

The impact on non-US entities is of a different nature and with an arguably larger impact. It creates a misalignment of settlement cycles (US on T1 and Europe on T2), and the resulting operational difficulties of performing multiple tasks involving multiple players in a compressed timeframe.

In this paper, we identify a number of scenarios where the shorter US timeframe will cause challenges for EU-domiciled funds.

Introduction

This paper identifies the key areas where asset management firms will be impacted by the United States move to a shortened settlement cycle (T+1) by May 2024.

The following areas are addressed:

- Trade Matching: Allocation, Confirmation and Affirmation
- FX funding
- ETF activities
- General fund settlement
- Securities Lending
- ETDs
- Corporate Actions
- Client contracts

Under section III, we examine the potential solutions that the industry will turn to and any associated policy implications. Section IV recommends areas where the European buy-side can further engage with service providers to better prepare for US T1. Section V suggests some conclusions from this analysis and an early outlook on how to assess an EU move to T+1 settlement.

I. Implications of T+1 Settlement in US for European Buy Side Firms

1. Trade Matching: Allocation, Confirmation and Affirmation

Along with a shortening of the securities settlement cycle to T+1, the SEC has also imposed additional requirements on the trade matching process. They have prohibited broker-dealers from entering into a trade unless the contract requires same-day allocation, confirmation and affirmation on trade date (which the industry has taken to be 9PM ET, 3AM CET).

The requirement to affirm may pose a challenge for European entities. Whilst many achieve very high rates of allocation and confirm (trade matching) on US trades on trade date, the affirmation process can be patchy. Trades can settle without being affirmed. Today, affirmation is generally undertaken by the custodians, though is not executed by all of them. Firms may wish to explore how the affirmation role can be completed post go-live given the time constraints, whether it's engaging with the custodians for better coverage, looking at vendor solutions or their own practices.

The timelines also present an issue, particularly for EU based managers without a US presence that they can rely on to cover parts of the operational process. Given that executions fills may come in close to close of US market close (4PM ET, 10PM CET) with the requirement to allocate, confirm and affirm by 9PM ET same day (3AM CET), there is no overlap with standard European business hours. Firms may have to explore how they can fully automate the process or rely on third parties or vendors to cover part of the process.

The SEC announcement also makes changes to Rule 204-2 for Investment Advisers (SEC register), to which some European asset managers are registered (SEC register), requiring that firms maintain books

and records of allocations, confirmations and affirmations. While firms in Europe are familiar with the allocation and confirmation processes that are also applicable in Europe, and should have access to records of these, some may need to take steps to ensure they have records of the trade affirmation, either undertaken themselves or through the custodian.

2. FX funding

SCENARIO 1	**Settlement FX Funding** o The timing of FX order generation will need to change. This will impact systems and staffing requirements. o The accuracy of the FX order may decline if managers need to generate the FX order prior to the completed affirmation of the underlying security transaction. o Managers will need to decide whether to establish or expand their operational presence in the US o The affirmation and settlement windows for FX will compress because of the shortened FX tenor, the time zone differences of foreign investors' middle and back office functions, and broker and/or custodian operational coverage. o Peak US and CAD dollar liquidity demands may move to the final hour of the US day and potentially beyond, to enable T+1 FX execution and settlement against the underlying security. o This is further exacerbated by current FX practices whereby many banks do not accept T+1 trades after 5pm NY time. This tightens to even closer to the US equity close on a Friday. o Pricing of FX deals may be impacted by the late-in-the-day nature of FX execution, with likely many investors looking to execute FX trades in the same direction. o FX order complexity may increase as demand shifts from the spot market to shortened settlement tenors. o Cross currency security rebalances, where a sale in one market is used to fund the purchase of another is going to create cash matching challenges.

There may need to be non-standard settlement for FX to allow for cost border trading between different settlement regimes. Standard settlement on FX is currently on T+2. Non-standard settlement would mitigate against costs that cannot be predicted in advance. A customised process would also help in ultimately charging the investor the right fees and managing appropriate, proper invoicing. At the same time, custom FX settlement may not be an option for many asset managers.

