

FEBRUARY 2011

HARMONISATION OF SETTLEMENT CYCLES WORKING GROUP

FINAL REPORT

REPLY TO THE CONSULTATION DOCUMENT OF THE SERVICES OF THE DIRECTORATE-GENERAL INTERNAL MARKET AND SERVICES ON CENTRAL SECURITIES DEPOSITORIES (CSDS) AND ON THE HARMONISATION OF CERTAIN ASPECTS OF SECURITIES SETTLEMENT IN THE EUROPEAN UNION

Introduction

This document is the final report of the Harmonisation of Settlement Cycles Working Group.

It incorporates responses from the Working Group to those questions that are part of the European Commission consultation document dated 13 January 2011 and entitled “Public Consultation on Central Securities Documents (CSDs) and on the Harmonisation of Certain Aspects of Securities Settlement in the European Union”; and that relate specifically to settlement cycles and settlement discipline.

This document falls into four parts:

- (i) Origins and Description of the Working Group
- (ii) Overview of the Work of the Working Group
- (iii) Responses to Specific Questions raised in the Consultation Paper
- (iv) Perspectives on Further Work.

(i) Origins and Description of the Working Group

The Harmonisation of Settlement Cycles Working Group (HSC WG) was set up following a meeting in February 2009 of a European Commission advisory group on post-trading issues (CESAME2). The HSC WG was set up specifically to produce advice on the topic of harmonization of settlement cycles in Europe.

The members of the HSC WG include representatives from the principal industry segments active in the post-trading area, including exchanges (FESE), CCPs (EACH), CSDs (ECSDA), banks (AFME and EBF), and fund managers (EFAMA). Representatives of the European Commission have attended meetings of the HSC WG.

(ii) Overview of the Work of the Working Group

The work of the HSC WG has to date looked at the desirability of harmonization, and the question of what would be an appropriate harmonized settlement cycle. The WG has issued documents strongly supporting harmonization, and concluding that a settlement cycle of trade date plus two (T+2) is the right harmonized solution for European markets.

The HSC WG has also looked at the question of how to create the conditions for European markets to move successfully, and with a minimum of operational disruption, to a cycle of T+2.

The HSC WG gave a first report to the meeting of CESAME2 on 2 March 2010, in which it set out recommendations on harmonisation of settlement cycles and on a move to T+2.

The HSC WG and its members have looked, amongst others, at the following matters:

- The current legal and regulatory preconditions for a harmonisation of settlement cycles
- Surveys of views of the asset management (EFAMA) and banking (EBF) communities on harmonisation of settlement cycles
- Data from ECSDA on settlement fail rates, current practices with respect to timing of matching, and current real settlement cycles (i.e. gap between trade date and intended settlement date)
- Data from EACH setting out the anticipated impact on collateral requirements if there were a change in settlement cycles

The HSC WG has set up sub groups that have looked in particular at the trade verification/trade affirmation process, the settlement instruction matching process, and the fail management process.

The HSC WG sees itself as having played a valuable role in bringing together market participants so as to build a common understanding, and to develop common proposals, on an important and controversial topic.

The HSC WG sees its role as finishing with this final report, given that any future work will be dependent on the outcome of the legislative initiative that the European Commission will take.

(iii) Responses to Specific Questions raised in the Consultation Paper

Q44: According to you, is the above described harmonisation of key post trade processes important for the smooth functioning of cross-border investment? Yes? No? No opinion? If yes, please provide some practical examples where the functioning of the internal market is hampered by absence of harmonisation of key post trading processes. If no, please explain your reasoning.

The Harmonisation of Settlement Cycles Working Group (HSC WG) does believe that the harmonisation of key post trade processes is important for the smooth functioning of cross-border investment, and does believe that it is important in the specific context of settlement discipline and of settlement cycles. In its work the HSC WG has looked at harmonisation issues only in this specific context, the HSC WG does not feel able to give specific comments outside of this context.

