EFAMA
European Fund and Asset Management Association

# IMPACTS OF US T+1 SETTLEMENT ON EU REGULATION

EU asset managers will face challenges in the application of a number of EU rules as the US moves to a T+1 settlement cycle and Europe remains on T+2 post May 2024. The settlement mismatch between the 2 jurisdictions will raise operational challenges as well as, we suspect, market structure changes. But another direct consequence of the mismatch will be in the enforcement of current EU regulation.

In this paper, we would like to identify those scenarios where EU rules will be tested, suggest the dimensions of that impact and request policymakers to explore how this regulatory burden can be eased and regulatory impacts of US T1 mitigated.

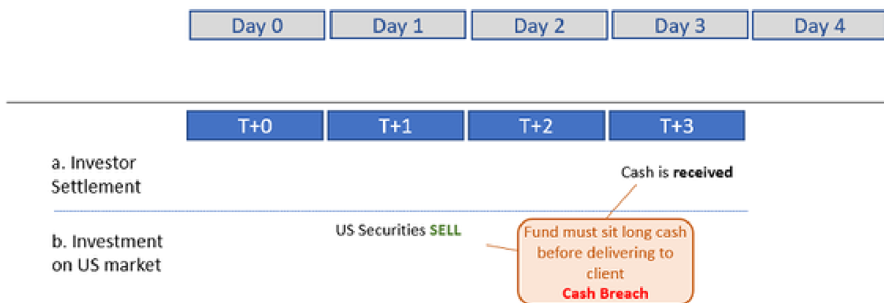
## 01 CASH BREACHES

*UCITS Article 52*
*1. A UCITS shall invest no more than:*
*(a) 5 % of its assets in transferable securities or money market instruments issued by the same body; or*
*(b) 20 % of its assets in deposits made with the same body.*

This rule in UCITS limits the amount of cash a fund can hold to 20% of the net assets of the fund. Temporary breaches can be tolerated under certain market conditions. However an active breach must be notified to the relevant NCA. We expect cash breaches to become a much more regular and frequent event with US T+1. However, application of the cash breach rule differs from jurisdicition to jurisdiction. Asset managers will require regulatory forbearance and a harmonized approach across the EU to any temporary exemptions.
Cash breaches as a result of the misalignment of settlement cycles can occur with traditional funds and exchanged trade funds alike.

Graphic A

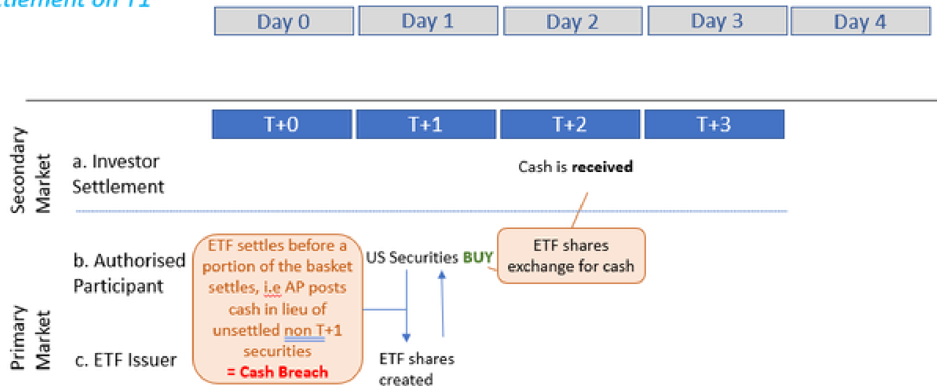
**Traditional Fund**
*Redemption*



Graphic B

**ETF**

*Creates, assuming mixed basket with 65% US equity (MSCI, S+P500) and primary settlement on T1*




### Dimension of problem

This is difficult to quantify as we cannot predict the daily flows in and out of funds. According to one large asset manager, 6.5% of primary market orders in their global ETFs over the past 3 years would have created UCITS breaches by being long >20% cash for one business day due to settlement cycle mismatches.