T+0 FX settlement may mean that there is no possibility to settle through CLS, with the existing cut-off times. This would mean that there needs to be bilateral, gross settlement with the counterparty. This would bring about an unintended increase in counterparty/operational risk.

CLS operates a multi-currency settlement system for FX transactions. It allows for simultaneous settlement through PvP (payment versus payment), thereby reducing settlement risk. To mitigate counterparty risk and avoid holding cash balances, ideally, fund managers would like to continue to settle through CLS.

Some EFAMA member firms would face even more challenging time constraints where there are global mandates, and for instance, APAC investors are involved. The stretch is even greater than the EU/US difference if a fund is sold in Australia and holds Australian dollars, and US securities are traded in that fund. The booking, matching and sourcing of FX, which could be done in the day following execution, will now have to be squeezed into 2 hours or less.

While Custodians may be able to step in to provide FX funding, and there unquestionably is a convenience factor there, to maintain price competition and minimise charges to the end client, ideally, access to third-party FX execution should be maintained.

Traders can occasionally ask for extended settlement (e.g. T+2/T+3), i.e. if there is a holiday in the home market, for the US settlement. But if this is a repeated and regular request, it is unclear if the SEC will accept this as best execution.

In summary, our primary concern is that there may not be sufficient time for investment advisers to match foreign currency amounts to settle all trades on T+1. The equity market closes at 4pm after which time, trades need to be matched and any resultant FX tickets raised and executed. One of the main issues is the lack of time between the closure of the equity market to when US based FX trading desks close for the evening (usually an hour or so later). Banks may reassure clients that Far East trading desks seamlessly take over the trading. Yet in practice this argument does not always stand up, for four very valid reasons:

(i) Trading in Asia will be for the following days trade date which means it needs to settle T+0. The cut-off for T+0 is mid-morning Singapore time, potentially creating liquidity issues. It will also mean all trades settle outside of Continually Linked Settlement (CLS) and therefore implies a marginally higher counterparty risk.

(ii) On a Friday evening, US FX desks currently close earlier, not much after 4pm when equity markets also close. This means all trading will either need to be pre-funded into USD, which is impractical, or traded in Asian hours on the Monday on a T+0 basis.

(ii) If there is a market holiday in the Investor's base currency then, in our opinion, it will currently be impossible to settle the FX T+1 or indeed T+0 so the equity trade will fail and need to be funded by the broker. The other issue leading to inevitable trade fails is if there is a market holiday in the other leg of the currency pair. For instance, if trading Australian Dollar to US Dollar, if there is an Australian public holiday the next working day, there is no possible way to ensure USD is available to settle a purchase of US securities. Speaking to market participants, it seems blockchain settlement of FX is still some years away. We are concerned that executing a trade knowing it will fail does not meet our best execution requirements.

(iv) In practice there is usually a gap between when the Asian trading desks start and the US desks close. Buyside traders are unlikely to consistently wait into the evening for this handover.

The issues described above impact both domestic and internationally based investment advisers. However, non-U.S. based investment advisers will face additional expenses in that they will, either have to set up an FX trading and settlement presence in North America (or Asia) or add staff abroad to create, execute, and settle FX transactions to meet a T+1 timeline.

We suggest several options for actions the SEC could take, separately or together, that could reduce disruption in FX markets. We believe that the third and fourth options would be the most effective in alleviating our concerns. We recognize that some of these options are likely to be troublesome to implement.

(i) Appropriate Market Authorities consult with the Commodity Futures Trading Commission (CFTC), which has primary responsibility for overseeing foreign currency trading, to determine whether that agency can take any action in the FX markets to support the Commission’s move to T+1 settlement.

(ii) Appropriate Market Authorities encourage banks to agree to extend the day of their FX trading activities in the United States and continue to provide liquidity up until at least 6 pm EST, five days a week, for T+1 settlement.

(iii) Appropriate Market Authorities mandate a change in the official equity trading day for U.S. markets to close one hour earlier, at 3 pm rather than 4 pm EST. This change would provide firms more time to match trades and ensure the settlement FX is in place for the following day, without, we believe, negatively impacting liquidity and trading volume.