The HSC WG understands that many of its individual members will respond in their own names to the consultation paper, and may well cover this question in more detail in their answers.

More detailed commentary on harmonisation in the context of settlement discipline and of settlement cycles is given in the answers to further question below

Q45: Do you identify any other possible area where harmonisation of securities processing would be beneficial?

See the answer to Question 44 above.

Q46: According to you, is a common definition of settlement fails in the EU needed? Yes? No? No opinion? Please explain why. If yes, what should be the key elements of a definition?

A common definition of settlement fails in the EU is needed.

Such a common definition is necessary so that comparable data on settlement fails can be collected across the EU. Such comparable data is needed by regulators, by market infrastructures and by market participants so that they can understand areas of risk, identify and target areas for improvement or mitigating action, as well as areas which may well require both regulatory and self-regulatory market discipline measures.

At the point of execution a transaction creates a contract which defines the economic details of the transaction and the point at which ownership and remuneration will transfer between the buyer and seller. A very simple and very high-level definition of a settlement fail is a securities trade that fails to settle on intended settlement date, no matter what the underlying reason is (unmatched, blocked/on hold, short of securities, short of money, etc).

The HSC WG believes that mechanisms to collect data on securities fails should, to the greatest extent possible, try to collect data based on this definition.

An important point is that a settlement fail is in the vast majority of cases the result of a technical failure in the process; a settlement fail does not amount to the failure (i.e. insolvency) of a business entity; it represents a delay in the fulfilment of obligations, rather than the inability to fulfil obligations.

Financial markets are deeply interconnected, and many parties are involved in the settlement process of securities transactions. A technical failure at one point in the process may be the result of one of many different root causes. (The ICMA/European Repo Council White Paper dated 13 July 2010 on the operation of the European repo market illustrates this point in detail).

The two principal types of entities that are best placed to collect data on settlement fails are CCPs and CSDs. They complement each other. CCPs will have data on all transactions for which they act as CCP, and monitor such transactions until final settlement. As CCPs may net transactions, either through a process of continuous net settlement or trade date netting, and effect buy-ins, they may have data on transactions that are not available to CSDs. CSDs will have data on all transactions that are instructed for settlement at the CSD.

There is a need for CCPs and CSDs across Europe to utilise a common methodology to produce data on settlement fails. ECSDA, representing the CSDs, reports that it has made substantial progress in establishing such a methodology (attached in annex the ECSDA document entitled “CSD Statistical Exercise).

The HSC WG encourages all CSDs to use this methodology to provide data, and it encourages CCPs to use a methodology that is consistent with the ECSDA approach, so as to produce comparable data.

In this context, two points are worth making :

- (i) Data may never be fully comprehensive, as there is the possibility that some transactions are submitted neither to a CCP, nor to a CSD, and are in due course cancelled, or rebooked; (this possibility applies very largely only to OTC markets, and not to trading on organised trading venues); however, the HSC WG believes that efforts should be made so that the data has as broad a coverage as possible.
- (ii) Participants in OTC markets should avoid rebooking of transactions as this would distort data; the control environment provides the relevant bilateral mechanism to minimise such activity.

CCPs and CSDs will collect data that show the symptoms (reduced settlement rates) of a problem. CCPs and CSDs by themselves will not necessarily be able to see or analyse the root causes of the problem. It is important that they make the data available to market participants, who may be better placed to analyse, and to identify the underlying root causes and to regulators who can monitor improvements.

Q47: According to you, should future legislation promote measures to reduce settlement fails? Yes? No? No opinion? If yes, how could these measures look like? Who should be responsible for putting them in place? If no, please explain.

We believe that it is important that there be a sound legal and regulatory framework, within which all market participants have incentives for good behaviour, namely to operate in such a manner as to facilitate and to achieve early matching and early settlement of transactions. (Early settlement typically means as soon as possible once the settlement system starts operations on intended settlement day. Same-day activity (when trade date and intended settlement date is the same) is slightly different, and early settlement means prompt settlement (i.e. that the trading parties forward their settlement instructions as soon as possible to the CSD and settle in the next available cycle).