### Request from EFAMA

- Exemption from cash breach rule when 20% limit is exceeded due to a settlement mismatch as above.
- Supervisory convergence: ESMA guidance to ensure that all NCAs apply same exemption in the same manner.
- The exemption should apply for as long as the settlement mismatch with the US is in place.

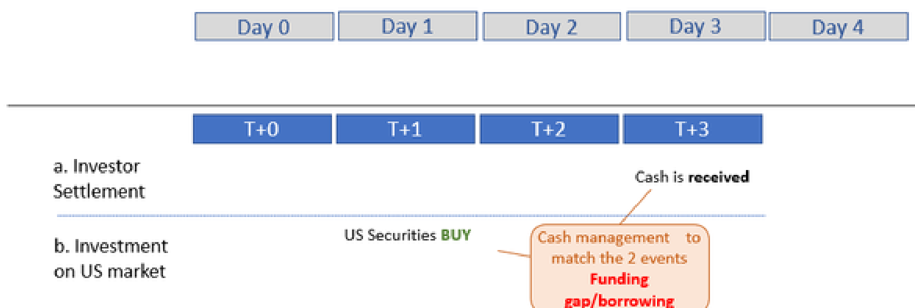
## 02 BORROWING LIMITS

*UCITS Article 83(2)*
*By way of derogation from paragraph 1, a Member State may authorise a UCITS to borrow provided that such borrowing is:*
*(a) on a temporary basis and represents:*
*in the case of an investment company, no more than 10 % of its assets, or*
*in the case of a common fund, no more than 10 % of the value of the fund; or*
*(b) to enable the acquisition of immovable property essential for the direct pursuit of its business and represents, in the case of an investment company, no more than 10 % of its assets.*
*Where a UCITS is authorised to borrow under points (a) and (b), such borrowing shall not exceed 15 % of its assets in total.*

Graphic C

**Traditional Fund**

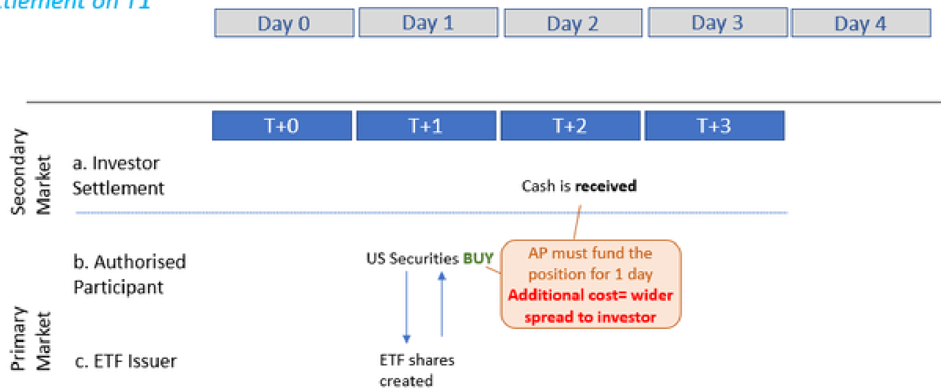
*Subscription*



Graphic D

**ETF**

*Creates, assuming pure or majority US equity ETF (MSCI, S+P500) and primary settlement on T1*




### Dimension of problem

The need to bridge funding gaps will be a reality for both traditional funds and ETFs. For traditional funds, the funding mismatch will have to be resolved by the fund, and this can bring about breaches of UCITS fund borrowing limits of 10% of NAV. Once again it is hard to predict the scale of the impact given that we cannot anticipate flows in and out of our funds. But anectodally, we can take a fund tracking MSCI all country, with 63% US equity exposure. If there is a 1bn EUR fund subscription, this will mean that the fund is immediately short 630m, and this amount will have to be borrowed to settle US security trades. In addition we know that 43% of all EU equity funds domiciled in Europe, are composed of US securities, giving an idea of the frequency of a funding gap in the portfolios that EFAMA members manage.