(iv) The Commission could allow for a mismatch of FX settlement dates as a valid reason for T+2 settlement arrangements without it breaching an investment adviser’s best execution obligation. While we appreciate that the Proposal would allow parties to agree to a longer settlement cycle, in order to avail themselves of that extended settlement date, the parties must reach that agreement at the time of the transaction. We understand that this would be difficult to implement in the context of trades that require the settlement of FX transactions to occur, for this reason a standing option to settle at T+2 would be more effective.

3. ETF Activities

ETFs will experience the same negative impacts as other traditional funds (FX, asset/liability mismatch, securities lending, post-market organisation, etc.). However, ETFs are traded in the secondary market in line with the local standard settlement conventions, as such they are also faced with the irreconcilable gap between settlement of the underlying (T+1) and settlement of the ETF shares traded in the secondary market (T+2).

SCENARIO 2	**For UCITS managers with US on T1 and EU on T2** o On share and unit **creations** the AP may have to sit long the ETF for a day before delivering to the client T2, which would remain as standard settlement cycle for secondary market trades. They would then have to price in the cost of funding the position for the additional day. o On share and unit **redemptions** they would inevitably fail for a day if they buy from a client T2 and have to deliver to the fund T1 as the fund would sell the basket on a T1 basis. This would lead to additional costs via fail penalties and increase operational burden of calculating and processing claims.

SCENARIO 3	**Specific issues for Global Developed baskets where orders are placed on T1** o Where MSCI World is 65% US stocks for example, managers may move settlement for primary trades from T2 to T1. This could cause cash breaches by settling the ETF before a portion of the basket settles, leaving as T2 would cause the fund to go overdrawn where the bulk of the basket settles before the ETF. o Redeems would have the opposite impact, i.e. moving to T1 would result in the funds going overdrawn and keeping as T2 could result in cash breaches where the fund is long cash for the day due to the proceeds of the US portion of the basket settling T1 o From an AP perspective there would be the same issues as the previous example o This is true for baskets tracking US indices (like MSCI), but could also impact UK tracking indices if the UK also moves to a shortened settlement cycle

The misalignment of fund and security settlement will have to be managed though the resulting cash breaches and overdrafts, though these cannot be overcome even with a move to T1 on the primary leg. There may be a need to move to custom settlement to align with the US securities. We also expect a widening of bid/offer spreads on ETFs given that the APs will pass on additional trading, hedging and/or settlement costs due to the misaligned settlement cycles via wider spreads (they will either be short cash for a day, hedge one day longer and/or incur CSDR penalties due to settlement fails)

Misaligned primary/secondary settlement cycles may generate both a financing requirement and, depending on the case, an increase in fail rates for UCITS ETFs. These two factors have a cost that will be passed on to the end investor (via a wider spread and therefore a less competitive price on the secondary market vis-à-vis the current status quo, as well as vis-à-vis US providers of ETFs where basket and ETF settlement cycles are aligned).

4. General Fund Settlement

SCENARIO 4	**Misalignment of settlement timeframe between mandates/funds and securities.** o Funds that currently settle T2 or T3 will need to be considered if they invest in US, Canadian or Mexican securities (or indeed any markets wishing to move to T+1 settlement for listed securities – India shifted to T+1 at the end of January 2023, and China local securities are also T+1). o Shortage of cash – On purchases, the cash flow timing differences would create a need for a line of credit or potentially an extended settlement of security transactions, thereby increasing costs. Currently the former is restricted by UCITS rules that stipulate that funds should not be borrowing in order to handle liquidity linked to investor transactions. o Concentration Limits – Funds with large cash flows could result in a concentration of a single currency which would trigger a UCITS concentration breach. A solution may be the systematic extension of settlement of US and Canadian securities. o From an APs perspective there would be the same issues as the previous example

Cash flows – the misalignment of settlement cycles will lead to inflows of cash into an EU fund when US securities have been sold for a redemption, but the fund is still settling on a T2 basis (and even more so for T3 funds, which are actually the dominant norm in EU-domiciled UCITS listed equity, fixed income and mixed asset funds). This will lead to regular active UCITS cash breaches which will have to be reported to the regulator.