We do not believe that legislation can, or should, prohibit settlement fails, as any market participant can suffer a failed settlement arising from causes beyond its direct control. Any such prohibition could punish the innocent, and would generate an incentive to move market activity away from the secure environment of the central infrastructure.

We do see a role for legislation setting out certain high level rules and minimum requirements.

We do see a role for regulators and supervisors, and, in particular, for ESMA so that there is coordination and consistency at a European level, in the elaboration of measures to reduce settlement fails. One key reason for the involvement of regulators and supervisors is that if they are not involved there is a risk that other regulatory and supervisory concerns may place obstacles in the path of progress towards reducing settlement fails. We understand, for example, that the implementation of the ECSDA/ESF Standards on Pre-Settlement Date Matching Processes has been delayed in some countries following concerns expressed by national regulators.

We see a role for national regulators and supervisors, in close collaboration with ESMA, to set benchmarks for settlement efficiency across the EU. Such benchmarks, together with the data collected by the CCPs and CSDs, will highlight areas for market and regulatory action. More detailed commentary on possible actions are set out in the responses below to Questions 48 and 49.

Q48: What do you think about promoting and harmonising these ex-ante measures via legislation?

We believe that utilisation of legislation to require market participants to carry out certain specific pre-settlement processes is very largely inappropriate.

Many market participants, namely those located outside of the European Union, will not fall under the obligations set out in legislation. Market participants (for example, broker-dealers) who are located within the European Union, and who have clients located outside of the European Union, may be dependent for their own compliance with, for example, trade verification requirements on the compliance of their clients. Too specific legislative requirements may impose, and freeze, specific market models, and specific technical solutions, and thereby impede competition and innovation.

We do believe that progress in reducing settlement fails can be achieved by further work in implementing existing market standards, notably, the ECSDA/ESF Standards on Pre-Settlement Date Matching Processes, and by the development of new market standards, notably in the area of trade verification.

As mentioned in our answers to Questions 46 and 47, we do fully support measures to harmonise monitoring and reporting schemes for settlement fails, and we would welcome the setting, by regulators, of benchmarks for settlement efficiency applicable across all EU CSDs.

Q49: What do you think about promoting and harmonising these ex-post measures via legislation?

A Sub Group of the HSC WG has reviewed in detail the topic of settlement discipline, including penalty regimes and enforcement rules, as tools to maximise settlement performance. It has also looked at the question of whether it would be desirable to impose a harmonised pan-European regime. (The report of the Sub Group is attached in annex to this report).

We believe that a harmonised set of measures and parameters to maximise settlement performance would be beneficial but this objective would best be achieved via market driven initiatives rather than legislation. This is because it is clear from the assessment conducted by the HSC WG that a “one-size-fits-all approach” will not deliver an optimal solution to EU harmonisation. Local market and product, or even sub-product, specificities must be carefully assessed to ensure the products or investors are adequately protected throughout the process and activity is not driven outside the robust infrastructures in place by the CCP and CSDs.

The explanation is fundamentally two-fold as discipline and enforcement regimes:

- (i) treat the symptoms (i.e. the settlement fail), and not the root cause of the problem;
 - (ii) work by strengthening the incentives for market participants to behave well.
- However, as markets and post-trading infrastructure across Europe are

currently still very diverse, market participants may be faced with very different incentive structures, so that any harmonised rules may well be inappropriate for the current situation in any given markets.

Q50: According to you, is there a need for the harmonisation of settlement periods? Yes? No? No opinion? Please explain why.

Yes. There is a need to harmonise settlement cycles.

The key arguments for the harmonisation of settlement cycles have been set out in the documents of the HSC WG, which are attached in annex to this report.

Q51: In what markets do you see the most urgent need for harmonisation? Please explain giving concrete examples.