As Graphic d shows, ETFs will similarly face a funding mismatch even if ETFs move their primary market settlement to T1, there will still be a mismatch with settlement with the end-investor. . Although it is important to note that in the case of ETFs, the funding shortfall will be for the brokers to resolve. Therefore there will not be a borrowing limit breach as the in case of traditional funds.Brokers (Aps) will incur additional costs managing the mismatch when they are either short cash or long hedge for a day on US and global ETFs. As such we predict an increased need for APs to access credit lines or establish overdrafts.These additional costs that will be absorbed by the AP may be passed onto the end investor through wider spreads. From a saver/retail investor point of view, the funding mismatch is unfortunate as it adds to the cost of products.

### Request from EFAMA

- We would like an exemption to the 10%NAV borrowing limit when the breach is due to a settlement mismatch
- We would also like the ECB to consider the liquidity in the market, and how conditions leading to availability of liquidity enhanced given that asset managers do not have committed lines of funding.
- Fundings needs are greater when the trade falls on a Friday or before a holiday in the corresponding jurisdiction.
- Longer funding periods,combined with the higher interest rate environment, substantially drive up the cost of funding.
- Access to funding will be more complicated for smaller asset managers.

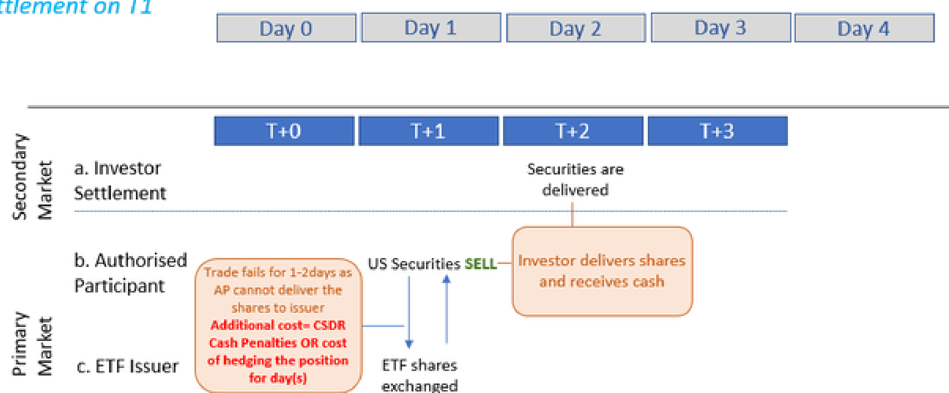
## 03 CASH PENALTIES

*CSDR (Regulation (EU) No 909/2014)*
*Requires that central securities depositories (CSDs) impose cash penalties on participants to their securities settlement systems that cause settlement fails (failing participants).*
*The application of the cash penalties regime is further defined in RTS 2018/1229, and Delegated Regulation 2017/389.*

CSDR Refit which is to enter into force shortly provides an exemption from cash penalties 'where those settlement fails are caused by factors not attributable to the participants to the transaction or for operations that do not involve two trading parties.' It is not yet clear to market participants if this change will exclude primary market transactions between Authorised Participants and ETF issuers.

Graphic E

**ETF**
*Redemption, assuming pure or majority US equity ETF (MSCI, S+P500) and primary settlement on T1*




### Dimension of problem

As with previous examples, the settlement mismatch between ETFs and their underlying exposure will create situations where trades will fail. Even if ETF issuers choose to move their primary settlement (creation and redemption of orders) to T1, they will still face investors settling on a T2 basis whether OTC or on exchange. The secondary market, reliant on trading platforms is not something we have control over as asset managers. The standard settlement cycle here will continue to be T2.

### Request from EFAMA

- Clarity from the EC and ESMA that cash penalties will not apply to primary market transactions, or failing that, will not apply to fails that are a result of the settlement mismatch with T1 jurisdictions.

**EFAMA is the voice of the European investment management industry**, which manages around EUR 28.5 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.
**More information is available at www.efama.org**