Overdrafts – similarly, for fund subscriptions, US securities will be purchased on a T1 basis leading to a shortfall of funds, as the fund units themselves (and investors' cash) are not settled before T2 (or indeed T3, making the problem even more acute). This means that EU funds with US securities exposures, will be overdrawn for 1 day or possibly 2. For T3 funds, only purchasing on T2 would avoid this issue, however that would mean that there is a potential cash drag in the portfolio between T and T2, which would further be compounded if the subscriptions represent a very large portion of the fund, thereby giving rise to guideline breaches (unless the regulators are willing to be tolerant of those due to the structural limitations).

There are a number of ways in which the cash shortfall could be addressed all bearing negative /costly consequences for our industry as detailed further below:

- Prefunding by the fund itself, with cash being posted in advance of trades, at a cost. Provided the fund has the cash, presumably either by asking the investor to settle early (not practical for most financial institutions) or through a credit line, provided this is admitted by the regulator. Although this approach will result in a performance drag.

- Location strategy – a presence in the North American hemisphere will allow firms to carry out their matching, confirmation, FX and other needs in the same time zone. This solves for potential errors in instructions and FX funding needs, but it would still not address the general funding mismatch.

- Moving all settlement to T1 – this would solve the cash mismatch for everyone, but it is unlikely that the market in Europe is ready for this. To be noted that this is also may be difficult to implement and would at the very least require issuance of NAV prices and confirmation statements to the investors by the end of the day on T, as otherwise investors dealing in units will not be able to instruct their payments for subscriptions on T1, and likewise the fund itself will not be able to execute on redemptions the next day. The problem will be particularly acute for Asian investors, who will receive confirmation statements in Asia on T1 - a detailed analysis of investor impacts is required. What this effectively means is that for North and South America markets, as well as potentially Europe and UK, it will be challenging to provide valuations based on close of business prices, which introduces a greater degree of volatility for investors but also funds. This may in turn cascade into further increases in swing pricing adjustments, as funds seek to recoup costs and protect themselves and their long-term investors against market risk.

Dual-listed securities (in US and EU) would present a special set of issues, with the ability to buy in one market and sell in another. It is unclear at this stage if, as a result of this move, more trading would move to the US due to the increased investor protection and robustness of the market, or if the opposite would happen with third countries preferring to trade US stocks outside the US to avoid having to comply with T1.

The one-day funding mismatch will generate costs in terms of required operational changes and significant costs due to the higher interest rate environment. In addition, fund prospectus may need to be updated to reflect new product features.

SCENARIO 4a	**NAV Calculations for funds distributed in Asia.** o For subscriptions and redemptions on EU-domiciled funds distributed in Asia, the NAV calculation will not be made until next market date. o Fund managers and custodians may have to move some operations into Asia or US to perform tasks. o Alternative: creating identical EU-domiciled fund strategy with a fund domiciled in an Asian country (requires fund management presence in Asia).

5. Securities Lending

SCENARIO 5	o T1 stocks will have to be returned in shorter time frame which will lead to an important increase in stock recalls. This is particularly heightened with ESG, which obliges funds to vote and therefore to recall securities for general meetings systematically. o The shortened timescales may cause a reduction in securities lending transactions with damaging consequences for liquidity and fund performance. Market participants involved in securities lending transactions in the United States will have a narrower window to initiate and complete lending transactions, which could affect their capacity to find suitable counterparties and negotiate favourable terms. o Where an instruction is late, recalls on sales of loaned securities could generate systematic buy-ins on certain markets, leading to substantial impacts (financial losses). o Banks that borrow securities and lending asset managers must comply with a shortened redemption period; this will have impacts on the pricing of the lending contract. o Finally, shortening the settlement cycle may have an impact on collateral management in securities lending. Borrowers will need to ensure they have acceptable collateral available in time to secure the borrowed securities, while lenders will need to manage cash inflows and returning collateral effectively within a reduced timescale.

The US move to T1 will introduce pressures for EU fund managers' securities lending programmes. With US securities on a T1 settlement cycle, EU fund managers may find that stock recalls are not back in time to satisfy the shorter settlement cycle in the US. This is especially a problem for trades that would come late in the day, given that it is standard industry practice for agency lenders to enforce a cut-off time 2 hours before markets close. Any trade that comes later will almost certainly fail the next day, as the stocks would not be recalled on time.