We believe that the most urgent need for harmonisation relates to markets for equities and equity-like products, as differing settlement cycles cause specific problems for corporate action processing. However, we do see harmonisation of settlement cycles as having generic benefits, and we do believe that there is no high level reason to exclude any class of securities from the harmonisation effort. The harmonisation of settlement cycles across different classes of securities has benefits to end investors, as they would not suffer any financing costs that may arise in transferring positions from one class to another.

Q52: What should be the length of a harmonised period? Please explain your reasoning.

We support the proposal to move to T+2 as the standard settlement cycle, and we do endorse the reasoning given in the paper with respect to the possibilities for transactions to settle using a shorter period.

We would, however, add that we believe that the other theoretical option, namely T+1 as the standard settlement cycle, is not a realistic option.

In this respect, we would refer to the HSC WG paper attached in annex, and entitled “Harmonisation of Settlement cycles: Reasons why T+1 was not considered as a valid option”.

Q53: What types of trading venues should be covered by a harmonisation? Please explain the reasoning.

We believe that as a general principle the effort of harmonisation should cover all standard cash trading and should cover all equity and debt securities. All like activity should follow the same settlement cycles regardless of the source location of the trade. Cycles which are less than the official cycle should be allowed.

However, it is accepted that there may be circumstances in which transactions or groups of transactions in product types, investor categories or due to the nature of the transaction may intentionally not follow the normal cycle (either shorter or longer than the norm) and these should not be prohibited by legislation.

Q54: What types of transactions should be covered by a harmonisation? Please explain your reasoning.

Harmonisation should cover standard cash trading.

It should not cover securities financing transactions, including repos, collateral movements and securities lending.

The rationale is that the underlying nature of the activity is different. The arguments for harmonisation of settlement cycles for standard cash trading very largely do not apply for securities financing.

Harmonisation of settlement cycles should not cover subscriptions and redemptions of investment funds.

Q55: What would be an appropriate time span for markets to adapt to a change? Please explain.

We would believe that it is important for there to be the earliest possible confirmation of an intention to impose T+2, and the earliest possible communication of a specific deadline for implementation.

We believe that it is important for market participants to be aware of the deadline for implementation so that they can plan accordingly. We believe that some categories of market participants may need to make significant preparations, including significant investments, in order to be ready for T+2.

We endorse the reasoning that implementation needs to be achieved by the time of T2S going live (September 2014). We believe that there may well be advantages if implementation takes place before the start of the testing period for T2S.

Accordingly, we suggest a deadline for implementation of the fourth quarter of 2013.

It is, of course, the case that detailed project plans will have to be set up. However, at this stage in the process, we take the view that the migration to a harmonised T+2 settlement cycle should take place in the form of a small number of waves, in fairly close succession, and within each wave several markets migrating at the same time.

(iv) Perspectives on Further Work

The Harmonisation of Settlement Cycles Working Group sees its role drawing to a close with this report and submission.

However, we foresee a need for further work, once there is clarity on the future legislative proposals of the European Commission.

In the event that there is a firm legislative intention to move to a harmonised settlement cycle of T+2 we would like to highlight the following suggestions as topics for further work :

- (a) Development of an operational model for equity markets in Europe in order to document the front to back process flow, and to help identify and develop best practice
- (b) Establishment, and endorsement by relevant industry associations, of a document setting out Market Standards for the trade verification/ trade affirmation process
- (c) Development of a set of proposals for a harmonised set of market discipline tools in Europe.

We believe that it would be helpful if in due course the European Commission expresses its views as to how this work could best fit into the legislative process.

Annexes :

- (i) ECSDA document entitled “CSD Statistical Exercise”
- (ii) Report from HSC WG Sub Group 4 entitled “Principles for the maximisation of settlement efficiency”
- (iii) HSC WG paper entitled “Harmonisation of Settlement Cycles : Reasons why T+1 was not considered as a valid option”
- (iv) HSC WG paper entitled “The role of settlement cycles in corporate action processing”
- (v) HSC WG paper entitled “The case for harmonising settlement cycles”