The identified impacts would be exacerbated if a major index like the MSCI rebalances requiring high volumes of securities to be bought/sold.

There are some possible adaptations that would alleviate some of these impacts. Fund managers could request Early Sale Notifications (ESNs) in an earlier timeframe to enable the generation of a SWIFT message and successful recall of the stock. We also expect that agency lenders could revise their cut-off

time to something closer to the actual close of markets. Another possible solution would involve the agency lender or custodian providing the stocks until these are back into the custodian account. This is easier if the agency lender and custodian are one and the same.

In terms of penalties for failed trades, under the US regime, the executing broker could force a buy-in with all the entailed costs. In the hypothetical scenario that the EU had also moved to T1, the CSDR cash penalties regime would kick in for any failing trades. Fund managers would likely have to consider the income generated by their securities lending programme versus the amount of penalties they would be responsible for due to the additional fails on EU T1.

Even factoring in some of the industry-led workarounds to accommodate US on T1, we still expect the net impact of the US move to result in a contraction of securities lending programmes, therefore less liquidity/efficiency in the market, and lower revenues for fund portfolios and consequently lower returns for shareholders.

6. Exchange Traded Derivatives

The impact on cash may have knock-on effect on the management of collateral.

7. Corporate Actions

The shortened time window between ex and record date may drive custodians and clients to review their processes.

8. Client contracts

The change in the US will trigger a massive re-papering with clients as we have to adjust for the new settlement date. Marketing materials, prospectus, etc would all need to shift as well.

II. Implications of T+1 on US fund managers when US moves to T1, and EU remains T2

9. ETF Activities

SCENARIO 6	**For US managers:** o Collateral calls will be made for 100% of the trade notional + haircut, where APs have to deliver securities T1, where underlying settlement cycle is T2, assuming they cannot borrow the international securities. o May cause borrowing to become more expensive if supply becomes an issue o Additional cost to trade for APs due to haircut, plus operational burden on managing calls for a portion of the basket that cannot settle before the call is made o Global exposures that contain a portion of non-US securities will have the inverse of the issues identified above for UCITS managers

III. Industry Solutions

Problem	**Remedies**	**Cost/Benefits**	**Policy Considerations**
FX Funding **(Scenario 1)**	Prefunding or cash pockets could be a solution for funds, although in the ETF market this is not likely to be an option for the APs. APs will not send cash in advance.	Pre-funding could greatly increase the number of manual processes required in order creation and settlement functions, as well as creating cash drag on performance.	
	Extend staffing and operations in US	A costly, but beneficial option from a time zone perspective.	
	Request flexibility in US, possibility to settle on T2		What would be the stance from the SEC on this (particularly any tangible limits e.g. what % of trades with extended settlement would be permissible?)
	Change to official trading day to 3pm EST for US equities	Adds much more time for the matching/affirmation/FX processes to take place at the end of day on trade date.	
	Avoid Custodians bringing FX funding in house as this could lead to less competitive rates	Custodian solutions are already being marketed as this will be seen as a revenue opportunity – but this comes at a cost to the end client (vs. end clients receiving market rates if their asset manager or a third-party is able to execute their FX).	

Problem	Remedies	Cost/Benefits	Policy Considerations
	An opposing view says that including FX in the custodian offering is welcome and facilitates access to FX.		
	Lines of credit	Cost of US funding is over 4% now Provision/usage of credit becomes much more expensive in a high interest rate environment (such as at present).	
	CLS cut off times extended	ETFs and shares stop trading after 5pm. This means that a later cut-off on CLS would still allow settlement on CLS.	Can CLS be approached to extend their cut-off times/work with custodian members on their cut-off times, to ensure FX settlement?
UCITS ETF fund with US on T1 and EU on T2 **(Scenario 2)**	On Creates: APs have to fund the position for a day on Creates	APs will bear the greatest impact from the misalignment of settlement cycles either by being overdrawn/ long on cash, or in the middle of a failing trade.	
	UCITS cash breaches will need to be reported to SICAV		Raise possibility with EU regulator to ease rules on cash breaches with the consequence that UCITS wrapper could suffer globally with US ETFs benefiting. Also possibility to request exemption of European funds from T1 obligations and request ability for basket to settle under T2. However even if an exemption is obtained how

Problem	Remedies	Cost/Benefits	Policy Considerations
			would global asset managers who trade on a bulk basis carve out only their UCITS T2 trades? Nonetheless rendering more flexible the requirements regarding cash breaches risk would at least create additional flexibility for specific scenario consideration.
	On Redeems: APs fail for a day as they buy on T2 but deliver on T1	Increase in failed trades in Europe which impose penalties.	
	NAV Calculations are more complicated		
ETF fund with predominantly US securities moves primary to T1, and **Misalignment of settlement timeframe between mandates/funds and securities.** **(Scenario 3, 4)**	Moving Creates to T1	Cash breaches	Request specific guidance from ESMA on how to handle cash breaches due to settlement cycle misalignment
	Leaving Creates as T2	Fund overdrawn	
	UCITS cash breaches will need to be reported to SICAV		Raise possibility with EU regulator to ease rules on cash breaches with the consequence that UCITS wrapper could suffer globally with US ETFs benefiting. Also possibility to request exemption of European funds from T1 obligations and request ability for basket to settle under T2. However

Problem	Remedies	Cost/Benefits	Policy Considerations
			even if an exemption is obtained how would global asset managers who trade on a bulk basis carve out only their UCITS T2 trades?
	NAV Calculations are more complicated		
	Constitute a buffer in securities	Performance drag	
	APs face CSDR cash penalties		
	Funds prospectus will need to be updated		
US ETF Managers with EU securities **(Scenario 6)**	Restricted FX markets could create a complication because the FX transaction will most likely not be known on T1. Striking a NAV will be difficult		
	If international securities unavailable, borrowing will become more expensive, and additional cost to trade for APs as they face collateral calls + haircuts.		Request from SEC that international exposures be exempt from T1. 40 Act ETFs with international exposure should be less impacted from the settlement mismatch, but could be used as precedent to argue for exemptions for EU ETFs/Funds.

Problem	Remedies	Cost/Benefits	Policy Considerations
Securities Lending **(Scenario 5)**	Sec lending cut off time will be narrowed. Today recall is done on a T+2 basis. However if you are trading up to market close, the recall time is condensed, and probability that recall will be late increases.		
	Agency lender or custodian provides the missing shares until these are back in the custodian account		
	Issuance of ESNs earlier in the day		
	Later cut-off times by agency lenders		

IV. Outreach to other players in the settlement chain

Custodians

Custodians play a key role in the ability of non-US participants to invest within the US market for a T+1 settlement cycle. New or changing requirements include:

> FX deadlines and offerings – Existing custodians deadlines to input trades for either CLS settlement or the gross settlement of FX transactions are particularly relevant under a T+1 security settlement requirement. Given the FX timings referenced earlier in this paper, the deadlines that custodians impose will have an impact on whether buy-side firms will be able to mitigate risk through CLS or not. Wide variance in custodian deadlines also pose a big issue for member firms; with buy-side firms potentially having to split an FX transaction into those that can settle through CLS or not.
>
> Trade affirmation – In the existing flow, custodians affirm trades for US securities though affirmation rates are low. Given the new requirements, there will be a dependence on custodians to be able to affirm trades and communicate this back to the buy-side. Sub-custodians may need to be used to help with obtaining affirmation status for the trading parties. If this is not managed, it could lead to a greater number of settlement fails.

ISLA/Agency Lenders

It is important to get a steer from the agency lenders to understand what solutions they are looking at to ensure that securities lending continues to remain attractive for both lenders and borrowers, even with the need to return the securities in a shorter timeframe. Greater automation and standardisation will likely reduce recall times and friction with intermediaries. The reality in the market today is that buy-side firms are operating with a T+2 settlement timeframe and processes are optimised for T2 settlement, not shorter.

Brokers

Explore role of brokers in helping effectively extending the settlement cycle through fronting stocks for a day or two or through other operations like providing credit lines.

CLS (Continuous Linked Settlement for FX settlement)

Discuss with CLS whether later cut-offs will be introduced to still allow for CLS settlement and avoid custom settlement direct with counterparties. Initial discussions indicate that there is not much appetite for CLS to modify their midnight CET cut-off time. There may be some margin to receive more time from custodians for their internal cut-offs. It would appear that to improve access to FX liquidity, there will still need to be a combination of potential USD cash pockets (prefunding), non-standard settlement (bilateral), and executing FX orders before a security settles.

V. General Conclusions

Attractiveness of US Securities

The misalignment of settlement cycles will lead to a greater number of trades not settling on time, if we consider ETF redemptions where an AP will be failing as it is unable to deliver shares on time to the ETF issuer. In addition, the settlement misalignment will drive up costs for asset managers as they face challenges on FX funding, cash management, and impact of fund cash breaches. As a result of increased trading costs and operational risks, EU investors may find trading in US securities less attractive.

Costs to European Asset Managers

Important also to note that there appear to be net winners and net losers with the US move to T1 and Europe remaining on T2. Custodians are clear net winners with the possibility to introduce new products and services in the form of FX funding, credit lines and provision of shares.

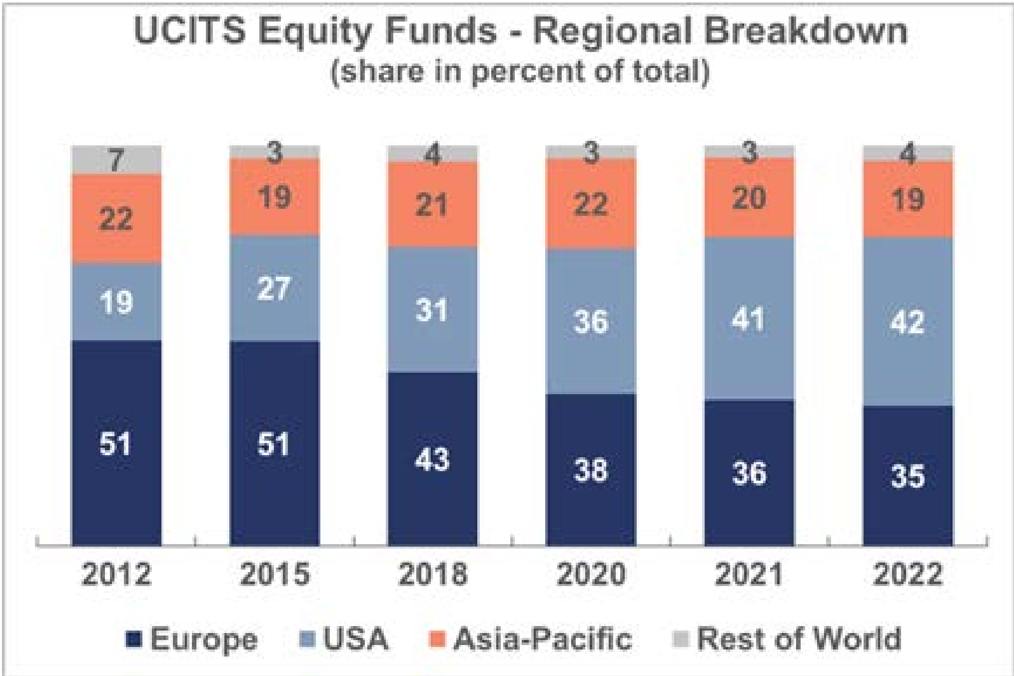
Fund managers will incur costs with requirements to:

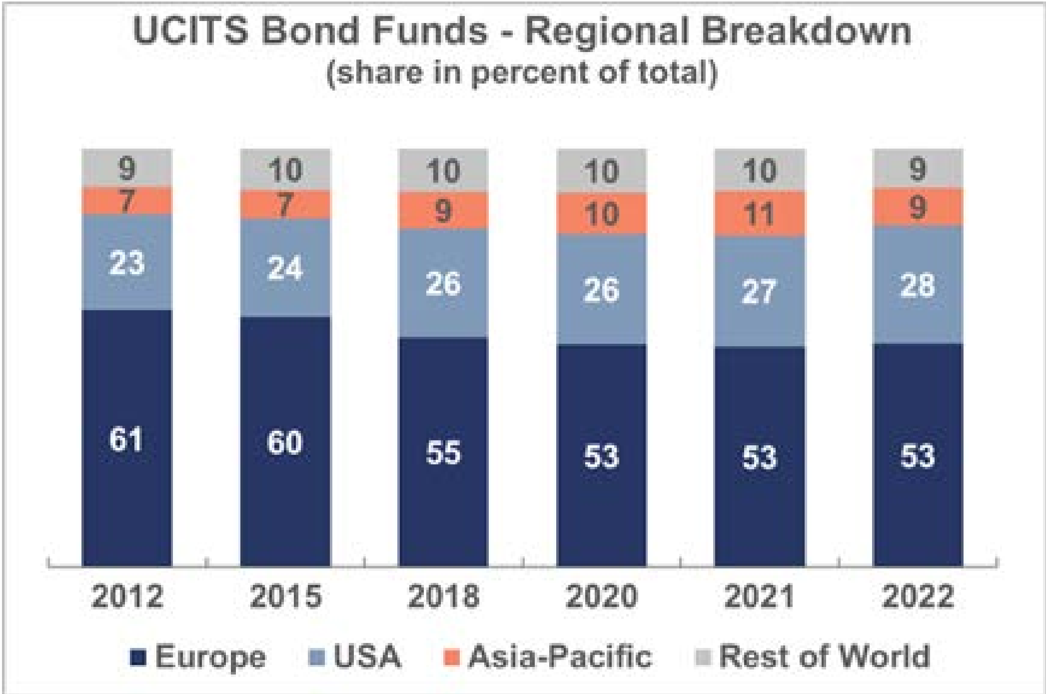
- Expand working hours in Europe to cover US hours,
- Staff and expand of North American operations or outsource to US-based 3rd party entities
- There is also a general recognition that outsourcing options, because of the need to comply with the US timeframe, are limited to the US East coast or further West, creating greater cost than if outsourcing could have moved East.
- Among the many required technology updates, firms may need to review how they can automate the US security trade matching process given that it concludes well past the European end of business day (US equity market closes 4PM ET (10PM CET) and trade matching to be complete by 9PM ET (3AM CET) on trade date. This may include greater use of intra-day processing and less reliance on batches.
- Costly solutions for FX funding gap, through custodians or other providers, prefunding, and executing FX orders based on unconfirmed executions, with a 'true-up' necessary the next day.
- Costly solutions for cash shortage, funding again through APs, custodians/brokers or prefunding
- Cash breaches with obligation to report to regulator

US T+1 Migration Process

The process to first explore a move to T+1 in the US, followed by the development of a T1playbook, testing framework and official SEC rule change has been and continues to be largely domestically driven. **This seems out of touch with the reality of a US securities market that is heavily exposed to international investors, approximately 20% in equities, and 23% in bonds.** And while this was not a major issue when different jurisdictions moved from T3 to T2, the compression into a single day of all post-trade activities necessitates a different approach, involving key global jurisdictions working together.

Data on Equity and Bond UCITS– breakdown of holdings by region (EFAMA Factbook 2023)





Importance of non-US investors in US equities and fixed income markets (Federal Reserve Data) :

Debt securities	(USD billions, at end 2022)	
Owned by foreign investors (RoW , assets)	12.654	
Total issued in the US (All sectors excl RoW, liabilities)	54.939	
Percentage held by foreign investors	**23%**	
Corporate equities		
Owned by foreign investors (RoW , assets)	10.829	
Total issued in the US (All sectors excl RoW, liabilities)	54.399	
Percentage held by foreign investors	**20%**	

ABOUT EFAMA

EFAMA is the voice of the European investment management industry, which manages over EUR 30 trillion of assets on behalf of its clients in Europe and around the world. We advocate for a regulatory environment that supports our industry's crucial role in steering capital towards investments for a sustainable future and providing long-term value for investors. Besides fostering a Capital Markets Union, consumer empowerment and sustainable finance in Europe, we also support open and well-functioning global capital markets and engage with international standard setters and relevant third-country authorities.

EFAMA is a primary source of industry statistical data and issues regular publications, including Market Insights and the authoritative EFAMA Fact Book.

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